BAIRD TRUST

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Baird Trust Market Commentary

The Hidden Cost of Overtrading

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In July of 2017, we wrote a piece titled "Our Favorite Holding Period is Forever." In it, we discussed our business owner investment approach and why that naturally leads us to hold our equity investments for very long periods of time, in stark contrast to much of today's investment industry. We stated:

"Quite simply, there is no better way to compound money at attractive rates of return than the long-term ownership of successful businesses run by talented people… investors should try to identify these sorts of enterprises and people, invest in them, and let those businesses compound their investment into the future."

Since these opportunities don't come around often, we spend much of our time preparing and waiting. There are often long periods of time with little or no trading activity in client accounts, but we always stand ready to act when opportunities appear. As Warren Buffett said, "You do things when the opportunities come along. I've had periods in my life when I've had a bundle of ideas come along, and I've had long dry spells. If I get an idea next week, I'll do something. If not, I won't do a thing."

Our Approach is Tax Efficient

Although it isn't frequently discussed, one substantial benefit to this approach is that it is very tax efficient for our taxable clients. As Benjamin Franklin once said, "In this world nothing can be said to be certain, except death and taxes." We will leave the topic of death for another newsletter and instead focus on taxes.

Intuitively, most investors know that capital gains taxes negatively impact the growth of their wealth over time. However, this impact and its magnitude are typically not discussed explicitly or quantified. There is good reason for this – taxes are personal. Each person's tax situation is different so

We are excited to announce that Hilliard Lyons Trust is now Baird Trust.

As we mentioned in our last newsletter, although the trust company now has a new name and brand, nothing is changing from a personnel, management or location standpoint. In fact, we're thoughtfully growing our team and increasing our footprint to ensure we're positioned for future business opportunities. We are committed to continuing the strong relationships we have built in our communities and are eager to build on that legacy as Baird Trust.

We are certainly excited about the new brand and prospects of future growth, but our No. 1 priority remains you. We thank you for your relationship and the trust you place in Baird Trust.

there is no easy, "one size fits all" formula to account for taxes. For this reason, the investment industry standard is to present portfolio returns on a pre-tax basis. This is a great starting point and allows for easy comparison against other investment strategies or funds.

Pre-tax vs. After-tax Returns

While the industry standard is pre-tax investment returns, an investor's after-tax return is much more important. Aside from charitable giving, it is nearly impossible to spend unrealized investment gains. The purest measure of monetary wealth is how much money is left after all taxes have been paid.

