WOODSTOCK

Quarterly Market Perspectives

Fall 2023

A quarterly newsletter offering our views on the market and economic topics of interest to investors.

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Management Fees and Tax-Loss Selling

William H. Darling, Chairman & CEO

Are portfolio manager fees "the only reliable predictor of performance"? "The lower the fees, the higher the returns realized by investors."[1] It depends. In a pooled investment vehicle, where the client is merely a creditor of the real owner of the investment, perhaps. For separately managed accounts made up mostly of individual common stocks, probably not. The difference between an active management fee of 100 basis points on a $1 million account and an average 35-basis-point fee for most passive investment vehicles is substantial. Some passive vehicles have lower fees and some predict we will see 10-basis-point fees or lower as investment firms race to lower fees.

If you are in a separately managed account of individual common stocks acquired in lots over a number of years, a technique called tax-loss selling is available to you and your investment manager. This is not possible if your portfolio is made up of pooled investment vehicles, except in a limited way to sell the vehicle (see sidebar). The advantage of using tax-loss selling is estimated to be between 110 and 142 basis points annually but realized intermittently over a number of years, according to one analysis.[2] Down market years are particularly valuable. A second study put the advantages at "100 basis points annually and potentially more in highly volatile years."[3] A quick check of the math shows that the use of tax-loss selling more than offsets the difference in fees before adding in the benefits of active management in the right hands.

After discussing fees, two other comments should be aired and discussed concerning the benefits of active management. Change happens slowly, so its impact on stocks will be slow. You don't have to move quickly (or "actively").[4] And secondly, "more than 90% of active managers fail to beat the market over

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Individual Stocks Purchased in Lots

When a stock, put forward on the recommendation of a portfolio manager, is voted onto the Monitor List at Woodstock, portfolio managers begin to buy it for client accounts. A full position at Woodstock might be a 3% position, so 30 to 40 stocks typically make up a portfolio. However, a new stock on the Monitor List might receive a 0.5% or 1% position initially as the manager seeks to become comfortable with that company's management team, business prospects and how the market reacts to the company and its news. Over time, the position may grow through increases in valuation and, also, by purchasing additional shares.

Each purchase of shares creates its own "lot" with a specific cost. If a stock's price chart moves steadily from the lower left to the upper right, each purchase will have a higher cost basis than the previous purchases. With a stock that the manager has confidence in, temporary "bad news" may create the opportunity to "buy on the down dip," creating lots with various costs, not depending on chronology. In a market downturn, such as at the end of 2022, some "tax lots" of even good companies may be "underwater," providing the opportunity for generating realized loses to offset realized gains taken in the portfolio during the year. This is called "tax-loss selling," a very valuable tool for increasing portfolio value, independent of performance.

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10- and 20-year periods."[5] The takeaways, or rebuttals, might be these: Look for a manager whose 10- or 15-year record at least approximates a market return with the opportunity for outperformance.[6] Also, at least realize that passive investment doesn't respond in advance at all. It passively accepts the market's verdict in arrears.

The current information on fees for mutual funds and exchange-traded funds (ETFs) is that the average expense ratio for equity mutual funds is 47 basis points. At the end of 2022, mutual funds had assets of $16.3 trillion dollars.[7] For ETFs, the average fee is 55 basis points but the asset-weighted average is 17 basis points, which "takes into account how much money is invested in what funds."[8] At the end of 2022, ETFs had $6.5 trillion in assets. The math on fees works here as well. ETFs still have a ways to go to have more assets under management than mutual funds. Both mutual funds and ETFs are pooled investment vehicles.

Why pick active management in this very competitive world? I believe that the following is a very good answer: "You (the active investment manager) point out the value of objective advice, and of personal service... You move toward working with a well-defined niche where you know your clients on a deeper level"[9] and explain that with a Woodstock-type account you are able to offset the fee differential and, historically, deliver more-than-competitive performance.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow. We thank you for your support and want you to know that we are dedicated to serving your best interest.

