



OSBORNE PARTNERS

Capital Management, LLC

Quarterly Wealth Report

January 2023, Issue 90

HAPPY

NEW YEAR

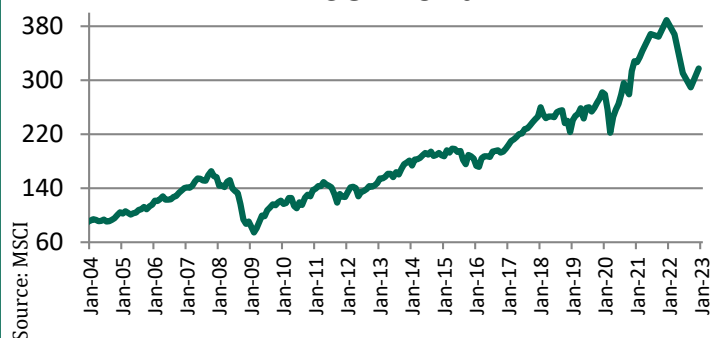
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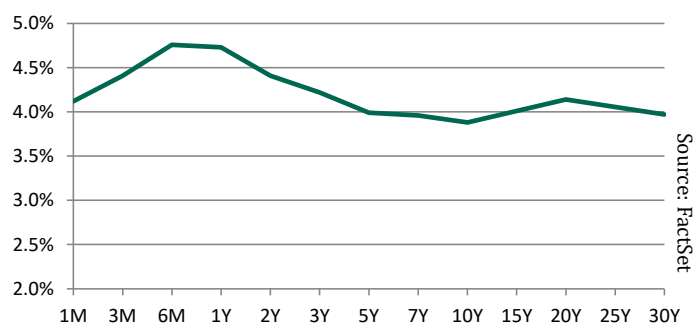
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MSCI World

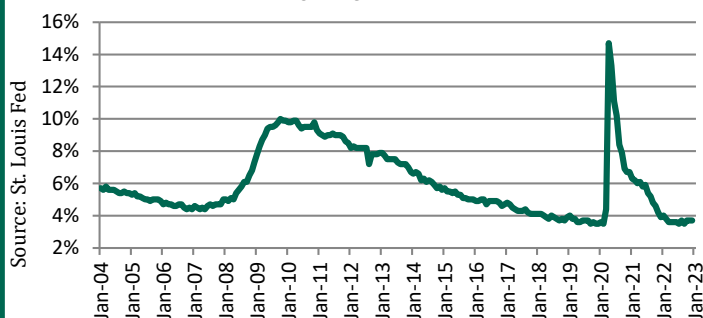


Treasury Yield Curve

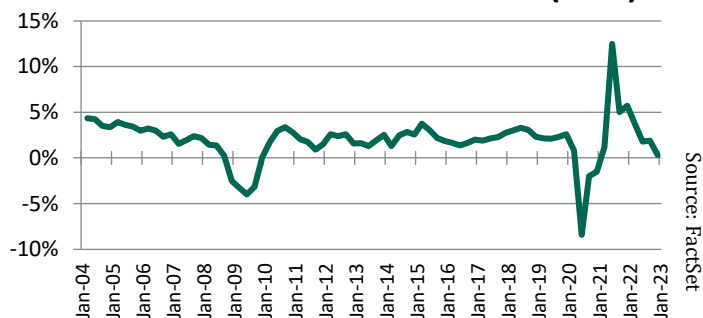


Global equities began to rebound from the bear market of 2022, while the yield curve warns of a potential recession.

Unemployment Rate



Real Gross Domestic Product (GDP)



Although unemployment is low, economic growth is turning negative.

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Known Unknowns

By: Justin W. McNichols, CFA

There are known knowns; there are things we know we know. We also know there are known unknowns...

"There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."

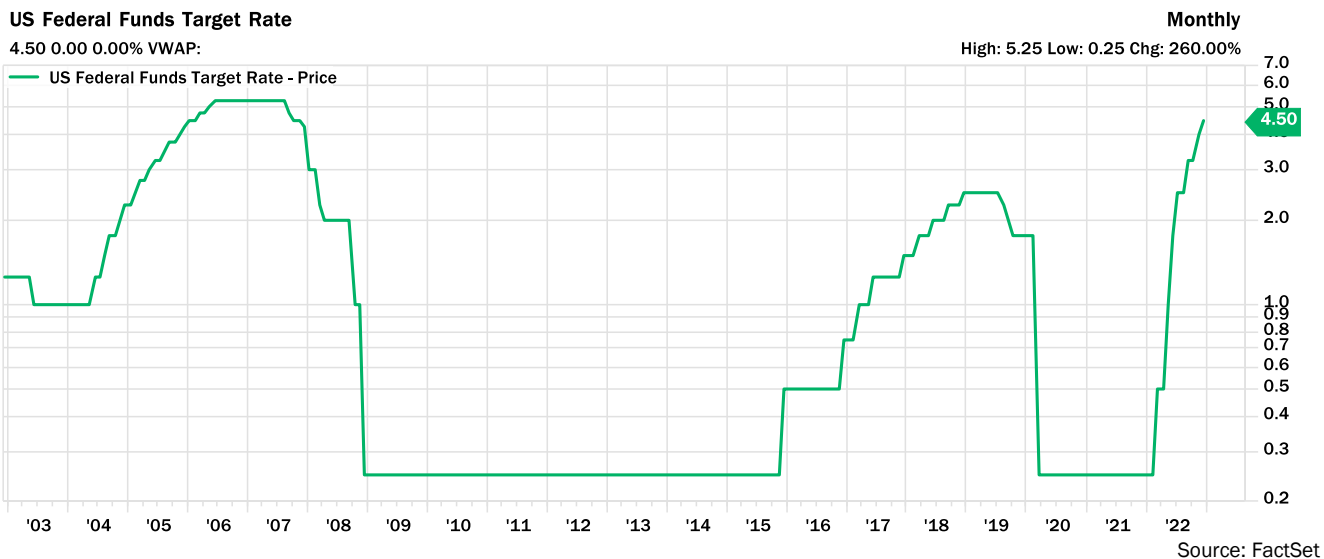
This quote is from a former U.S. Secretary of Defense in 2002 who was discussing intelligence regarding a potential military conflict. The framework of existing facts (known knowns), known events with unknown variables and outcomes (known unknowns) and completely unknown risks (unknown unknowns) is as applicable to investing as it is to foreign policy. In managing your portfolio at Osborne Partners, we are constantly trying to balance the various known and unknown risk factors, constantly incorporating and refining them when building the risk-to-reward estimates for our investments. For known unknowns such as earnings revisions or the risk of a recession, we utilize internal research and historical precedent to inform our estimates about the severity and probability of the risk. Risks from unknown unknowns is ameliorated by our multi-asset class investment discipline as evidenced last year with the Natural Resources and Alternatives asset classes posting positive returns during a bear market for nearly every other asset class.

Last year was one of the worst years in history for most asset classes, fraught with numerous known unknowns and unknown unknowns that confounded and punished markets. Known unknowns that dominated the market were questions such as: when would China reopen their economy?, how high would the Fed raise short-term interest rates?, when would inflation peak?, how low would equity valuation multiples fall?, and how far would equity earnings drop? These questions whipsawed the markets as estimates about the unknown part of the risks changed on a seemingly weekly basis, moving the markets up and down in unusually rapid fashion. The Russia/Ukraine war represented the largest unknown unknown to shock the markets. The conflict quickly evolved into a known unknown with potentially catastrophic consequences as fears that the war would escalate into a broader conflict peaked during the summer. All of these major risks surfaced and evolved in 2022, resulting in most asset classes experiencing serious price and valuation resets. As we enter 2023, investor sentiment is generally negative and fearful. However, an advantage entering 2023 is that the known unknowns of 2022 are now more well known with the risks and range of possible outcomes better understood.