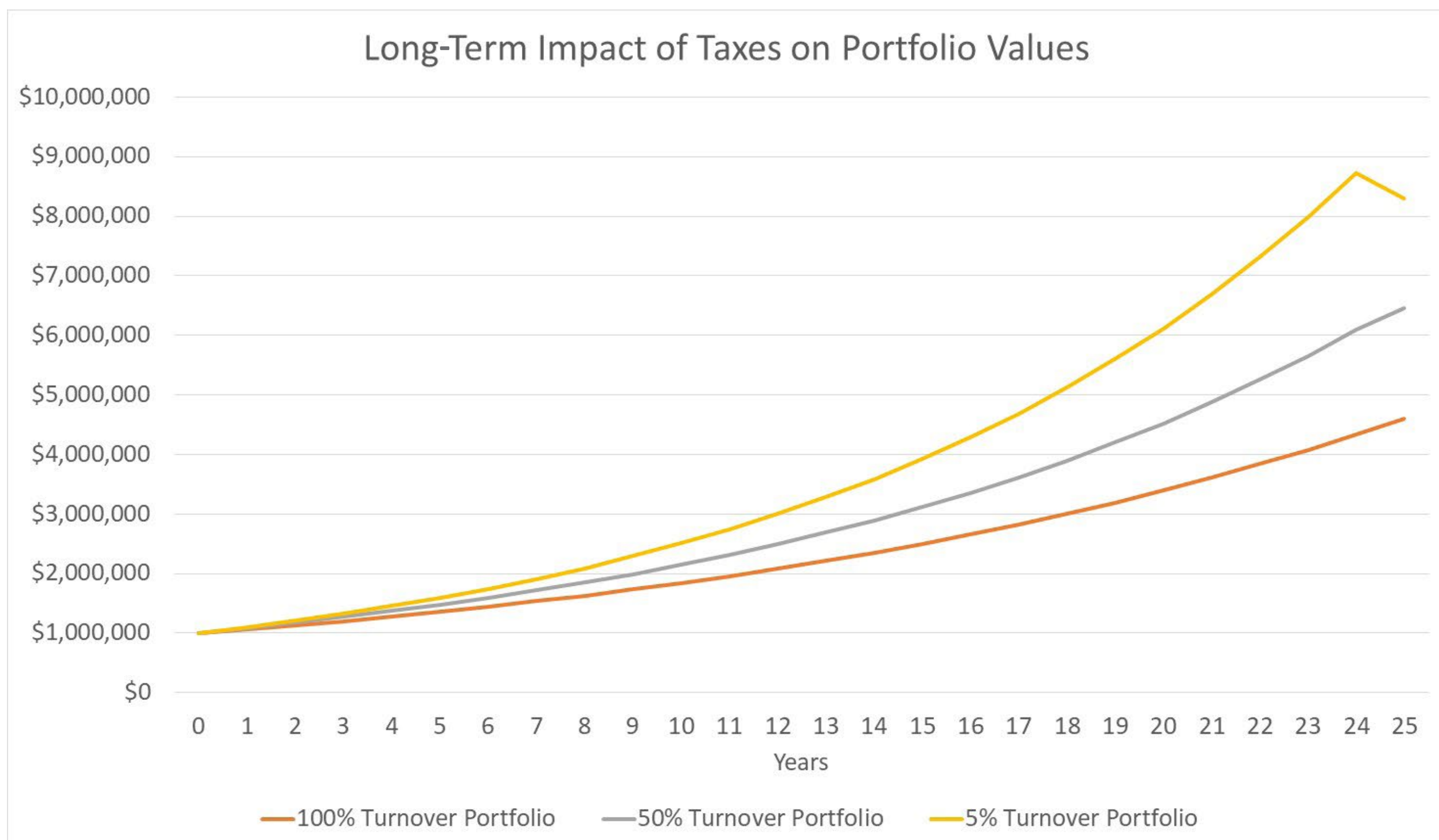
Unlike most other taxes, the timing of capital gains taxes is unique in that they are entirely within the investor's control. This is because a capital gains tax is only paid when a stock or bond is sold at a profit. Upon sale, this unrealized gain becomes a realized gain, and a tax is due.

Therefore, the main driver of the frequency and magnitude of capital gains taxes is the amount of trading activity in the investor's portfolio, also known as portfolio turnover. Turnover is often quoted in percentages, referring to the percentage of the dollar value of the portfolio that is traded annually. For example, a $1 million portfolio with 100% turnover means that, in aggregate, there were $1 million worth of purchases or sales within the portfolio in the last 12 months.

Assuming a positive investment return over time, a higher level of trading activity triggers more capital gains taxes and results in a lower after-tax return. This phenomenon can create a sizeable, but often unnoticed, headwind to long-term investment performance.

I will use a hypothetical example to illustrate. Consider three equity portfolios:

1. **High Turnover (100%)** – A highly active, short-term trading strategy with 100% annual turnover, never holding a stock for more than one year. All capital gains are short-term in nature.
2. **Moderate Turnover (50%)** – This portfolio typically holds stocks between six months and three years with annual turnover of 50%. There is a mix of long-term and short-term gains, with 75% long-term in nature and 25% short-term in nature.
3. **Low Turnover (5%)** – This portfolio typically holds each of its stocks for more than 10 years with annual turnover of 5%. All capital gains are long-term in nature.



