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Robert G. Elliott's Financial News

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How Inflation Affects Bonds

While a little inflation is healthy for the economy, inflation has a direct impact on all of us in some way. For investors, the degree of impact varies, depending on their asset allocation. For example, the effects of inflation on stocks are often deemed negligible, since stock prices often rise in correlation with the price of goods and services. Inflation's effects on bonds, on the other hand, are more tangible.

When you purchase bonds, you're essentially lending money to either the government or a corporation with a promissory note in the form of a stipulated interest rate (coupon) and the maturity date when your principal will be returned. Because any given bond transaction occurs in today's dollars, there's always the likelihood that the principal you lend through purchasing bonds simply won't hold the same purchasing power by the bond's maturity date, particularly since many bonds have a 5-10-year life span, therefore increasing the probability of inflation. The relationship between inflation and bonds is an inverted one: the higher inflation rises, the less valuable bonds become.

When we consider a bond's cash flow from purchase to maturity the effects of inflation become a bit more complicated, particularly over the course of a bond's lifetime, its coupon and the current interest rates don't always align. While this can certainly work to your favor when interest rates are low, it can be problematic during times of inflation, when the Fed typically raises the interest rates in an attempt to slow inflation's pace. Remember: most bonds are similar to stocks in the sense that they're traded on the market. Even the slightest rise in interest rates affects their market price because they must now be traded at a discount lower than their face value. Therefore, in spite of the par value you've paid for the bond, it might sell for less or more than the value, depending on market interest rates. Bonds with a coupon lower than the current interest rate must sell at a discount to offset the interest rate hike.

If you own individual bonds, assuming you hold them to maturity, their par value is generally secure, except for the call or default risk. Likewise, your bond's interest payments will continue at the originally promised rate. Sell prior to maturity, however, and you'll incur the loss in face value. For this reason, many individual bond holders avoid selling; though, depending on inflation and interest rates at the time of your bond's maturity date, selling currently held bonds and purchasing new investments could provide better return in the long run.

Much of the impact of inflation on your individual bonds, too, depends on the term and even type of bond. Short-term bonds hold less risk when it comes to inflation for a few reasons: a) there's less chance of inflation within a shorter investment period; b) the rate at which inflation occurs is likely to be less; c) there's a greater chance you'll hold the bond to maturity. This comes at a price, since short-term bond coupons are typically much less attractive than those of long-term bonds. Your bond's exposure to inflation also depends on the category of bonds you invest in. TIPS bonds, for example, are designed to rise in value with inflation.

Any fluctuation in the economy, regardless of the direction, can affect bonds and stocks alike, albeit in different ways. The inherent risk even in an investment praised for its stability only serves to highlight the importance of portfolio diversification. To discuss the relationship between your investment plans and changing investment rates, please call.

(Allie, Bob, & Sarah)

A Note from Sarah

Wow, what a year! I feel like I've come so far since joining Wiley Bros.-Aintree Capital in July, 2018. I am so grateful for the warm welcome I have received from our clients, our associates, and our administrative staff. This past summer I enjoyed a fun time with my family and my puppy Sammy. I adopted her this past January and she has gotten much bigger than either I, or the Humane Society, expected when I brought her to my apartment in the Gulch. She initially weighed about 10 pounds and has grown to well over 60 pounds! We love to go on walks together and she gets to play with lots of her friends at the dog park. She is coming up on her first birthday December 1st and she is so excited! I am very thankful for a great first year working with everyone and looking forward to many more to come.

Bob's Personal Note

I do not know about you, but it seems that there are new ways of communicating because of technology that is changing the English language. New terms and/or words appear on a regular basis such that I feel like I need an urban dictionary to interpret some of the text messages I receive. Luckily for me, I have daughters who are well versed in the modern vocabulary and can act as my translators. Sarah is my oldest daughter and as many of you know she has been working as my business partner for the past year and a half. One of her favorite sayings is **YOLO** which translates to "**You Only Live Once**". Her younger sister, Tate, peppers her text messages with "**IDK**" when I ask her difficult questions such as "What time did you get home last night?" or "How are your grades this semester?" Many times I **LOL** when I hear her answers! (By the way, if you need assistance and your children or grandchildren are not available you can utilize: www.urbandictionary.com as a reference.)