Known Unknowns

In examining these previously “unknown unknowns,” today we have improved confidence that each are toward the tail-end of their unknown status. First, China is now actively opening their economy after being in some form of lockdown for the majority of the past three years. Second, the Russia/Ukraine war appears to be isolated, with a low probability of the war spreading to neighboring countries. Next, when analyzing the economic unknowns, they have largely morphed into “known knowns” as we enter 2023.

For the economic unknowns, the Federal Reserve increased the Fed Funds rate at a historically rapid pace, moving the rate from essentially zero to 4.50% in less than one year (20-year history shown below).



Although the Fed Funds rate increased to 4.50% from 0% in 2022, at the time of this writing, market implied probabilities indicate that the tightening cycle is likely near its end. Markets assign a 65% chance that the Fed Funds does not peak above 5.00%, and nearly 0% odds that the terminal rate reaches 5.50%. While at this time last year, it was nearly impossible to gauge where Fed Funds would peak, this previous unknown points to a terminal rate only about 0.50% above where it presently sits.

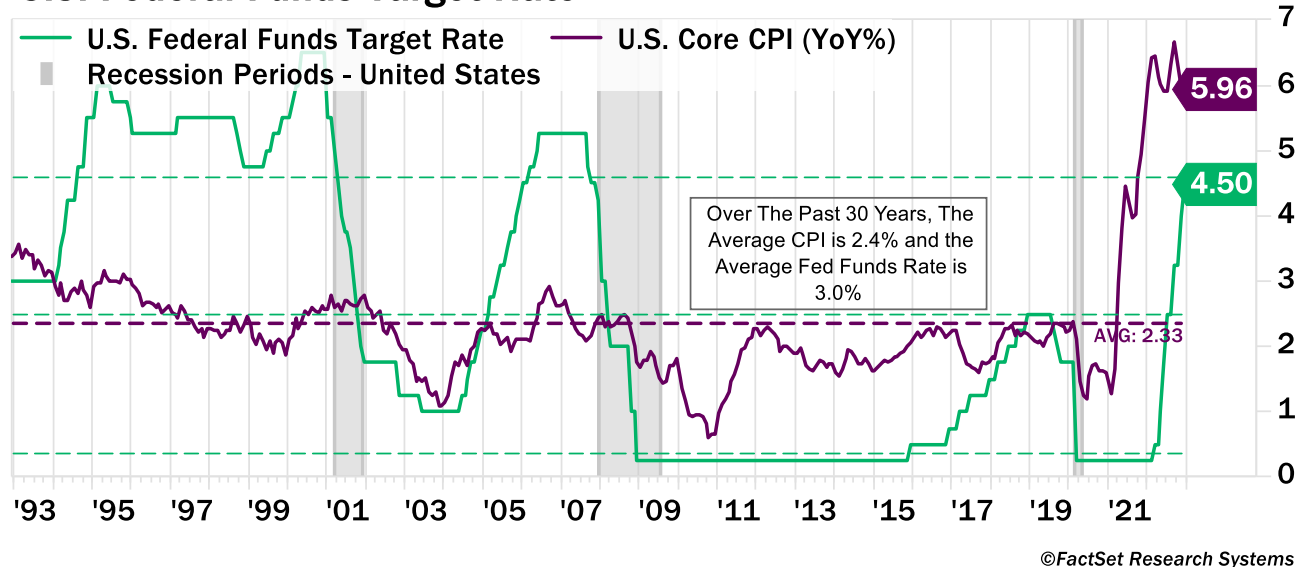
On the inflation front, after bottoming in February 2021 at 1.3%, core CPI began a torrid and relentless rise. By December 2021, core CPI had risen by over 4x to a multi-decade high of 5.5%. At the beginning of 2021, there was not a peak in sight and many prognosticators were calling for core CPI to rise above 8% with headline CPI potentially piercing double digits. Fears of a stubborn 1970's style stagflation cycle caused fear and confusion across asset classes. However, once headline CPI peaked in June at 9.1% and core peaked in September at 6.6%, it appeared inflation was starting to normalize. As seen below, the Fed raised interest rates (green) mainly in response to core CPI

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Known Unknowns

inflation launching (purple). As CPI continues to fall, the odds are high that the Fed Funds rate will follow in the future, resulting in another known unknown.

U.S. Federal Funds Target Rate



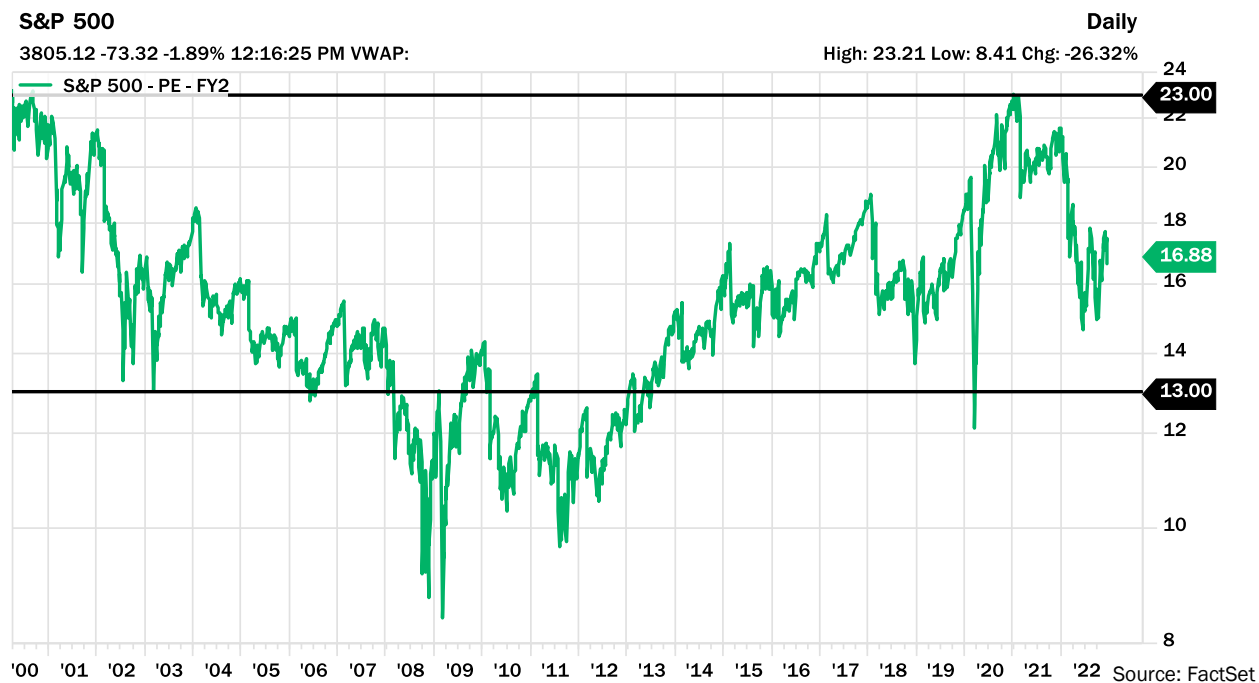
Turning to U.S. equities valuation, after falling to under 13x during the pandemic in 2020, the forward P/E multiple of the S&P 500 rose strongly for four straight quarters, even with earnings normalizing higher. By 2021, the S&P 500 forward P/E had reached the highest level since 2000 (see the following chart). According to our research, for the S&P 500 to achieve a 23x multiple, interest rates would have to be close to 0%. As soon as the Fed started tightening by raising interest rates, it was nearly impossible for the S&P 500 to trade at that multiple. The known unknown became – how far would the S&P 500 multiple have to fall to achieve a fair valuation? To hypothesize how low the multiple could sink, one would need to have an educated guess about interest rates and know the history of bear markets.