Let's assume each portfolio starts with $1,000,000 today and achieves a pre-tax return of 10% annually over 25 years. For high income households, per the current federal tax code, short-term capital gains are taxed at 37% and long-term capital gains are taxed at 20%. For the sake of simplicity, we only focus on federal capital gains taxes. However, capital gains may also be subject to state and local taxes as well as a 3.8% federal tax surcharge for some investors. The inclusion of these would only further amplify the divergence among the three portfolios in this example. Finally, at the end of the 25-year period, any remaining unrealized gains are taxed in full at the long-term capital gains rate of 20%.

In this example, the low turnover portfolio performed the best, far outpacing the other portfolios. The values at the end of 25 years are:

- High Turnover: $4,606,081 (6.3% annualized after-tax return)
- Moderate Turnover: $6,449,918 (7.7% annualized after-tax return)
- Low Turnover: $8,298,571 (8.8% annualized after-tax return)

In this simple hypothetical example, there is only one reason for the significant difference in ending values – the timing and magnitude of capital gains tax payments. While we must acknowledge the real world is a bit more complex than this example, the underlying point remains true. The more taxes an investor pays along the way, the less money they have in the end.

Tax Leakage Stifles the Magic of Compounding

Over the short term (less than 5 years), the differences are barely noticeable, but they become clear over time. The moderate and high turnover portfolios are constantly experiencing tax leakage through trading activity that results in tax charges. Over time, these tax charges add up and have a devastating impact on the rate of return. Alternatively, the low turnover portfolio has very minimal tax leakage, allowing its unrealized gains to compound tax-deferred.

Due to these tax headwinds, highly active short-term investors are at a fundamental disadvantage compared to more patient, long-term investors. More active investment strategies must generate a higher pre-tax return simply to stay even with less active investment strategies. How much higher? In the example on page 2, the low turnover portfolio's 10% pre-tax annual return resulted in an 8.8% after-tax annual return. To match that 8.8% annual after-tax return, the high turnover and moderate turnover portfolios must generate annual pre-tax returns of 14% and 11.4%, respectively. A tough task, indeed.

Our ultimate goal at Baird Trust is to help you compound your wealth over long periods of time while controlling for risk. We strongly believe our long-term business owner approach to investing is the best way to achieve this goal for both taxable and tax-exempt investors. But for investors with taxable accounts, our strategy's tax efficiency is an added long-term benefit.

As always, we thank you for your relationship and continued trust you place in us as stewards of your financial assets.

To request a copy of "Our Favorite Holding Period is Forever" (2017), please email BairdTrust-Info@rwbaird.com.

Tax Proposals Still Up in the Air – Action May Still Be Required

Mark McLennon, J.D. CPA, CFP®
Trust Strategist

Back in April, in this same newsletter, I wrote a piece discussing proposed estate, gift, and capital gains tax changes, making an observation that tax policy can turn around as easily as the skies change with an oncoming storm. Well, the summer storm season has passed and here we are in October with fall and all it brings looming in front of us. My earlier analogy about there being "something in the air" still holds true; however, what is airborne now is a football, a political football that is, being passed and kicked back and forth, not yet landing on solid ground. As the months have passed, no new tax legislation has passed, although it seems very close, as much of the focus of late has been on the debt ceiling and the top line size of the human infrastructure (reconciliation) package. While an errant flying football analogy may seem appropriate for the season, legislative uncertainty still brings with it the angst, or the sense of urgency, that occurs when certain high-stakes rules are changing but no one is yet quite sure how. Eventually, perhaps very soon, there will be some clarity around some of these changes and, as before, understanding what may come and what actions may be appropriate in response to or in anticipation of such changes is critical to the process of working to achieve long-term goals.