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[1] *Burton G. Malkiel, "Indexing is Still the Best Bet for Investors," WSJ, 9/14/2023, p. A17*

[2] *Derek Horstmeyer, "How Valuable Is Tax-Loss Harvesting?", WSJ, 12/6/2021*

[3] *Tim Helman, "Generating Alpha through Tax-Loss Harvesting," Financial Planning, October 2020, p. 36*

[4] *Burton G. Malkiel, "Indexing Is Still the Best Bet for Investors," WSJ, 9/14/2023, p. A17*

[5] *Ibid.*

[6] *Please ask to see Woodstock's GIPS performance record (particularly the Growth Composite) over the last 15 years.*

[7] *Jack Pitcher, "First ETF Transformed Investing," WSJ, 1/23/2023, p. B2*

[8] *Jack Pitcher, "Index Tracking ETF Fees Spiral Closer to Zero," WSJ, 9/19/2023, p. B10*

[9] *Bob Veres, "No Free Pass for Vanguard," Financial Planning, December 2018, p. 16*

"Although high inflation, high interest rates and incessant recession predictions have cast a shadow over the economy the past year, a sudden increase in innovation has provided some much-needed hope and a glimpse into a brighter future."

"Starting in 2009 three investment managers at Woodstock began managing what we call the strategies in three sectors: energy, healthcare/biosciences, and technology"

Smarter and Thinner: Opportunity in Disruption

David Layden, Portfolio Manager

Although high inflation, high interest rates and incessant recession predictions have cast a shadow over the economy the past year, a sudden increase in innovation has provided some much-needed hope and a glimpse into a brighter future. Recent advancements in artificial intelligence and weight-loss pharmaceuticals threaten to shake up their respective industries. While the major players—Microsoft, Alphabet and Eli Lilly—will all likely benefit, these innovations will also provide an opportunity for new, smaller companies that can lead across these technological changes.

Woodstock Corporation primarily invests in tried-and-true companies that combine a track record of earnings growth and solid balance sheets. Many of these companies will certainly benefit from the above-mentioned innovations—either directly or indirectly. Additionally, Woodstock Corporation implements two strategies across separately managed accounts with investment objectives that could provide exposure to these breakthroughs: Technology Strategy and Healthcare & Biosciences Strategy. The smaller companies that these strategies pinpoint to invest in will, in many cases, have a higher degree of risk than normal, but will offer the chance at a higher return. As the business landscape changes, these companies could be well positioned to move higher with it. (Woodstock also implements an Energy Strategy; see sidebar.)

While the advancements in artificial intelligence and weight-loss drugs will have far-reaching implications across sectors and industries, it's always wise to consider Amara's Law:[1] "We tend to overestimate the impact of technology in the short run and underestimate the effect in the long run." In the meantime, let's examine how each sector could evolve.

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[1] *After the late Roy Amara, American scientist, futurist, and president of the Institute for the Future.*

Woodstock's Sector Strategies

Starting in 2009 three investment managers at Woodstock began managing what we call the strategies in three sectors: energy, healthcare/biosciences, and technology. The companies to be invested in would be smaller and, potentially, more volatile than companies that make up Woodstock's Monitor List. The Monitor List is the approved list of approximately 100 companies that Woodstock's investment managers place in client accounts. Each strategy would hold ten to sixteen stocks within the sector definition. Our Global Investment Performance Standard (GIPS) reporting includes three composites—Growth, Growth & Income, and Conservative—and the three strategies to make up six components of our GIPS reporting.

At the present time, the strategies have the focus described below.

The **Energy Strategy** is a portfolio diversified across energy subsector niches of integrated international oil, exploration and production, refining and marketing, onshore drilling, oilfield service, and another category that offers exposure to gold and copper, a critical material in the energy transition. Undervalued and inflation-protected yield, net asset value growth potential, leveraged beneficiaries of higher energy commodity prices and a lower US dollar are investment themes expressed in various holdings. The Energy Strategy portfolio yields 2.2% and trades at 9x forward earnings per share (EPS). Currently, there are sixteen holdings in the portfolio; over its fourteen-year existence, the number of holdings has ranged from ten to sixteen.

The **Healthcare & Biosciences** Strategy primarily focuses on late-stage clinical and commercial bioscience companies working on therapeutics with substantial commercial potential. It also looks at medical technologies addressing diagnostic and treatment administration. Major areas of attention include neurology, nephrology, oncology and gene therapy.

