Positioning your investment portfolio for 2025: Year-end investment strategies – Nov. 4, 2024

David: Welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we're discussing 2024 year-end strategies to help investors set themselves up for 2025 and beyond with our Director of Portfolio Management (West Region), Tim Michel. Welcome to the podcast, Tim.

Tim Michel: Hello, David. Thank you.

David: Well, thanks for joining us today. This is a great topic to be talking about as we're entering into the final quarter here and trying to get portfolios squared away for the balance of 2024 and really set up for 2025. As we're thinking about the portfolios right now, how are you approaching year-end inside portfolios and what are you thinking about, Tim?

Tim: It's really a thought pattern to review everything. As we get to year-end, we're meeting with clients, prospects, and the first thing that we ask them is, "Has your risk tolerance, your risk profile changed?" And what typically happens, or often happens, is that as an investor ages, they wish to reduce the risk profile within their portfolio.

We've had a good run in the market, as we take a look at the macro events that have happened over the past several months, we're seeing the Fed (Federal Reserve) normalizing interest rates. Scott Colbert (Chief Economist and Director of Fixed Income Management for Commerce Trust) has mentioned this in previous podcasts, but it's simply the Fed is lowering interest rates because they have been able to bring down the rate of inflation.

As that's occurred, we're seeing a broadening within the stock market, and so the Magnificent Seven that has been driving much of the performance throughout the course of the past few years, not that they have stopped going up, but we're seeing mid-cap companies starting to perform better, so this broadening of the stock market has been occurring over the past few months.

David: I think that's a great point, Tim, that over time as we look at portfolios, especially with the solid market returns that we've gotten out of U.S. equities over the past couple of years, people's allocations have shifted. So, it's a good opportunity as you close out any one given year, but specifically two years of solid market returns, to be able to review the overall asset allocation, make sure it lines up with your risk tolerance, and that you have a conversation around what goals and circumstances are going to govern that choice of what level of stocks, bonds, and cash you should have in the portfolio.

I do think this idea of having a little bit more of a focus on assessing the current marketplace, whether that be the equity market that's had this great run or the fixed income markets. As we look at fixed income today, a bond portfolio is able to yield considerably more than it was four or five years ago. The Fed has started on the path of lowering interest rates, in September they cut rates by a half percent.

And as they go on this path, the yields that we've enjoyed out of our cash funds or short-term treasuries are going away and now might be the time to examine the possibility of getting a little more durable yield inside a portfolio by buying a little bit longer dated fixed income security, or bonds, inside of a portfolio.

As we think about that rebalancing, Tim, what are the factors that you consider inside any portfolio rebalancing?

Tim: Periodic rebalancing of the portfolio not only realigns the allocation back to its original target, but also presents additional investment opportunities as you just alluded.

David: As we think about that rebalancing, I think that can pair nicely with year-end tax strategies or year-end strategies to be able to minimize taxes inside of a portfolio. So, as we embark on rebalancing, typically that's going to be moving from equities towards fixed income, especially after the strong run we've had over the past couple of years. How can we most effectively do this without triggering massive capital gains?

Tim: Investors may be able to reduce the impact of rebalancing their portfolios through tax-loss harvesting. And this strategy uses capital losses from the sale of a position to reduce any taxable capital gains while reinvesting in other investment vehicles with similar characteristics. And it's as simple as looking for losses at the end of the year to offset gains that have occurred throughout the last one-, two-, or three-year time periods.

An additional thing that our portfolio managers do at Commerce Trust is take a look at individual tax lots. And so, as a portfolio grows over time, they've purchased ABC company at $15 a share, at $25 a share, and at 50 (dollars per share). And as we get to year-end here, if the stock is selling at 40, we can sell that third tax lots to recognize some losses to offset gains that may have occurred within the portfolio.

David: That's a great point, Tim, that especially after we've had a nice run, as you mentioned, up over 60% since the end of 2022, there could be multiple times that we've purchased a security and that all of them are at different levels of cost and there could present an opportunity for us to do some tax-loss harvesting.