Now that we are up to date on a few popular acronyms, there is another one you might not have heard about but might impact your financial future. Earlier this year, the House of Representatives passed a new bill called the **S**etting **E**very **C**ommunity **U**p for **R**etirement **E**nhancement Act, aka the **SECURE Act**. (Acronyms are kind of a thing in Congress.) As the name implies, the bill has important ramifications for people's retirement savings. In this letter, I want to give you a preview of what the bill is designed to do.

Now, before I do that, it's important to note that the SECURE Act must first be passed by the Senate and then signed by the president before it actually goes into effect. Many things in the bill could change before that happens, though, so it's impossible to know exactly what the final law will look like. And of course, it's always possible the Senate could choose *not* to pass the bill, or make so many changes that the House decides to rework their version.

That said, the SECURE Act enjoys bipartisan support. In fact, only three members of the House voted against it, with 417 members voting for.[1] So it's expected the Act will become law sometime soon. As your financial advisor, it's my job to get familiar with the bill now so I can help you prepare for the changes it will bring.

What is the SECURE Act? The SECURE Act does many things, but at its core, it's designed to help more Americans save for retirement. Many of the bill's provisions are designed specifically for businesses, which I won't get into in this letter. But there are also provisions that impact regular individuals, including pre-retirees, the recently retired, and even their children. None of these changes are particularly dramatic, but they are important nonetheless.

Changes to IRAs and 401(k)s [2] One of the changes the bill makes is lengthening the time people can contribute to their IRAs. Currently, retirees can only contribute to an IRA up to age 70½. Once they hit this milestone, they are required to begin making withdrawals, called **required minimum distributions**. Under the SECURE Act, that age would increase to 72. That means retirees have an additional 18 months to benefit from the tax advantages that come with IRAs.

Another change the bill makes is for new parents. Under current law, you must be 59½ years old to make withdrawals from a traditional IRA or 401k. If you withdraw money earlier than that, you would have to pay a penalty of 10% on the amount you took out. There *are* a few exceptions, such as if you need the money to pay large medical bills, buy a home, or manage a disability. But, generally speaking, the government wants the money you contribute to your retirement accounts to be saved for retirement.

Under the SECURE Act, new parents will also be able to withdraw funds penalty-free. This is to help cover birth and adoption expenses, and it's especially helpful for younger parents who have high deductible insurance plans. There is a $5,000 cap on withdrawals, though, and they would need to be made within one year of the birth or adoption.

Changes to inherited IRAs [2] **-** Another important change – especially from an estate planning perspective – regards inherited IRAs.

For years, one of the more popular estate planning strategies has involved the use of **Stretch IRAs**. When a parent or grandparent dies, they can leave their IRA to their children, grandchildren, or other heirs. Under current law, the beneficiary can take distributions from their inherited IRA based on their official life expectancy. This allows them to "stretch out" the value of the IRA – and the tax advantages that come with it – for a longer period of time. For example, if a 50-year old with a life expenctacy of 85 inherited her mother's IRA, she could stretch out her distributions over the next 35 years.

If the SECURE Act goes into law, this will no longer be possible. Instead, the beneficiary must take out 100% of the IRA's assets within 10 years of the original owner's death. As distributions are taxable income, this could have a major impact on the beneficiary's tax situation.

Planning ahead - As I mentioned, the SECURE Act has not yet become law, and it's uncertain when the Senate will vote on it. That said, it's important that we start planning ahead. If you have any questions about the SECURE Act, please let me know.

If any of the changes you just read about don't affect you, but could affect someone you know, please share this letter with them. Or, please let me know so I can reach out to them if and when the bill becomes law.

In the meantime, Sarah, Allie, and I will keep a close eye on Washington as this bill makes its way through Congress. As soon as the situation is clearer, I will pass along additional information.