In January of 2022, when the Fed Funds was tethered at 0% and the 10-year U.S. Treasury was yielding 1.50%, attempting to pinpoint where interest rates would be toward the end of 2022 was nearly impossible. However, in analyzing the history of bear markets, the Investment Team knew a number of characteristics about all 14 bear markets since 1950. First, the forward P/E multiple has compressed by 32% on average. The only four instances when it compressed more than 32% were during the Global Financial Crisis, the Internet Bubble, the Nifty-Fifty bubble in the 1970s, and briefly during the Crash of 1987. In 2022, a 32% compression would result in a forward P/E multiple bludgeoning from 23x to under 16x. Additionally, the average trough in a bear market was in the 14.5-15.5x area with Osborne's proprietary interest-rate adjusted multiple bottoming at

Known Unknowns

14x. The result is all of these bear market statistics pointed to the P/E multiple bottoming just under 16x and 14x on an interest rate adjusted basis.

As the calendar turned to October, the 10-year U.S. Treasury hit a yield of 4.33%. At that level, and having confidence that inflation had peaked, you could have been confident in a solid risk-to-reward ratio at a P/E under 16x and 14x interest rate adjusted, matching bear market history. At the October lows for the S&P 500, the P/E multiple broke below 15x and 14x interest rate adjusted (shown below; now 16.8x).

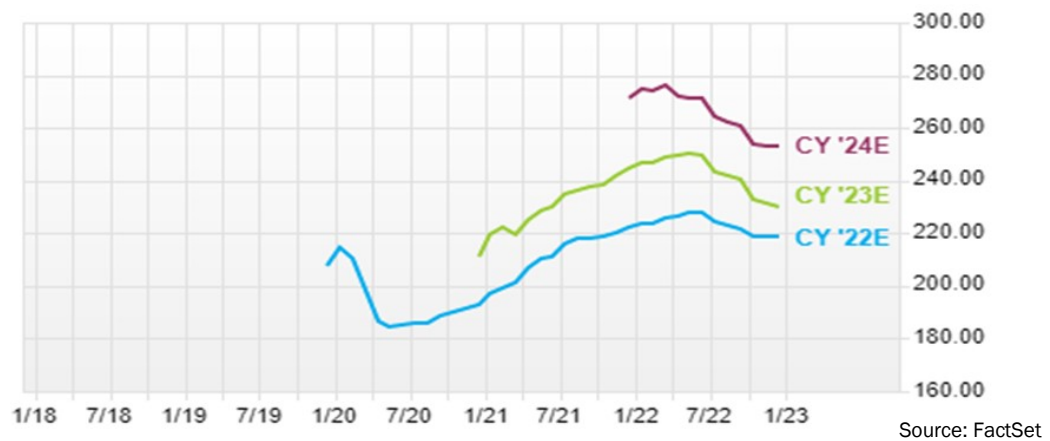


The final unknown from this year is the level of 2023 S&P 500 earnings, although this is gradually coming into focus. In the early summer, 2023 earnings estimates peaked at \$251 per share. However, since then, the impact of interest rate hikes filtered through the economy and began to negatively impact corporate earnings, with estimates falling and likely continuing to fall in early 2023 as fourth quarter earnings are released. The latest consensus estimate for 2023 S&P 500 earnings is now below \$230, with many strategists estimating they will fall further to \$200 (following chart).

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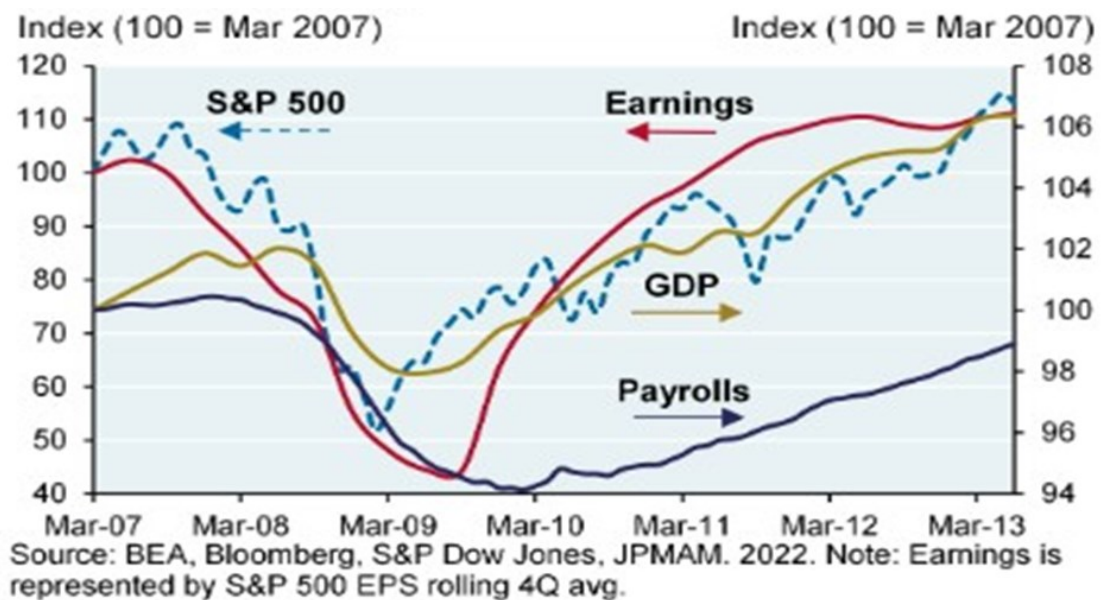
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S&P 500 ANNUAL EARNINGS ESTIMATES



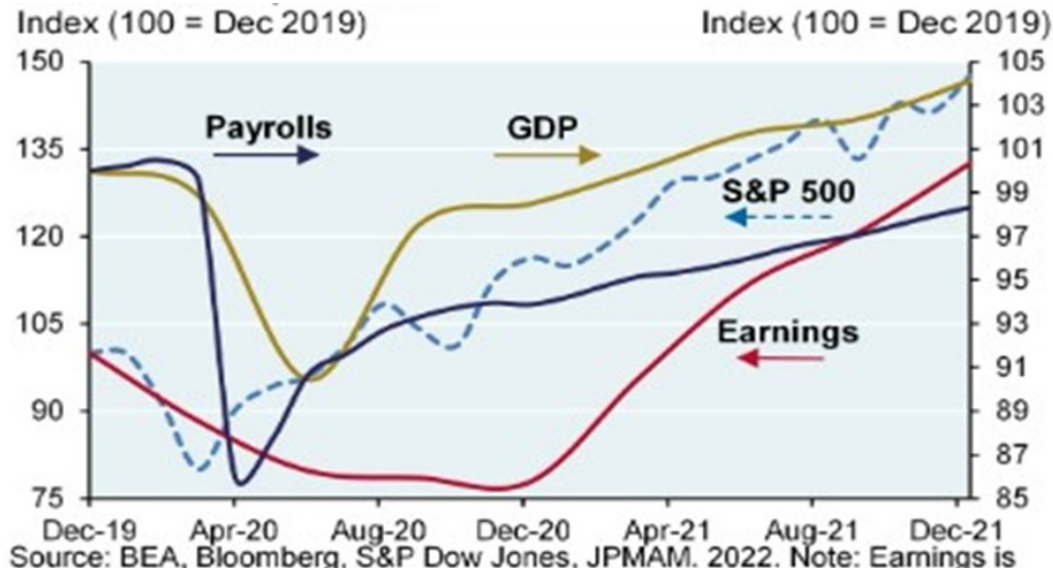
As explained in some of our recent Investment Team videos, we have long felt that investors would shift focus to the major known unknown of 2023, earnings growth, versus other unknowns as 2023 begins. This shift in focus has begun, however we believe the consensus could be making an assumption mistake by being overly pessimistic. We now regularly hear Wall Street strategists say: “If earnings are \$200 per share and the appropriate bear market P/E is 15x, then the S&P 500 should trade at 3,000” – nearly 15% below the October low. The math is appealingly simple and logical with this thesis becoming ubiquitous. While making for good CNBC headlines, we believe this theory is inaccurate. History shows that the forward P/E multiple (and markets) bottom before earnings. Examples from the two most major bear markets over the past 15 years are below.