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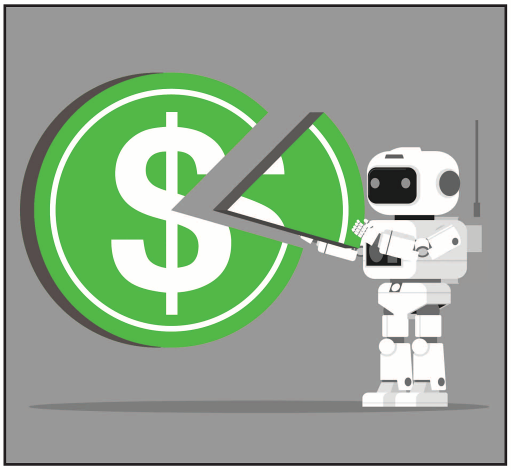

AI Disrupts Tech Sector and More

Since the introduction of ChatGPT in November 2022, artificial intelligence has received an enormous amount of attention both in the mainstream and financial media. All this attention has helped move the S&P 500 technology sector up almost 40% year to date despite higher interest rates, which typically weigh down technology stocks, since profits are usually further out in the future. The expectation is that artificial intelligence's large language models will make it easier for people and businesses to find information, create content and analyze data. Large data sets will now be simpler to access and understand for everyone.

The applications of artificial intelligence will be wide ranging, from the likely disruption of internet search to companies being able to convert their large amounts of existing data into actionable decisions in a far timelier manner. Disease diagnosis, drug discovery, forecasting, legal contract writing, job application screening, and customer feedback analysis are all functions that artificial intelligence could upend. The so-called "pick-and-shovel" businesses, like microchip maker NVIDIA and its industry-leading graphics processor, have been the early winners. Beyond the chipmakers, it's likely that software companies, cloud-computing service providers and the usual mega-caps will be in the mix to capitalize on this shift. This is where opportunity exists for both big and small companies.

The **Technology Strategy** invests in information technology companies. The portfolio includes companies exposed to the following technology themes: consumer internet, digital advertising and entertainment, software, information management, cloud computing, artificial intelligence, cybersecurity, network management, semiconductors, hardware, and technology consulting.

An important aspect of Woodstock's strategies is that they are not "pooled investment vehicles." Each investor has a separate account in each, or only one, strategy with a proportionate number of shares of each investment for the strategy.

However, challenges lie ahead for artificial intelligence. None other than Tesla CEO Elon Musk called for restraint in development back in March 2023. Musk was among a group of industry leaders that penned a letter requesting a pause. They believe "powerful AI systems should be developed only once we are confident that their effects will be positive and their risks will be minimal."[2] Also, regulators are starting to weigh in on privacy concerns and copyright infringements.

Additionally, the implications of artificial intelligence on the workforce are hard to ignore. Technological advances have mostly resulted in net positive jobs looking back hundreds of years across all fields. At the peak in the 1950s, almost 350,000 telephone switchboard operators were employed.[3] Those jobs were obviously replaced by technology and then some, but this time could be different if the disruption happens too quickly. None of these concerns should be completely dismissed, but they are unlikely to

[2] *"Elon Musk and Others Urge AI Pause, Citing 'Risks to Society,'" Reuters, March 29, 2023,* **https://www.reuters.com/technology/musk-experts-urge-pause-training-ai-systems-that-can-outperform-gpt-4-2023-03-29/**

[3] *David A. Price, "Goodbye, Operator," Econ Focus, Federal Reserve Bank of Richmond,* **https://www.richmondfed.org/publications/research/econ_focus/2019/q4/economic_history**

"The applications of artificial intelligence will be wide ranging, from the likely disruption of internet search to companies being able to convert their large amounts of existing data into actionable decisions in a far timelier manner."

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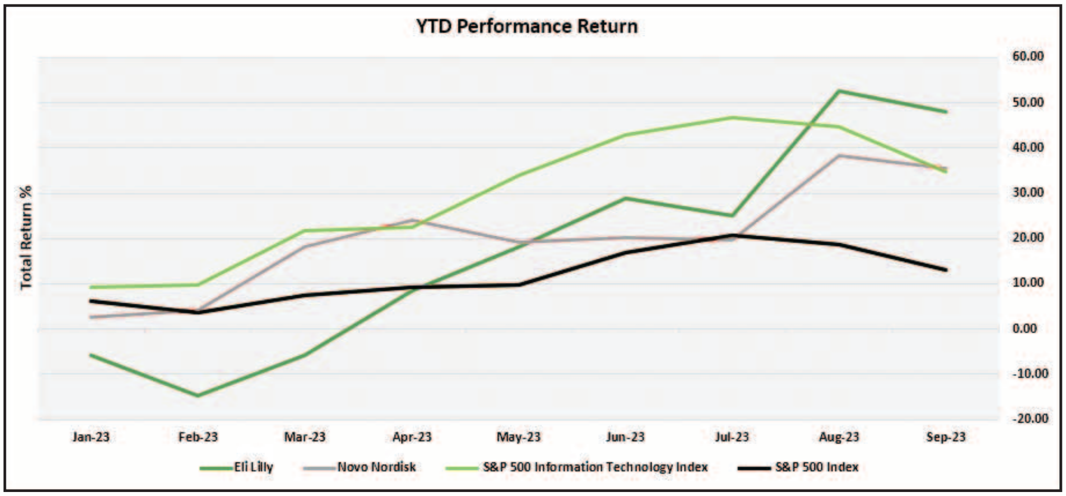
> "As is often the case, the speed and scope of these changes will be difficult to predict, but big companies with deep pockets and small companies that are nimble and adaptable are in the best positions to succeed."

