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The Welcome Cost of Investment Success

In our last commentary, we briefly highlighted several financial planning considerations investors should keep in mind. This quarter, we will take a deeper look at those issues and the market environment that has helped create them. The topics discussed below also touch on three of the most requested subjects from our recent client survey: tax and estate planning, rising healthcare costs, and navigating market volatility.

Over the years, we have often emphasized that headlines rarely determine long-term investment returns. Wars, tariffs, elections, and countless other newsworthy events can create uncertainty and tempt investors to make emotional decisions. Ultimately, stock market performance is driven by the earnings growth of the companies' investors own.

Businesses have demonstrated a remarkable ability to adapt regardless of geopolitical events or political outcomes. Like individuals, companies adjust to changing conditions and work to remain competitive. Those that fail to do so are eventually replaced by businesses that better serve consumers and generate stronger earnings. While capable management certainly matters, productivity improvements and innovation are often the most powerful drivers of long-term earnings growth. Today, artificial intelligence (AI) is emerging as a significant catalyst for both productivity gains and expanding corporate profits.

If the market maintains its current pace through year-end, the S&P 500 will have produced four consecutive years of double-digit returns. The last time investors experienced a similar streak was from 1995 through 1999. The parallels between these periods are noteworthy. In the late 1990s, the rapid adoption of the internet fueled innovation, improved productivity, and drove corporate earnings to new heights. Today, AI appears to be playing a similar role.

While many investors remember how the technology boom of the late 1990s ultimately ended, there are several important differences between that period and the current environment.
First, the strong market performance of 1995 through 1999 followed four additional years of positive returns, including a gain of more than 30% in 1991. By contrast, the current advance began immediately after the S&P 500 declined ~18% in 2022. A meaningful portion of the early gains in this cycle represented a recovery from those losses rather than a move to entirely new highs.

Second, the five-year rally of the late 1990s produced cumulative S&P 500 gains of ~247%. Since the beginning of 2023, the S&P 500 has gained ~109%, less than half the appreciation experienced during that earlier period. Even after the market decline from 2000 through 2002, investors who remained invested throughout that eight-year span still achieved cumulative gains greater than those seen in the current cycle.

Finally, many technology companies during the internet boom were valued primarily on expectations of future profitability rather than established earnings. Today, many of the companies leading AI development are already highly profitable businesses with substantial revenue streams. Apple will continue selling millions of devices even if its AI initiatives fail to meet expectations. Google will

continue generating significant revenue from its core search business regardless of the ultimate success of Gemini. The key distinction is that many of today's AI leaders have established businesses and meaningful earnings power that can support their operations even if the most optimistic projections fail to materialize. While that does not eliminate valuation risk, it does provide a stronger foundation than many technology companies had during the dot-com era.

Strong markets bring many obvious benefits. Most importantly, rising portfolio values improve the outlook of financial plans. Investors often gain additional flexibility to increase spending, retire earlier, enhance gifting strategies, or simply enjoy greater confidence that their financial goals remain within reach.

However, investment success can also create planning challenges.

Many of our clients rely on their portfolios to generate income. Meeting those cash flow needs often requires selling appreciated securities, which can result in capital gains taxes. While we work diligently to manage portfolios in a tax-efficient manner and maintain agreed-upon risk allocations, four years of strong market performance have increased unrealized gains across many accounts. As a result, generating cash from portfolios often creates larger taxable gains than it did just a few years ago.

Another consequence of market growth is its impact on Required Minimum Distributions (RMDs). Higher IRA balances generally lead to larger RMDs once investors reach the applicable distribution age. Because RMDs are based on the account value as of December 31 of the previous year, rising account balances can translate directly into larger taxable withdrawals. As investors age, the required distribution percentage also increases, amplifying the effect over time.

Both larger capital gains and increasing RMDs can contribute to higher taxable income. In some cases, that additional income may move investors into a higher Medicare premium bracket. Because Medicare premiums are based on income from prior years, strong investment returns can carry indirect costs through increased healthcare premiums. With several Medicare surcharge tiers in place, even relatively modest changes in taxable income can affect future premiums.

These are, in many respects, good problems to have. They are a byproduct of portfolio growth and long-term investment success. Nevertheless, they reinforce the importance of proactive financial planning. At Legacy, we help clients navigate both the opportunities and challenges that accompany investment success. Strategies involving charitable giving, tax-efficient distribution planning, estate planning, and thoughtful portfolio management may help mitigate some of these unintended consequences. Your relationship manager is available to discuss the planning opportunities most relevant to your situation.

A comprehensive financial plan remains one of the most effective tools for navigating life's changing circumstances. While the planning challenges you face will evolve over time, our commitment to helping you address them remains steadfast. If you do not currently have a financial plan in place, we encourage you to contact your relationship manager to begin the process.

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