Notice the S&P 500 (blue) bottomed in March 2009 while earnings did not bottom until six months later.



Known Unknowns

In 2020, the S&P 500 bottomed in March 2020, yet earnings did not bottom until eight months later.



In examining the bear market of 2022, based on our internal research and history, one could surmise that equities tend to bottom after 1) the P/E multiple bottoms, and 2) after approximately half of the negative earnings revision cycle is complete. If earnings estimates are set to fall from \$251 last summer to \$200, then somewhere in the \$215-\$225 area makes sense. This would indicate the dire (and common) calls for the S&P 500 to fall to 3,000 or below are too pessimistic.

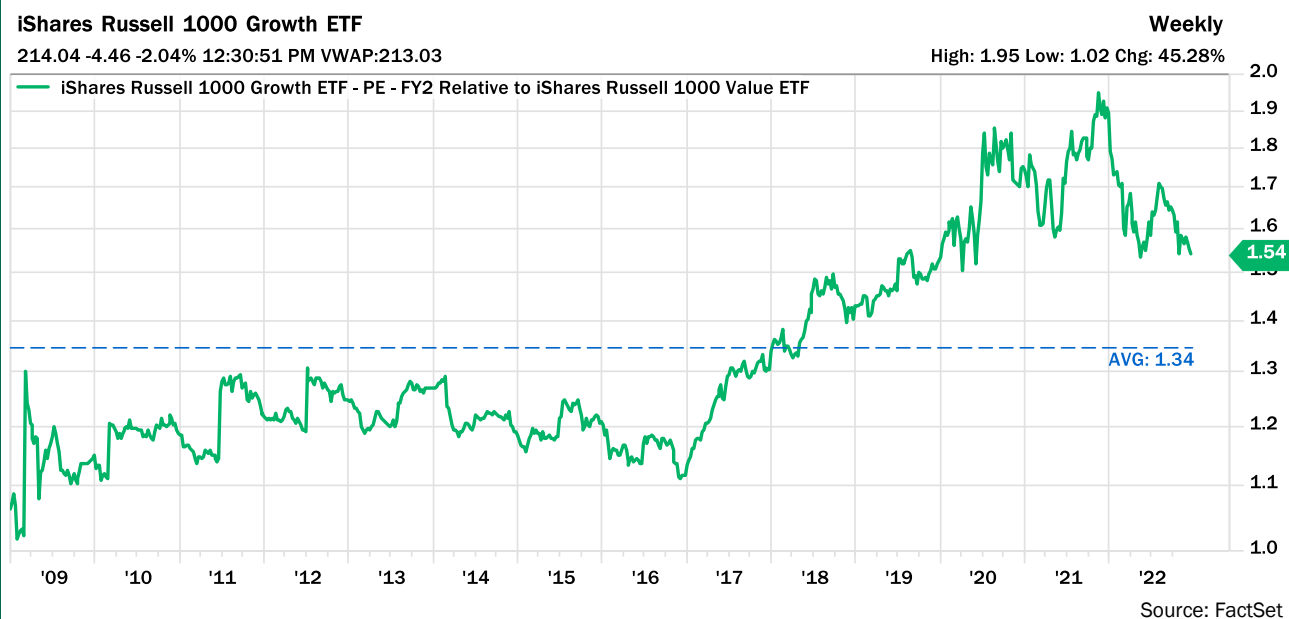
With all of these unknowns becoming more known recently, we also note a few extremes that could be tailwinds to different asset classes in 2023. First, after a strong move of over 25% in just over a year, the U.S. dollar reached a 20-year high (chart below). If a top is in place, a flat-to-down U.S. dollar could be a tailwind to the Foreign Equities asset class (see Jay Skaalen's piece in this Wealth Report).



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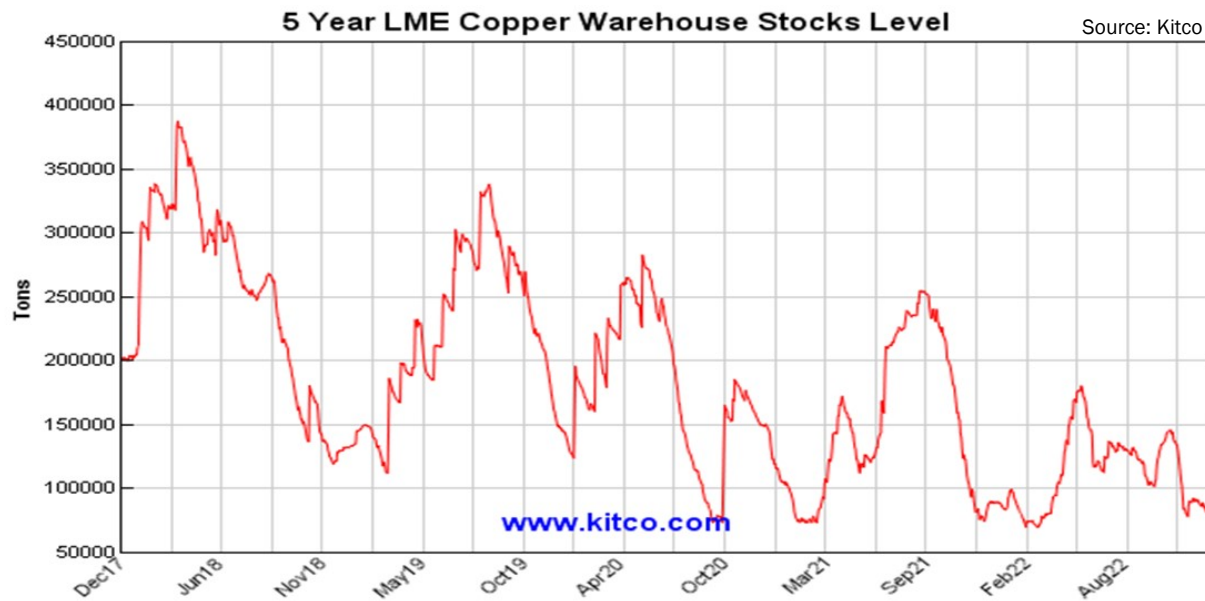
Next, in 2021 we warned about excessive valuations and overly bullish sentiment in growth stocks due to record low interest rates. Growth stocks have strongly underperformed since November 2021 as more value-oriented investments have performed well. However, growth stocks continue to trade at a meaningful premium to value stocks (following chart).