To revisit again another tax strategy out there, as we're thinking about moving out of cash towards some longer dated fixed income, how are we approaching that question as to what sort of fixed income we should be buying?

Tim: It comes down to an investor's tax bracket. And at (a) certain tax bracket, as you get into those higher tax brackets, tax-exempt fixed income is the preferred method. Our analysts do a great job of evaluating the credit quality of the municipalities that we purchase and locking in a rate which may be lower than the taxable equivalent, but when taxes are encapsulated within that decision, oftentimes it's appropriate to purchase those tax-exempt securities.

David: That's a great point that through 2023 and 2024, as we've enjoyed those higher yields off of our cash, or short-term treasury positions, that often came to you as fully federally taxable. Whereas you have an opportunity to transition to a tax-exempt security on that durable yield or on that longer duration, or that longer dated bond out there, that could help shape your overall tax picture for 2025 as we're looking into the new year.

The other big thing that can drive great tax outcomes is evaluating that decision about where to take distributions. So especially people that are in retirement typically have multiple pools that they can draw that from, both at taxable account, as well as their traditional and possibly a Roth IRA (individual retirement account) out there. Tim, how are you thinking about how people should be crafting their decision around where they should be taking their distributions?

Tim: Investors who own retirement accounts, whether it be a traditional IRA, or an employee-provided defined contribution account, those individuals must start taking withdrawals in the year that they turned 73 to avoid (excise) taxes on undistributed amounts, so that's something that has to happen. There is something unique about 2024 for those individuals that have Roth IRAs. For 2024 and following years RMDs (required minimum distributions) are no longer required on those Roth IRAs, so that can be very beneficial in helping clients from a tax standpoint.

David: Not only is it the assets inside of the portfolio that can help drive tax efficiency and lead to clients or investors holding onto more of their funds by paying less in taxes, but also evaluating the decisions about where to take those distributions. Oftentimes our financial planners in our financial advisory services unit can help illustrate that decision for our clients.

Tim: One of the first things that is important to look at is the gift tax exemption limit, and for 2024, individuals can give $18,000 to a child, a grandchild, anybody else that they may want to gift to, and a couple, a married couple can gift up to $36,000. So that's one area that's advantageous to those individuals.

Also, donating appreciated securities or a stock that's become overweight within a portfolio (to a qualified charitable organization) allows investors to reduce the concentration and not have to incur the capital gains tax that would be incurred if they held it, sold it, and then gifted the money.

One thing that's also important for many individuals is taking advantage of a donor advised fund where they can gift multiple securities to build out their own fund for gifting.

David: That's a very important reminder for us that as you're considering your philanthropy, there are many different vehicles out there for people to be able to maximize some tax efficiency. Whether that's a donor advised fund, typically that's going to be for larger gifts that you're consolidating multiple years into giving, or whether that be direct donation of appreciated securities, so you don't have to pay the capital gains on those securities to a particular charitable organization. Or many other strategies out there. You mentioned earlier the gift tax limit for 2024. As we think about other, what I would call more estate planning strategies out there, anything else people should be thinking about?

Tim: That's a great point, David. Remember, some of the provisions of the Tax Cut(s) and Jobs Act are scheduled to sunset December 31, 2025. At this point, it's uncertain whether some of these provisions will be extended, so it's important to work with your wealth management team now on a strategy to maximize tax efficiency.

David: Totally agree, that it's a very much of a coordinated approach as we see that sunset not too far away, about five quarters away from us right now at the end of 2025, as you mentioned, I think it can be very effective. To start the conversation to visit our website, commercetrustcompany.com and go to the estate planning section, which offers you insights into the different vehicles.

Tim, thanks for the interesting discussion today. For more information on this topic, please download our companion piece at www.commercetrustcompany.com. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcast, Spotify, Amazon Music, or wherever you get your podcast from.

Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

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