Figure 1



stand in the way of progress. Many businesses now consider themselves "technology" companies because they implement technology others sell. Eventually, most will consider themselves "artificial intelligence" companies.

New Drugs Impact Healthcare and Other Industries

The "mega" theme in this space involves the recent development of weight-loss drugs, GLP-1s, which work by suppressing patients' appetites. The potential impact here is huge, given that 40% of US adults are considered obese.[4] These drugs could improve the lives of around 85 million Americans with pre-existing cardiovascular disease.[5]

Competition is sure to follow, but Novo Nordisk and Eli Lilly are the clear leaders for now. Novo already has two FDA-approved drugs for Type 2 diabetes and weight loss—Ozempic and Wegovy. Lilly has an FDA-approved drug for Type 2 diabetes with a weight-loss drug, Mounjaro, expected to be approved by the end of this year. And if potentially helping tens of millions of Americans lose weight wasn't enough, these drugs could reduce strokes, heart attacks and sleep apnea. These are the market-changing developments that will create winners and losers in this space. (See Figure 1.)

Like artificial intelligence, the GLP-1 impact is expected to be far reaching. Medical-device stocks have been hard-hit since the rise of appetite-suppressing drugs, as healthier people require fewer procedures and treatments. For example, Intuitive Surgical, a surgical robot maker, has seen weaker demand for bariatric surgery. The ripple effects are starting to extend much further out. Walmart reported a "slight pullback in the overall basket" of food purchases and snack makers are now studying the potential effect these drugs will have. On the good-for-business side, more health-conscious people will want to monitor their overall health, including glucose levels, blood pressure and weight. Apparel will also likely benefit as people lose weight and require new clothes, and even the airlines. One analyst projected United Airlines would save $80 million annually if the average passenger lost 10 pounds.[6]

Also, like artificial intelligence, GLP-1s still have hurdles to clear. These are not the first drugs to make grand promises about weight loss and the end of obesity. Side effects include nausea, vomiting, intestinal blockages and even stomach paralysis. Additionally, there are open questions on how long the

[4] *Josh Nathan-Kazis, "How Ozempic and Wegovy Could Break the Healthcare System," Barron's, 09/21/2023,* **https://www.barrons.com/articles/wegovy-ozempic-obesity-drugs-healthcare-system-20307eea?st=dqtyddb0b9hgxbo**

[5] *Lauren R. Rublin, "12 Stock Picks From Our Healthcare Roundtable Pros. Weight Loss Isn't the Only Big Deal in Medicine," Barron's, 10/07/2023,* **https://www.barrons.com/articles/healthcare-stock-picks-roundtable-weight-loss-medicine 65441be4?st=fa4ke 7j5pu59mdv**

[6] *Daniel Gilbert and Laura Reiley, "Food, Clothing, Airlines: Ozempic Is Coming for These Industries and More: Analysts Predict Weight Loss Drugs Will Have Ripples across Many Industries," Washington Post, 10/09/2023,* **https://www.washingtonpost.com/business/2023/10/09/ozempic-weight-loss-drugs-impact/**

"Change is coming directly for technology and healthcare and indirectly for the remaining nine Global Industry Classification Standard (GICS) sectors."

"Bubble-like behavior may arise, much like in the early days of cloud-computing companies."

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drugs will need to be administered and if insurance can and will cover them. All valid concerns, but if the drugs work as hoped without the nastier side effects, then resolutions will be found to these open questions and a different healthcare sector will emerge.