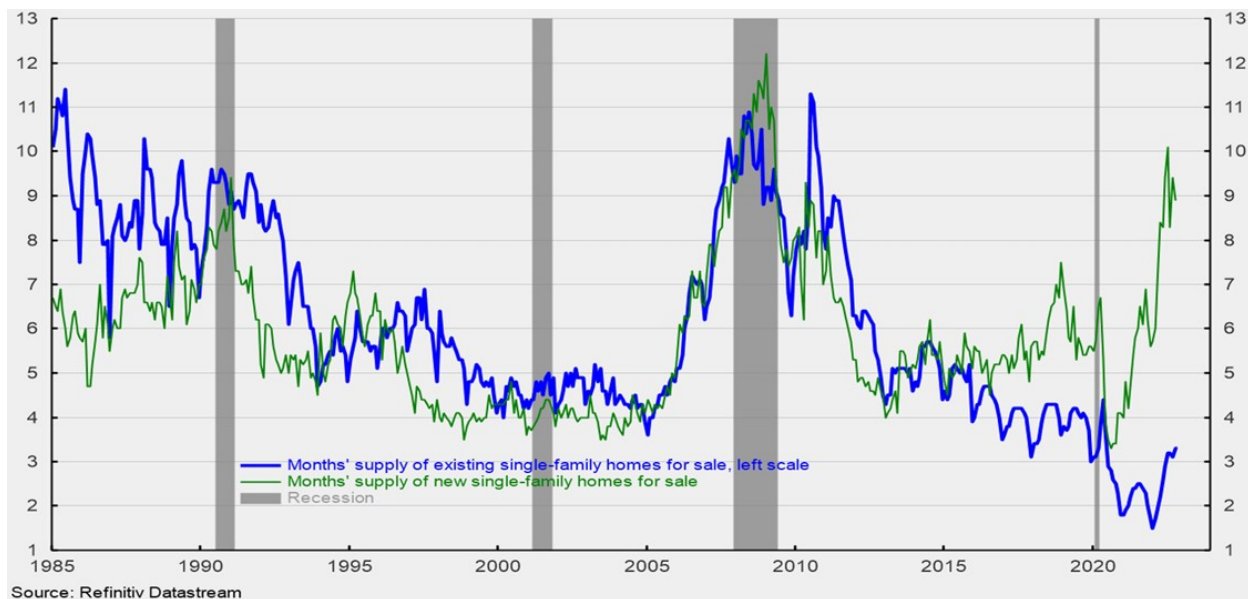
Growth focused managers and their investors have seen their portfolios destroyed over the past 15 months. In contrast, Osborne Partners' style-agnostic discipline has enabled us to purchase the strongest fundamental situations with the best reward-to-risk ratios, regardless of the investment's size or category.

In the Natural Resources asset class, although the asset class has performed extremely well over the past 18 months, and we reduced exposure earlier in the year when inflation was peaking, certain areas like industrial metals continue to sport strong fundamentals. We show the five-year inventory level of copper on the London Metals Exchange (LME). Inventories are anchored at the five-year low, which could be bullish for copper's already positive long-term secular fundamentals.

Known Unknowns



Finally, in the Real Estate asset class that is comprised of allocations to global REITs, commercial real estate companies, and residential real estate companies, the inventory situation is not worrisome, especially on the existing home side, despite our reduction in exposure to residential real estate last spring.



We believe 2023 will likely see a continuation of the elevated volatility experienced in 2022. However, as the unknowns become known, volatility will subside and a clearer path in which to make investment decisions will emerge. Along the way, our style-agnostic discipline will help us avoid being “trapped” in a style that is out of favor. Being style-agnostic has helped our portfolio avoid lengthy periods of underperformance due to the environment not being just right for a particular style. ■

Quarterly Wealth Report



Overlooked but Not Forgotten

By: Jay Skaalen, CFA, CFP®

Less conventional asset classes including Real Estate, Natural Resources and Alternatives helped insulate our portfolios in an incredibly challenging market environment last year.

By most measures, 2022 was a challenging year for financial markets. Scratch that... “challenging” doesn’t quite do it justice. Painstaking? Frustrating? Agonizing? We’ll let you choose your own adjective but suffice it to say the year was hard and left few places to hide as far as returns go. Want some numbers to back that up? For the S&P 500 Index, it was the fourth-worst calendar year performance since the index was reconstituted in 1957. Foreign Equities¹ managed to perform only modestly better than their U.S. counterparts, but still ended the year down 16%. For bonds, as measured by the Bloomberg U.S. Aggregate Bond Index, it was the worst year in history. Not surprisingly, this means that for a “diversified” 60/40² portfolio this past year marked the second worst annual returns since data has been tracked – second only to 2008. But it wasn’t all bad news. At Osborne Partners, we have long touted the virtues of having exposure to complementary asset classes like Real Estate, Natural Resources, and Alternatives – and within these asset classes there was some positive news to share. In this article, we’ll share some of these positive developments, reiterate why these smaller asset classes can have larger impacts on your portfolio, and offer a brief glimpse at what may be in store for these investments in 2023.

Let’s start by taking a look at Real Estate. Like many other “risk” asset classes, it was a difficult year overall. Returns were modestly worse than global equity markets as rising interest rates, inflation, and broader worries around the health of the global economy weighed on performance. Within U.S. and Global REITs (Real Estate Investment Trusts), more defensive parts of the market held up admirably (healthcare, lodging, timber) while some cyclical end markets saw more notable pressure (apartments, industrial, office). Within homebuilding, solid fundamentals met head-on with rapidly rising interest rates, resulting in a volatile year for the group. Companies involved in commercial real estate services saw similar dynamics, with investors doing their best to assess the impact of higher rates on a still-recovering commercial real estate market.

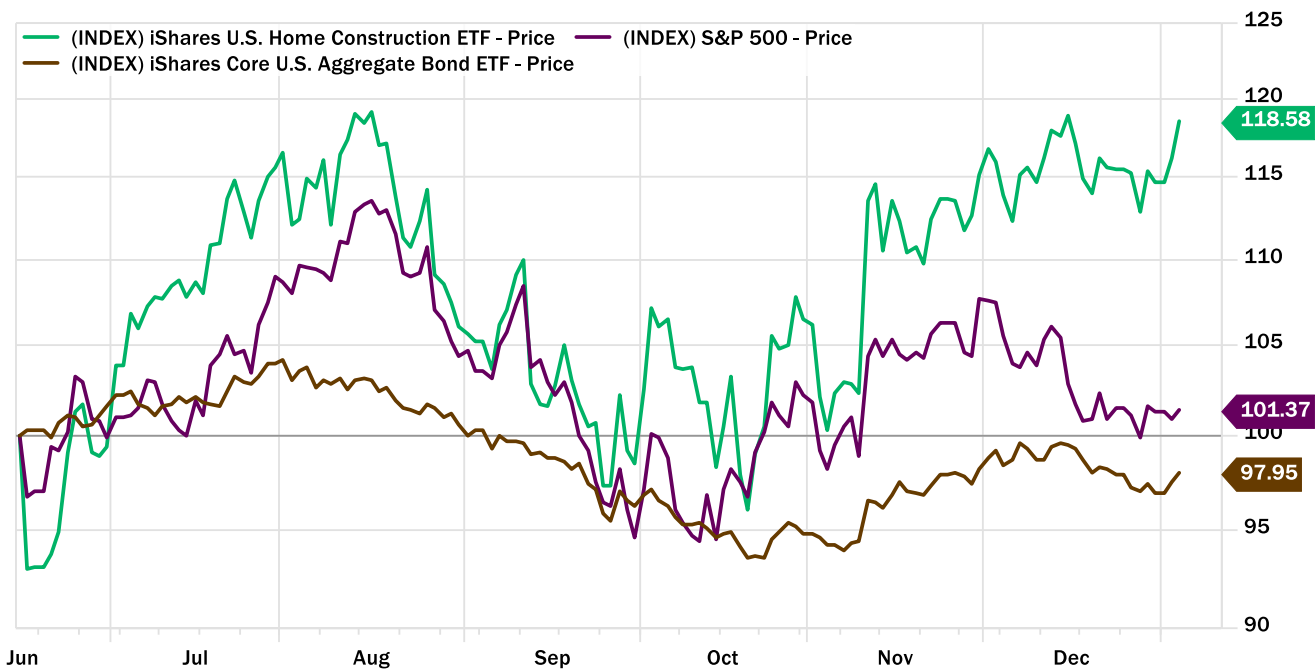
Despite the various headwinds, the Real Estate asset class still provided value to portfolios. How? First, our diversified REIT exposure helped with income generation driven by the roughly 4% yield these investments offer. Second, our skilled nursing facility exposure via Omega Healthcare³ (ticker: OHI), finished the year up nearly 4%, outpacing the benchmark by over 25%. Lastly, after being down sharply through the middle of June, our homebuilding exposure via Lennar Corporation (ticker: LEN) saw a notable inflection, rallying over 32% from its June bottom through year end. As