Taking a break from the weather and sports analogies, let's look at some of the more likely estate tax proposals that may find their way into the law when the fog clears and/or the final whistle blows (oops, sorry). At this point in the process, which began even prior to the November 2020 election, discerning between items that are from some politician's lifelong aspirational wish list and those which may actually be reduced to law is important. Without getting into too much of a civics lesson, federal tax legislation officially initiates in Congress, more specifically in the House Ways and Means Committee (HWMC), so that is a good place to start. Around the middle of September, that committee released legislative text and an outline regarding a number of proposals involving individual and corporate income taxes, as well as estate and gift taxes. The text was over 600 pages and it contained a few things that were expected and a few things that seemed a bit more out of the blue. To provide just a brief overview, which may be enough to prompt certain higher-net-worth individuals or families to contact their attorney if they have not already, below are some of the key proposals related just to estate and gift taxes:

Accelerating the planned lowering of the gift/estate tax exemption. The Tax Cuts and Jobs Act (TCJA) in 2017 effectively doubled the size of the then-existing exemption, allowing estates of $11.7 million (for 2021) to essentially avoid being subject to estate or gift tax. With proper planning, this number is actually $23.4 million for a married couple (again for 2021). This "doubling" is, under the law as currently written, to revert back to its pre-TCJA level after 2025. This reversion has caused many higher-net-worth families to contemplate, or actually initiate, larger gifts in trust to take advantage of this larger exemption before it is reduced. The recent HWMC proposal would essentially cut that exemption in half (i.e., accelerate the reversion to pre-TCJA law) beginning in 2022, not 2026. The actual exemption amount is based on a cost-of-living adjustment, so the exemption would go down to roughly $6 million per person in 2022 ($12 million for a couple with proper planning). Such a proposal is enough to create even greater urgency for large gift planning in 2021. But there's more…

Changing of "grantor trust" rules to eliminate estate and income tax benefits. By way of background, assets held within an irrevocable trust are generally excluded from the estate of the grantor (the person who created the trust) for federal estate tax purposes. Individuals create and fund these trusts with the goal of getting the *future* appreciation of

those assets out of their estate. Certain rights or benefits in the trust retained by the grantor may thwart that purpose and cause estate inclusion at death, but there are also provisions that allow the grantor some continuing connection to the trust without incurring that negative estate tax result. In fact, there are certain provisions which cause the grantor to be treated as owning the trust assets for *income tax purposes*, but the assets are still excluded from the grantor's estate. These are known as the "grantor trust" rules and they make the grantor responsible for paying income and capital gains taxes on any income that those trust assets earn. Although that may seem like a disadvantage to the grantor (in fact, these are often called "defective" trusts), from an estate and gift tax perspective it allows the assets in the trust to grow, and the grantor's other estate assets to shrink, as the grantor is obligated to send the IRS the taxes due, not the trustee. Even though this benefits the trust, these tax payments are not considered gifts to the trust due to that obligation. The "grantor trust" rules also allow for assets to be sold to the trust by the grantor without incurring any current gain (essentially, for income tax purposes, a grantor is selling the assets to themselves).

The provisions that cause a trust to be considered a "grantor trust" are spelled out in the Internal Revenue Code, and for decades estate planners have incorporated these into a number of acronym-laden strategies, including GRATs, ILITs, and SLATs, being careful to ensure "grantor trust" treatment is achieved for income tax purposes without causing estate tax inclusion. The HWMC proposal would eliminate the benefits of the "grantor trust" rules (no estate inclusion, deferral of gain recognition on asset sales, etc.), a move which would seriously curtail or eliminate the use of the strategies mentioned above. The potential effective date would be for trusts created (or additionally funded or modified) after the date of enactment of any legislation, which of course could be prior to 2022 or virtually at any time. This potential change, coupled with the proposed lowering of the exemption four years ahead of schedule, has caused many to consider taking action now. But, there's even more…

Valuation discounts on certain transfers disallowed.
Another provision found within the HWMC proposal is eliminating the use of valuation discounts for gifts of certain types of interests, primarily those involving passive investments. Such discounts have been used to reduce the size of lifetime gifts, thus preserving more of the lifetime exemption for other gifting and estate planning strategies. As such a change would also have an effective date that may mirror the date of enactment of any legislation, it has also created a sense of urgency from those who could benefit from such a strategy.