1 "Congressional Leaders Want SECURE Act Passage in 2019," Plan Sponsor, October 7, 2019. https://www.plansponsor.com/congressional-leaders-want-secure-act-passage-2019/
2 "Text of H.R. 1994," Congress.gov, 6/3/2019. https://www.congress.gov/bill/116th-congress/house-bill/1994/text

Managing Bond Risks

All investments are subject to risk, although the types of risk can vary. While you can't totally eliminate risks, you can minimize them. For bonds, consider these strategies:

Interest rate risk – Interest rates and bond prices move in opposite directions. A bond's price will increase when interest rates fall and decrease when interest rates rise. This occurs because the existing bond's price must change to provide the same return as an equivalent, newly issued bond paying prevailing interest rates. The longer the bond's maturity, the greater the impact of interest rate changes. Also, the effects of interest rate changes tend to be less significant for bonds with higher-coupon interest rates.

To reduce this risk, consider holding the bond to maturity. This eliminates the impact of interest rate changes, since the total principal value will be paid at maturity. Thus, selecting a maturity date that coincides with your cash needs will help reduce interest rate risk. However, you may still receive an interest income stream that is lower than current rates. Selecting shorter maturities or using a bond ladder can also help with this risk.

Reinvestment risk – You typically know what interest income you will receive from a bond, but you must then take the periodic income and reinvest it, usually at varying interest rates. Your principal may also mature at a time when interest rates are low.

Staggering maturities over a period of time (laddering) can lessen reinvestment risk. Since the bonds in your ladder mature every year or so, you reinvest principal over a period of time instead of in one lump sum. You may also want to consider zero-coupon bonds, which sell at a deep discount from par value. The bond's interest rate is locked in at purchase, but no interest is paid until maturity. Thus, you don't have to deal with investment risk for interest payments, since you don't receive the interest until your principal matures.

Inflation risk – Since bonds typically pay a fixed amount of interest and principal, the purchasing power of those payments decrease due to inflation, which is a major risk for intermediate- and long-term bonds.

Investing in short-term bonds reduces inflation's impact, since you are frequently reinvesting at prevailing interest rates. You can also consider inflation-indexed securities issued by the US government, which pay a real rate of return above inflation.

Default and credit risk – Default risk is the possibility the issuer will not be able to pay the interest and/or principal. Credit risk is the risk the issuer's credit rating will be downgraded, which would probably decrease the bond's value.

To minimize this risk, consider purchasing US government bonds or bonds with investment-grade ratings. Continue to monitor the credit rating of any bonds purchased.

Call risk – Call provisions allow bond issuers to replace high-coupon bonds with lower-coupon bonds when interest rates decrease. Since call provisions are generally only exercised when interest rates decrease, you are forced to reinvest principal at lower interest rates.

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Municipal Bonds

We offer the following bonds subject to prior sale or change in price as of November 1, 2019.

Ref No	Issuer	Maturity Date	Coupon	Yield to Maturity	Yield to Call	Call Date	Rating	Price
1	Lawrenceburg TN	06/01/44	2.625	2.800	2.800	06/01/27	AA/A+	96.904
2	Memphis TN Wtr Revenue	12/01/37	3.000	2.756	2.525	12/01/27	Aa1/AAA	103.448
3	Germantown TN	08/01/47	4.000	3.350	2.340	08/01/27	Aaa/AAA	111.685
4	Tennessee ST Txbl-Ref-Ser	08/01/31	2.666	2.390	2.214	08/01/26	Aaa/AAA	102.813
5	Tennessee HSG DEV AGY	01/01/27	2.900	2.043	2.043	N/A	Aa1/AA+	105.676

Callable at 100% beginning of the call date above and every call date thereafter with 30 days notice.

In addition to the bonds listed, we have several other corporate bonds available. If you are looking for a specific bond or maturity, please feel free to contact me with your requests.

We are also interested in buying corporate bonds. If you have bonds for sale, please call me for a bid and details on how you can convert your present bonds to cash or alternative investments.

Finally, new bonds are coming to market every day. If you give me a call, I will be more than happy to go over current market offerings and conditions with you.

Although the information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate. All put/call information may not be displayed and Wiley Bros.-Aintree Capital assumes no responsibility for such undisclosed features or omissions. All are subject to market conditions and/or prior sale.

Bond Risks...