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far as 2023 goes, our team expects another volatile year for this asset class. As opposed to 2022, which saw a major valuation reset alongside more stable fundamentals – 2023 could bring more pressure to fundamentals. Although, importantly, valuations have already been recalibrated and interest rates should be less of a headwind. As such, after being net sellers of this asset class for the past year and a half, we are starting to see attractive opportunities emerge which could result in opportunistically increasing exposure.

iShares U.S. Home Construction ETF

Source: FactSet Daily

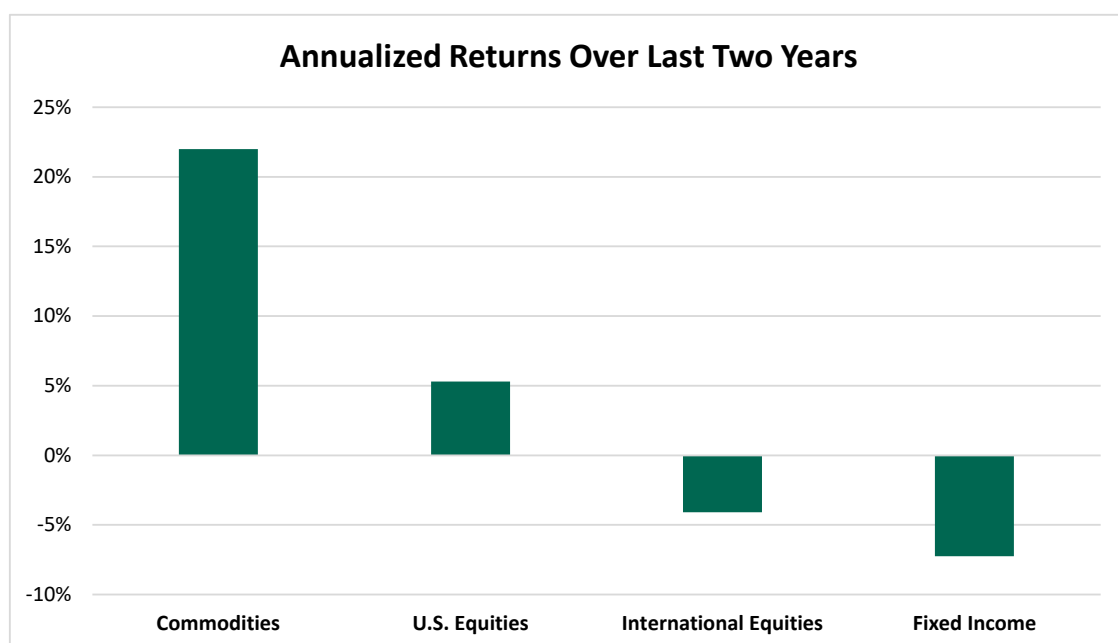


In prior years, our team has written about the importance of having exposure to asset classes with low correlations to the rest of your portfolio. If this sounds familiar, it is probably because this is one of the core tenets of diversification. For some, diversification simply means adding some bonds to a portfolio of stocks and stopping there. But in years like 2022 that saw multi-decade highs in inflation and one of the fastest Federal Reserve hiking cycles in history, this approach clearly falls short. This is why our Investment Team has stressed the importance of holding assets that perform well in a much wider variety of economic environments – including the one we saw last year. And there is no better example of this than Natural Resources. After being the worst performing asset class for much of the last decade, it has become the best performing asset class over the last two years, and the only asset class outside of cash and alternatives to record positive returns last year (the Bloomberg Commodity Index finished the year up 16.1%). After leaving the asset class for dead, many investment managers are just now waking up to the realization that Natural Resources

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deserves a role in portfolios. But surely after two stellar years, 2023 is poised to be a disaster for this asset class, right? Not so fast. In the wake of the COVID-19 outbreak, the initial surge in commodity prices was catalyzed by stimulus-fueled demand outpacing structurally constrained supply. This was largely true across the entire commodity complex – everything from grains to gasoline. This imbalance led to outsized appreciation in commodity prices and contributed to the inflation dynamics we are still grappling with today. But in more recent months, we have seen a moderation in demand across many commodities in conjunction with normalizing supply conditions. The result of this has been significant declines in most commodity prices since the highs we saw last summer. In 2023, many commodities need to see further demand destruction to balance the still off-balance supply-demand picture. As such, we think this asset class could once again play a valuable role in a truly diversified portfolio.



Source: Last two years ending 12/31/22. OPCM. Commodities: Bloomberg Commodity Index, U.S. Equities: S&P 500 Index, International Equities: MSCI All Country World Ex-US Index, Fixed Income: Bloomberg Aggregate Bond Index

Across all the asset classes we invest in, Alternatives will typically be the one that is least correlated with the rest of the portfolio. And while the asset class may be relatively small, its role in the portfolio is not, serving as a hedge against outsized moves in key variables like interest rates and the U.S. dollar, or providing niche exposure to assets like merger arbitrage, private equity and distressed securities. Our exposure to these hedging and niche baskets will vary over the economic cycle and, in general, will lean more heavily towards “niche” exposure very early through the middle phase of economic cycles, and will lean more heavily towards hedges from the middle through the

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late phase of the economic cycle. You may have noticed this dynamic starting to manifest in portfolios this year. Throughout the course of 2022, we exited our interest rate hedge, trimmed our U.S. dollar hedge – both of which were two of our best-performing positions – while also exiting our S&P 500 Index hedge. In total, our Alternatives finished the year in positive territory and accomplished its primary job – helping insulate the portfolio during a year that saw a constant barrage of headwinds. So, what's next? While increased exposure to portfolio hedges can be viewed as risk mitigation, it's possible that in 2023 a greater portion of this asset class will be comprised of pro-risk niche investments that attempt to take advantage of dislocation in asset prices. As usual, any changes we make won't happen overnight and will be driven by our team's time-tested discipline and process.

2022 was a great reminder of the significance of complementary asset classes like Real Estate, Natural Resources, and Alternatives in a diversified portfolio. Hedging against key variables, enhancing the income generation of portfolios and performing well in a high-inflation, high-interest rate environment are just a few of the many beneficial characteristics these asset classes possess. As our Investment Team looks ahead to 2023, we expect another active year within these asset classes, as well as across client portfolios, and we look forward to sharing our thoughts and commentary with you as we navigate what we expect will be another eventful year. As always, thank you for placing your trust in Osborne Partners – we look forward to engaging with each of you soon! ■

1 As measured by the MSCI All Country World Index Ex-U.S.

2 A 60/40 portfolio references a portfolio consisting of 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index

3 There are client portfolios which do not hold specific individual securities mentioned in this article.

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Credit Markets: 2022 Marks Worst Year for Bonds in History

By: Charles Else

Aggressive interest rate hikes led to unprecedented losses in the bond market.