What to do. What to do. The resolution of this round of potential legislative changes to the estate planning rules is still a toss up, but seems to be in the fourth quarter. It is a game of back and forth, but for many the stakes are extremely high and many of the proposals have far-reaching consequences. Whether any particular action needs to be taken will depend on individual circumstances, but it is not a time to stay on the sidelines.

Spotlight on Equity Portfolio Manager

John C. Watkins III, CFA®
Vice President
Equity Portfolio Manager

After five years of serving as Associate Portfolio Manager for Baird Trust's Large Cap Equity strategy, John C. Watkins III, CFA®, was promoted this summer to Co-Portfolio Manager, working with his longtime friend and mentor Andy Means, CFA®, who has been managing the strategy for nearly 25 years. We asked John to explain his investment philosophy, what he brings to the Large Cap Equity team, and his favorite experience in America's national parks.

Talk a little bit about your background and your journey to the trust company.

The journey began in the summer of 2007, when I was an undergrad at the University of Notre Dame and got a summer internship working with Andy Means on the Large Cap Equity strategy. The next summer, I took an internship with Fidelity in Boston, which turned into a full-time role as an equity research associate on the health care team in 2009. After two years with Fidelity, I moved back to Louisville and joined River Road Asset Management as an equity analyst.

After I had been back in Louisville for several years, Andy and I rekindled our relationship and started getting lunch on a regular basis. That led to the realization that both of us thought a lot alike and resulted in him extending an offer for me to come join him at Hilliard Lyons Trust (now Baird Trust) in August 2016 as Associate Portfolio Manager.

How would you describe your working relationship with Andy?

There were two main reasons I decided that this was the right opportunity for me: One is the investment philosophy, but the other was to be able to work directly with Andy. He's a mentor for me, and I try to learn as much as I can from him.

We've known each other a very long time. We think about investing the same way; we challenge each other; we learn from each other. At the end of the day, we're both driving toward the same goal with the same underlying investment philosophy. We have an excellent working relationship, and that won't change at all in terms of execution or managing the portfolio.

We don't think exactly the same on everything. We have definitely had disagreements, which I think is healthy. One thing that I have added to the team is that I come from a different generation, which is important given how technology and software are totally changing the way that businesses work. From my vantage point, being more knowledgeable about that change allows me to add something unique to the strategy.

The Large Cap Equity strategy has essentially been Andy's life's work. He's been the lead manager for nearly 25 years, and the investment track record he's put together over that time is impressive. I'm incredibly humbled to become an equal partner with him on the strategy.

What do you do on a day-to-day basis as an equity portfolio manager?

My goal every day is to learn something new. This could be something about a business that we already own in the portfolio. It could be about a business that we don't own but might want to own. It could be about an industry that impacts a business we own. It could be about a management team, or anything that could impact our investment decisions.

Most of my days are spent reading company filings, news articles, interviews with management teams, conference transcripts, and even books on a company's history. It's a compounding of knowledge that builds up over time so that when an investment opportunity does come along, we can use that knowledge to make a well-informed investment decision, whether that's a purchase or a sale or simply to continue holding an investment in the portfolio.

We have more information than ever at our fingertips these days. How has this changed investment management?

The widespread availability of information has made it harder for professional investors overall, but also easier in some ways for people like us who have a very long time horizon. How is it harder? Well, it's nearly impossible now to get any kind of information advantage over everyone else. It's extraordinarily difficult to find some unique piece of information that's going to give you a huge edge on a stock. Twenty years ago, that was a real thing, where you could find that nugget that no one else knows about. Today, that is all but impossible to do, especially in the large cap space.

Our advantage is being able to think in five- and 10-year increments. Much of today's investment industry has become so short-term oriented, sometimes missing the forest for the trees. A few years ago we were researching a specialty retailer, and there was so much fear that Amazon was going to enter the category and destroy this business. But all our research told us that that fear was overblown over the long term.

Investors who were worried about the next one or two quarters didn't really care that three to five years down the road, there wasn't really going to be a problem. And so we were able to take advantage of that sort of time arbitrage. That longer-term time horizon is huge for us. Not a lot of people think about stocks this way.