(Continued from Page 3)

US government securities do not have call provisions, while most corporate and municipal bonds do. Review the call provisions before purchase to select those most favorable to you.

Keep in mind the assumption of risk is generally rewarded with higher return potential. One of the safest bond strategies is to only purchase three-month Treasury bills, but this typically results in the lowest return. To increase your return, decide which risks you are comfortable assuming and implement a corresponding bond strategy. Please call if you'd like help with your bond investing strategy.

A Note from Allie

My husband, Jack, and I recently visited Spring Creek, North Carolina for a family reunion. After winding through the Pisgah National Forest, we arrived at our cabin in a three-mile valley surrounded by the beautiful Smoky Mountains. Our golden retriever, Nola, really enjoyed the leash-less freedom of country life. So much so, she ran and jumped into an algae-covered pond and came out dyed completely green head to toe, with a giant smile on her face. We gave her a quick rinse in the creek, and she was good as new again. After spending time fishing and hiking with family, it was time to put Nola's leash back on and return to the city life …. although it was a very nice break!

On the drive back, we discussed our many plans for the fast approaching holidays. Hard to believe it's already getting to be that time of the year! I hope everyone is able to take a break, and enjoy a wonderful, stress-free holiday season! Please let us know if we can be of any assistance as we wrap up 2019!

Converting to a ROTH IRA

ROTH IRAs are a valuable retirement planning tool, as they offer a source of tax-free income after you retire. And since the federal government relaxed conversion rules in 2010, even high-income earners have been able to convert to ROTH IRAs. Despite some advantages, ROTH IRA conversions aren't right for everyone.

What is a ROTH IRA Conversion? In simplest terms, a ROTH conversion involves changing the tax treatment of your retirement savings. Generally, contributions to a traditional IRA are tax deductible in the year you make them (contributions may be allowed but not deductible if your income exceeds certain limits. The money you contribute grows over time; when you start making withdrawals in retirement, you pay taxes on the money you take out.

Contributions to ROTH IRAs, on the other hand, aren't tax deductible in the year they are made. But earnings grow tax free; when you withdraw the money, you don't pay any federal income taxes. A ROTH IRA conversion involves taking funds from a traditional IRA, paying tax on any previously untaxed funds, and then putting the funds in a ROTH IRA so that you can have tax-free income in retirement.

Pros of ROTH Conversions For anyone who suspects they may be in a higher tax bracket in retirement, converting to a ROTH IRA may be appealing. ROTH IRA conversions may also be a smart move if the value of your IRA has recently dropped, because you'll pay less tax on the conversion, or if you have other deductions or credits you can claim to help offset the tax on the converted amount. If you're young and in a relatively low tax bracket, ROTH IRAs are also advantageous since you won't get much of a tax break from current deductible contributions and your taxes are likely to be higher in the future.

People who have significant assets may also use ROTH IRA conversions as an estate-planning tool. If your other assets will be sufficient for your retirement income needs and you don't anticipate a need to make withdrawals from your ROTH IRA during your lifetime, you may want to use it as a way to leave tax-free income to your heirs. Since there are no required minimum distributions form a ROTH IRA, the money can grow undisturbed during your lifetime, plus the distributions to your heirs should be free of income tax.

Cons of ROTH Conversions When is it not a good idea to convert to a ROTH IRA? If the steep tax bill for converting makes you squirm, a ROTH Conversion may not be fore you. After all, if you're in the 32% tax bracket and convert a $100,000 IRA, you'll owe $32,000 in taxes. Plus, most expects recommend using cash outside the plan to pay the tax on conversion to avoid depleting your retirement savings. Paying the taxes with cash is especially critical if you are under age 59 ½ because if you use money from your IRA to pay the tax, you'll owe a 10% penalty on the amount not rolled over into the ROTH IRA. Likewise, if you plan on spending the ROTH IRA funds early on in retirement (within five years of the conversion), you may not have enough time for earnings in the ROTH IRA to make up for taxes paid on the conversion.

ROTH IRA conversions are complicated. If you're considering converting, don't attempt to go it alone. The tax- and estate-planning consequences of a ROTH IRA conversion can be significant, so please call if you'd like to discuss this in more detail.

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