Amidst continued aggressive monetary tightening by the Federal Reserve, the U.S. bond market notched its worst year on record in 2022. At the start of the year, the Federal Funds Target Rate Range stood at just 0-0.25%; by year-end, the range was 4.25-4.50%. Two fourth quarter hikes, combining for an additional 125 basis points of tightening, solidified the fastest and most aggressive year of interest rate policy moves since the early 1980s as the Fed remains laser-focused on taming inflation. Overall, the average U.S. bond fell over 13% with damage across all types of bond issues. U.S. Corporate bonds fared worst, losing nearly 16% for the year, while Municipal bonds fared best losing about 7.6%.

Announcing the most recent rate hike in mid-December, Fed Chair Powell noted a welcome reduction in the monthly pace of price increases in October and November but indicated the Fed will need to see substantially more evidence showing inflation is on a sustained downward path before halting rate hikes. The median expected “terminal rate” at which the Fed believes these hikes will end currently stands at a 5.1% Federal Funds rate.

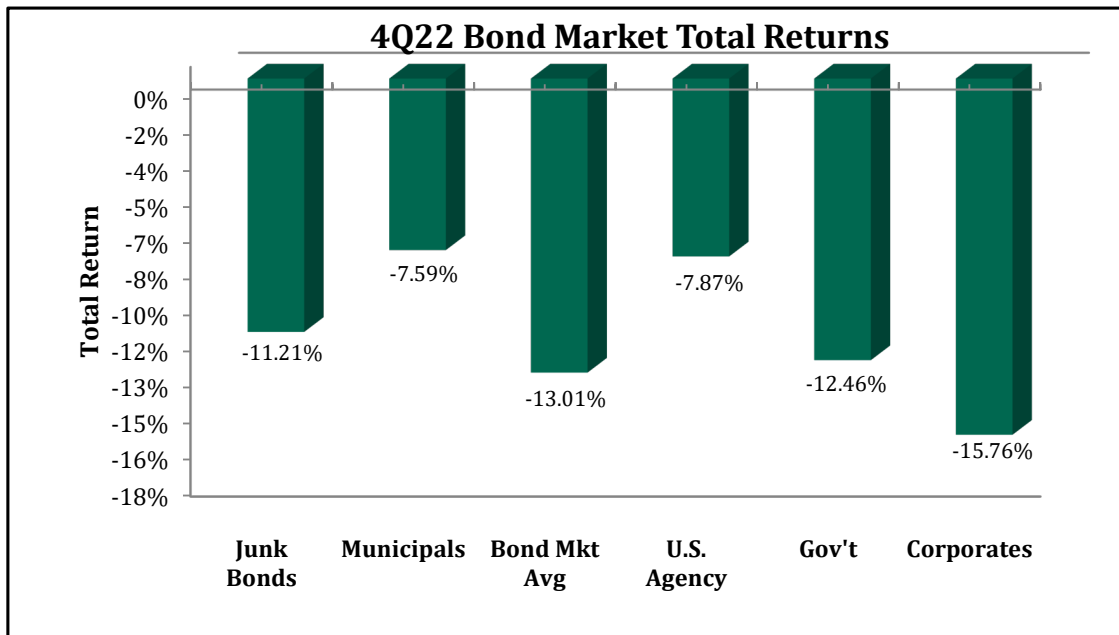
Historically, the yield on the 2-year U.S. Treasury has been a reasonable indicator of peaks and troughs in the Federal Funds rate. The 2-year rate most recently hit a high of 4.81% in early November and currently sits at 4.41% as of this writing. So, despite the fact policy members at the Fed are projecting at least a couple more rate hikes from here, markets seem to be less sure they’ll ultimately be that aggressive. Either way, 2022’s aggressive Fed policy has likely brought us close to the end of this tightening cycle and should allow the Fed to pause hiking rates soon. ■

Bond Market Yields 12/31/2022

Average Money Market Fund	0.34%	10 Yr. AAA Muni Bond	2.64%
5 Yr. AAA Muni Bond	2.56%	10 Yr. AA Corporate Bond—Long Term	4.72%
5 Yr. AA Corporate Bond—Intermediate	4.58%	10 Yr. U.S. Treasury	3.88%
		30 Yr. Fixed Rate Mortgage (Conforming)	6.66%

Source: Bankrate.com

Credit Markets: 2022 Marks Worst Year for Bonds in History



Making Smart Stock Moves in a Down Market

By: Daniel Haut, CFP®, CIMA®

Spotting the silver lining; Utilizing financial planning to lock in lower stock valuations during a bear market.

Arguably, 2022 will offer a future case-study that the old adage “buy low and sell high,” is the most appropriate *long-term* investment strategy. Sure, “buying low” in 2022 may have felt more like getting proverbially kicked in the teeth. To add insult to injury, the “selling high” part of this aphorism wasn’t exactly applicable last year as in previous years of tumult like 2020. As you may recall, in 2020, the pandemic bear market lasted all but one month (late February to late March). However, over the course of any long-term investment horizon, employing a disciplined strategy can enable investors to achieve this truism more often than not.

To be clear, “buying low and selling high,” doesn’t mean timing the *exact* top and bottom perfectly. If this was only so easy (I can feel reader’s eyes rolling, sarcastically). Rather, over a multiple year time horizon, it is possible to purchase securities at relatively inexpensive intrinsic price points with a disciplined strategy. As I will discuss in this article, making smart moves in a down market can be easily done in retirement and employee executive compensation plans.

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Making Smart Stock Moves in a Down Market

1. TAKE RMDs WITH STOCK VS. CASH

Paying taxes on IRA RMDs (Required Minimum Distributions) can be painful enough. However, paying taxes can feel doubly worse when doing so during a bear market. Further, if one has insufficient cash in their IRAs, selling distressed securities to raise cash for the RMD can lock in losses.

One strategy that many investors are unaware of is that they are able to take RMDs with stock instead of cash. During a down market, taking stock distribution as an RMD can serve many benefits.

First, you avoid locking in losses (e.g. selling stock during a poor market). Second, you can maintain your asset allocation (just in a different part of your portfolio). Third, you end up paying less tax per distributed share (e.g. same RMD divided by greater number of shares). Fourth, you lock in a greater number of shares for future market rebound at advantageous capital gains rates.

To illustrate the efficacy of this strategy, let's look at an example.

Jay McFagan is age 72 and is required to take out his \$100,000 RMD by 12/31 of the current year from his \$2,750,000 IRA.

Not only is Jay in the 37% tax bracket, but he has insufficient cash to take the RMD without selling securities. Doing so would lock in egregious market losses. While his IRA is diversified, he does have some concentrated employee stock in it as well. It just so happens that the employee stock is equivalent to the RMD amount. While the market is down 20%, his employee stock is down 30%.

For his pending RMD, Jay is trying to determine whether he should sell some of his securities to raise cash or distribute shares of distressed employee stock "in kind" to his outside living trust.

In order to demonstrate the potential benefits of this strategy, let's make a few simplifying assumptions. First, let's assume that Jay's life expectancy is age 95 (another 23 years). Second, the stock will produce an annualized 7% return until he passes away. Lastly, let's assume that Jay pays tax withholdings (federal/state) on his RMD with an outside account. To be clear, this strategy works best when taxes are paid from non-IRA assets.

Under scenario 1, Jay decides to leave the \$100,000 of old employee stock in the 401k and sell other securities to raise cash for that year's RMD. At age 95, the \$100,000 of employee stock not distributed (for that one year) is \$474,000 based on a 7% annualized return. Since the stock is still in the 401k, the "after-tax" value, based on a 37% federal tax rate (don't include state taxes), is \$298,653.

Making Smart Stock Moves in a Down Market

Under scenario 2, Jay decides to take \$100,000 in distressed employee stock as his RMD. Again, based on a 7% annualized return, the employee stock is now worth \$474,000 at age 95. Jay paid taxes on the initial RMD, so his cost basis is \$100,000. Assuming a capital gains rate of 20%, his taxes are \$74,800 ($\$374,000 \text{ gain} \times 20\%$) and his after-tax value is \$399,200.