How would you describe your investment philosophy?

My investment philosophy and the Large Cap Equity investment philosophy are one and the same: to think and act like long-term business owners at all times. We don't view stocks as trading chips to be shuffled around on a daily or monthly basis. We view each investment as a fractional ownership stake in a business that we intend to hold for the long term.

We try to block out all the noise and focus on three things: the quality of the business, the strength of the company's management team, and the stock price in relation to what we think the business is actually worth. Once we identify an investment that meets all three criteria, our intention is to own it for as long as possible. If you look at the history of the portfolio, on average we will hold each investment for more than 10 years.

How often do you buy or sell issues in the portfolio?

It's relatively infrequent, although it typically happens in bursts. We made a number of changes in 2020 because there was a lot of volatility, which created several opportunities to invest in great businesses that we had been watching for a number of years.

This year we haven't made any portfolio changes because there just haven't been many opportunities to take advantage of. Often what happens is we will find a business that we love, but it's not trading at a price that we love yet. So we will watch it for months, sometimes years, until that opportunity comes where we can take advantage of some sort of dislocation in its stock price.

Who else works with you on the Large Cap Equity team?

The third team member is Ross Demmerle, an equity analyst whose role is to support our research efforts. He does a terrific job, and our job would be much more difficult without the work that he does. The three of us have been together as a team since August of 2016, so we know each other really well. We all feel comfortable challenging one another when we have a different viewpoint, which is an important team dynamic in investing.

Talk about how the Large Cap Equity team interacts with the larger Trust Company.

The Large Cap Equity strategy has been the cornerstone of the trust company's investment offerings. We're in constant communication with the trust portfolio managers, both informally but also through more formalized weekly investment meetings where we'll get together and discuss our portfolio.

We use what we call a Core + Satellite investment approach for Trust clients that utilizes the Large Cap Equity strategy as the core equity allocation while gaining exposure to additional asset classes through mutual funds and ETFs and individual fixed income. Additionally, the Large Cap Equity strategy can also be accessed through Baird's Separately Managed Accounts (SMA) program at a minimum of $80,000. So you don't have to be a trust client to use this investment strategy – all Baird clients have access to it through a model-based portfolio.

What do you like to do away from the office?

I love being active and I love to travel. My wife and I do a lot of rock climbing, hiking, camping, and backpacking, both in Kentucky but also at national parks around the country. In May 2021 we went to Yosemite National Park, which is my favorite of the ones we have visited. I actually got a chance to climb a little bit of the famous El Capitan – just the very bottom 50 feet of the 3,000 total feet, but that was a pretty special experience.

What's on your bucket list?

I would love to hike to base camp at Mount Everest in Nepal, or do the W Trek down in Patagonia, which is a five-day hike. Antarctica has always fascinated me, so hopefully I can get down there at some point in the future.

Andy Means, CFA®, longtime portfolio manager for the Large Cap Equity strategy, on John Watkins

A big part of our relationship is the mutual respect that we have for each other. At the times when you don't see eye to eye, it's important that you respect each other's abilities as you hammer through whatever the difference is.

New industries and new companies are creating profound changes in the economy. If there's any risk that I might be stuck in the past, there is no risk that John is stuck in the past. We can really benefit from the knowledge base that he's got of this new world.

The Large Cap Equity strategy has been my life's work, so it's really important to me that this record that we've established be extended out for several more decades. And here was the answer: a young guy who's got a long runway ahead of him, who thinks exactly like we do, with razor-sharp intelligence and a passion for investing.

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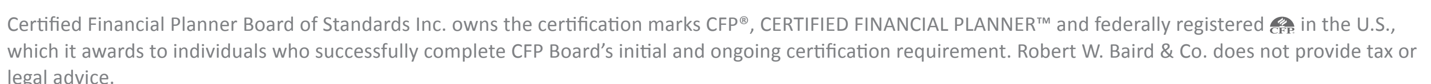

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