Change is coming directly for technology and healthcare and indirectly for the remaining nine Global Industry Classification Standard (GICS) sectors.[7] We are still in the early innings and the endgame is very much unknown. There are sure to be stock price changes that are overblown, both up and down, as investors try to understand the impact of the new technologies, especially in the areas downstream where the secondary effects are more difficult to fully appreciate. Bubble-like behavior may arise, much like in the early days of cloud-computing companies. As is often the case, the speed and scope of these changes will be difficult to predict, but big companies with deep pockets and small companies that are nimble and adaptable are in the best positions to succeed. "Change is inevitable. Growth is optional."[8]

[7] *MSCI and S&P Dow Jones Indices developed the GICS classification standard to provide investors with consistent and exhaustive industry definitions; see* ***https://msci.com/our-solutions/indexes/gics.***

[8] *John C. Maxwell*

> *"The quick rule of thumb about what the Internal Revenue Service (IRS) is likely to want to look at or to audit, if so inclined, is the current year plus the prior three years."*

> *"As we've noted in previous issues of QMP, direct indexing is becoming a very popular pooled investment vehicle."*

Tax Update: Audit Timelines and Direct Indexing Benefits

William H. Darling, CPA – Chairman & CEO
Jeanne M. Fitzgerald, CPA – Tax Manager

The quick rule of thumb about what the Internal Revenue Service (IRS) is likely to want to look at or to audit, if so inclined, is the current year plus the prior three years. These are called the "open years." If fraud may be involved, it is the current year plus six prior years. The timing schedule is called the statute of limitations. It is meant to help compliant taxpayers trying to do the right thing from being subject to audit beyond a reasonable period, hence three open years. However, if items are omitted from a filed return, making the return "false, fraudulent or otherwise represents a willful attempt to defeat or evade tax, the statute of limitations doesn't start running."[1] These rules apply to taxes due, interest and penalties.

The criminal, rather than merely financial, aspects have a slightly different set of rules. Here the statute of limitations may start to run but "begins to run when the last affirmative act of concealment occurs."[2] The facts and circumstances applicable here relate to "whether acts of concealment prevented or delayed" the start date of the statute of limitations. On top of this, if the taxpayer and tax preparer include all relevant information but treat it in a way that knowingly violates a rule or regulation, the parties must highlight the departure on the tax return by "red-flagging" it. In other words, let the IRS know dramatically.

How would this even arise? The same way the alternative valuation date for estates arose, from a dramatic shift in asset values in 1929. "The Revenue Act of 1935 introduced the optional valuation date election... and... allowed an estate to be valued, for tax purposes, one year after the decedent's death. If the value of a decedent's gross estate dropped significantly after the date of death—a situation faced by estates during the Great Depression of 1929—the executor could choose to value the estate at its reduced value after the date of death. The optional valuation date, later was changed to six months after the decedent's date of death."[3] In 2000 after the dot-com bubble burst, taxes due on a partial sale of a bubble stock during the prior tax year may have been more than the entire value of the remaining holding or all of a taxpayer's other assets in the following year, when the return had to be filed and final payments made.

Benefits of Direct Indexing

As we've noted in previous issues of QMP, direct indexing is becoming a very popular pooled investment vehicle. Direct indexing allows a client or advisor to pick which stocks in an index are to be held in the portfolio, individually. The "No. 1 reason investors turn to direct indexing is tax-loss harvesting benefits."[4] Even though funds are still in a pooled vehicle, the investment manager can choose to take gains or losses to benefit the individual client, not exclusively for performance reasons.

While taking losses is available to portfolios containing only exchange traded funds (ETFs) rather than mostly individual stocks, a portfolio of individual stock holdings could rack up three times the tax-loss harvesting yield of one composed of ETFs over 20 years.[5]

If you or any of your advisors have questions about the issues raised here, please contact your investment manager or one of us.

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[1] *Eileen J. O'Connor, "Hunter Biden May Face a Big Tax Bill," WSJ, 9/28/23*

[2] *Ibid.*

[3] *Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, "The Estate Tax: Ninety Years and Counting," Internal Revenue Service,* **https://www.irs.gov/pub/irs-soi/ninetyestate.pdf**

[4] *Tobias Salinger, "Direct Indexing Offers Big Tax Advantages, Sometimes," Financial Planning, October 2023, p.39*

[5] *Ibid.*

And check out our latest pie chart.
It's delicious.

"Happy Holidays!"

Your ideas and questions are important to us. What would you like to see in our Quarterly Market Perspectives? Please contact your portfolio manager, or anyone from Woodstock's team of professionals, and let us know. **We want to hear from you!**
If you're new to Woodstock, you can reach us at **info@woodstockcorp.com**.