It is theoretically possible for Jay to achieve something similar by liquidating the cheap stock in his IRA (no tax consequences) and rebuying it at the low in his trust. Wouldn't this offer the same benefits you may ask? In theory, yes. However, operationally, it will take some time to process both the sale in the IRA and RMD transfer into Jay's trust. In the meantime, the stock could've skyrocketed in value, which means you'd be buying in at an otherwise higher price than simply transferring the stock in kind. Remember, during bouts of volatility, being out of the market for even a couple of days can translate into a 5-10% move.

As you can see, by taking distressed company stock as his RMD for that one year, Jay's after tax amount is ~\$100,000 greater under scenario 2 due to tax arbitrage. Jay is freezing a greater number of shares (due to market drop) that will pay advantageous capital gains rates vs. ordinary income.

2. EXERCISE INCENTIVE STOCK OPTIONS (ISOS) UP TO AMT BREAK-EVEN

For employees who are granted ISOs (Incentive Stock Options), timing when to exercise them can be fraught with complexity. Not only do these options have an expiration window (10 years), but exercising ISOs can inadvertently expose the owner to AMT (Alternative Minimum Tax) – more on this later.

Fortunately, when equity markets are down, exercising ISOs can be a way to turn lemons into lemonade.

The benefits of exercising ISOs in a bear market are two-fold. First, with a reduced price per share, the owner can exercise more shares in a down market before paying the dreaded AMT. Second, the owner can start the capital gains clock, which is important if one has concentrated stock with a goal of selling and diversifying. In order for capital gains rates to apply (on sale), ISOs require the owner to hold employee stock for 2 years from grant and one year from exercise. By accelerating the clock, the owner not only exercises more shares without triggering AMT, but they quicken the process of concentration risk reduction.

Before we get into a scenario, it is important to review some basic mechanics of ISOs.

Quarterly Wealth Report

Making Smart Stock Moves in a Down Market

Both ISOs and NSOs (Non-qualified Stock Options), have what's called the "bargain element" attached to them. The "bargain element" is the difference between the exercise price (the price at which a share can be purchased) and fair market value (FMV) of the stock. When options are "in the money," the strike price is at a discount to the FMV of the stock and the owner is compelled to purchase. However, based on the "bargain element," options (ISOs and NSOs) have different tax implications when the owner exercises them.

With ISOs, (unlike with NSOs), the owner does not owe ordinary income tax on the "bargain element." However, when calculating whether AMT is owed, the owner does have to add back the profit (e.g. bargain element). In fact, not only is the "bargain element" of the ISO added back, but a whole host of deductions like property taxes, mortgage interest, medical expenses, etc. are also added back. After an AMT exemption is applied, the FAMTI (Final Alternative Minimum Taxable Income) is taxed at 26% to 28%. The FAMTI is compared with taxable income and the difference is owed.¹

The point: exercising too many ISOs can result in owing more money to the IRS in the form of AMT than one otherwise would. However, when stock prices drop, this serendipity allows owners of ISOs to take advantage of a higher "break-even AMT" threshold – exercising more options without paying the tax. Below is an example scenario.

Jocelynn Cheng is earning a \$250,000 salary. She is married, files jointly, and uses a standard deduction for tax purposes (doesn't itemize). Let's also assume that Jocelynn's company grants her 5,000 shares of ISOs every year that vest at 25% per year. Jocelynn is worried about being overly concentrated in company stock and wants to diversify to reduce risk.

Jocelynn just became vested in 5,000 shares with a strike price of \$20/share. In January of 2023, the market value of her company stock was \$35/share and at a high. While she wants to exercise now, her CPA and financial advisor told her that doing so would result in AMT, in fact \$12,355 worth. The "bargain element," of \$75,000 ($\$35 - \$20 \times 5,000$ shares) is added back to income. Despite applying the AMT exemption (\$118,000), she would still owe over \$12,000 when comparing to her taxable income.

Dejected, her CPA calculates that her "break-even AMT" threshold is \$25,000 (vs. \$75,000).

In June of the same year (six months later), the stock market drops by 30% (along with her company stock). The stock is now \$25 (from \$35/share). As it just so happens, her "break-even AMT" threshold happens to be \$25/share and Jocelynn exercises all 5,000 vested ISOs!

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Her “breakeven AMT” threshold is calculated as $\$25 - \$20 \times 5,000$ shares, or \$25,000. This amount is added back to income, and after AMT exemption applied (same \$118,000), she owes \$0 in AMT!

Additionally, she starts the long-term capital gains clock, and will be able to sell concentrated stock at advantageous capital gains rates when the market rebounds in one year.

3. MAX ESPP IN DOWN MARKET

In ESPP (Employee Stock Purchase Plans), participating employees defer a percentage of salary (up to \$25,000/year) to buy company stock, often at a 15% discount. To be able to buy company stock at eighty-five cents on the dollar is enticing enough. However, during a downward market, both the employee and market discount can offer very cheap price points.

In short, during a down market, there are a couple of benefits to participating or increasing contributions to your company ESPP.

First, with a drop in stock price, you can purchase more ESPP shares per fixed dollar contribution. For example, if the ESPP allows a 15% discount, a simultaneous 15% drop in market price/share offers a 27.75% overall discount to the previous price!

Second, by buying employee stock when the market is down, one is *locking* in a lower ratio of ordinary income tax per share (relative to capital gains) at disposition. In ESPP plans, the “bargain element” (15% discount) is considered “compensation” and taxed as ordinary income upon sale. In essence, by buying ESPP stock at a low point, you’re also freezing ordinary income tax per share (AKA “compensation/share”), at a low point. Assuming an employee holds said shares for at least 2 years from grant and 1 year from exercise, any profit (difference between sales price and FMV at sale) is taxed at advantageous capital gains rates. This is akin to tax arbitrage.

Here’s an illustration of the power of this strategy.

Aaron Von Millan is currently contributing 5% of his salary to his company ESPP plan. His company allows ESPP stock purchases at a 15% discount. The company stock is trading at a high of \$20, and so he is able to purchase at \$17 ($85\% \times \20). Aaron’s salary is \$250,000 and his 5% ESPP contribution is \$12,500. At the market high, he can purchase 735 shares ($\$12,500/\17).

Six months later, both negative earnings and a drop in the market results in company stock dropping 20% (from \$20 to \$16). Aaron’s ESPP allows a “lookback provision” which enables a discount from the beginning of offering period or end of purchasing period, whichever is less. Since the stock is \$16 per share by the end of each purchasing period, he can buy it at \$13.60/share ($85\% \times \16)!

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To be clear, in certain markets, it may be beneficial to sell ESPP shares immediately. While it is a “disqualifying disposition,” the short-term capital gains on an immediate sale would be negligible. However, in a down market, waiting the full 2 years from grant and 1 year after exercise is optimal if you don’t want to lock in losses.

In short, the above illustration shows the benefits of ESPP contributions in a down market. First, by taking advantage of a 20% drop in price, along with his 15% ESPP discount, Aaron was able to purchase his company stock for 32% less than the high point (\$13.6 vs. \$20). With good fundamentals, this can translate into an excellent bargain. Second, with a reduced price, Aaron is locking in lower ordinary income tax per share. He can now purchase 919 shares vs. 735 shares, or 25% more shares per tax dollar (e.g. \$12,500/\$13.6)!

In summary, a down market, while unsettling, can provide opportunities for many investors who show fortitude, patience, and discipline. For investors who are RMD eligible and/or participating in employee compensation plans, market turmoil can provide a silver lining.

Before making any tax related transactions, please check with your CPA and Wealth Counselor. ■

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