BELTZ IANNI & ASSOCIATES

RETIREMENT TIMES

NEWS AND UPDATES FOR RETIREMENT PLAN SPONSORS AND FIDUCIARIES

Volume X | Number III | March 2017

Assessing the International Equity Markets

The end of 2016 saw another subpar year in the international equity markets when compared to U.S. equity markets. The MSCI EAFE[1] (NR USD Index[2]), a proxy for international stocks, finished slightly higher during 2016, up 1.00 percent[3]. Compare that to the S&P 500[4] (TR[5]), a proxy for U.S. stocks, which was up 11.96 percent[3] over the same time period. The margin of outperformance for U.S. stocks is even greater when you look out over the past five calendar years. The five-year annualized performance for the S&P 500 was 14.66 percent, which was sizably better than the MSCI EAFE, at 6.53 percent, over the same time period.[3]

In addition to the aforementioned weaker relative performance, there are other issues and risks inherent with non-U.S. investing. Currency risk[6] is one in particular to consider. Our research shows that the current environment has the U.S. dollar in a position of strength and appreciating in relative value versus most other currencies. A stronger U.S. dollar leads to dilutive returns in the international markets (unless a manager is hedging a fund's currency exposure) as investments are translated back into U.S. dollars. In our experience we find that geopolitical risks[7] continue to surprise investors. In addition to Brexit (Britain's exiting from the European Union) there could be more departures in 2017. With all of these issues, as a plan sponsor, you may be questioning whether or not it's worth the risk of having any direct international managers in your plan's lineup.

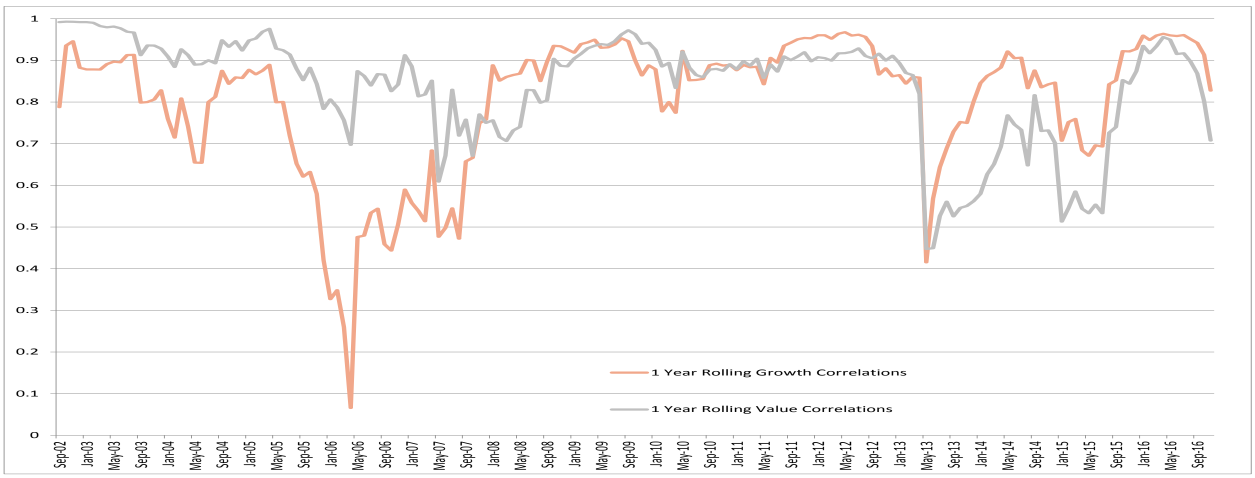
Despite the challenges in the international equity markets, risks appear to be priced in from a valuation perspective. As shown in the chart on page 4, U.S. large cap and small cap stocks have much higher forward price-to-earnings (P/E)[8] ratios and price-to-book (P/B) valuations[9] than international stocks. International stocks sport a higher dividend yield by more than 1 percent when compared to U.S. large stocks. In addition to international stocks, emerging markets appear to be even more attractively priced, at least from a forward P/E and P/B perspective. While we generally do not advocate emerging markets as a stand-alone option in a fund lineup, most active international managers have a dedicated allocation to this asset class. We believe that international and emerging markets appear priced for bad news, and any surprise to the upside, could lead to multiple expansion and an improvement in international equity returns.

Valuations Exhibit

Index	Forward P/E	Price/Book	Dividend Yield
S&P 500 (Large Stocks)	17.08	2.89	2.08%
Russell 2000 (Small Stocks)	23.89	2.13	1.51%
MSCI EAFE (International Stocks)	14.79	1.60	3.27%
MSCI Emerging Markets	11.61	1.45	2.60%

Source: JPMorgan Asset Management Weekly Market Recap, December 26, 2016

Growth and Value Correlations[10]



Note: This chart shows the 1-Year Rolling Correlations of Growth and Value indices. The Growth indices are the correlations between the Russell 1000 Growth and MSCI EAFE Growth. The Value indices are the correlations between Russell 1000 Value[11] and MSCI EAFE Value.

There was also a strong political trend toward anti-globalization in 2016 (i.e., Brexit, Trump's win and the Italian referendum, etc.) As a result, international stocks may benefit from this trend. Over the last few decades, there have been rising correlations among equity asset classes, a result that some might argue is due to globalization and the overall positive trading environment. If that trend is no longer true, correlations could reverse the trend and start falling, thus offering greater diversification benefits to investors. The chart above shows the one-year rolling correlations between U.S. and international stocks, from the perspective of value and growth indices[12]. While it is still early in the anti-globalization movement, it does appear that correlations are starting to roll over for both growth and value stocks and the trend is lower.

Reversion to the mean is the tendency for prices and returns to eventually move back toward their long-term averages. While the scope of this article is beyond a detailed review of research supporting this hypothesis, an example showing long-term returns might be helpful. The 40-year average annual return for the MSCI EAFE is 9.07 percent[3], well above that for the last five years (6.53 percent[3]). The 40-year average annual return for the S&P 500 is 11.07 percent[3], well below that for the last five years (14.66 percent[3]). If you buy into the "reversion to the mean" hypothesis and also take into account better valuations, the expectations for the MSCI EAFE returns should be better in the future.

While there are risks involved with international investing, and to be fair, some of those risks are not associated with U.S. investing, there are also good reasons to continue to support having a dedicated International asset class in your lineup. Valuations look better overseas than here in the U.S., correlations between U.S. and International stocks could fall further, and if you believe in reversion to the mean, international markets could outperform U.S. stocks over the next few years.

[1]***MSCI EAFE® (Europe, Australia and Far East) Index*** *- is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of December 2003 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. EAFE is a registered service mark of Morgan Stanley Dean Witter, Discover & Co.*
[2]*Net returns U.S. Dollar*
[3]*Data from Morningstar*
[4]***S&P 500 Index*** *is an unmanaged group of securities considered to be representative of the stock market in general. You cannot directly invest in the index.*
[5]*Total returns*
[6]*Commonly referred to as exchange-rate risk, arises from the change in price of one currency in relation to another*
[7]*Risks of one country's foreign policy influencing or upsetting domestic political and social policy in another country or region*
[8]*A measure of the P/E ratio using forecasted earnings for the P/E calculation. It is used to calculate a relative value based on a company's level of earnings and stock price*
[9]*A ratio used to compare a stock's market value to its book value. A stock's market value is forward-looking and reflects a company's future cash flows. A company's book value is based on its historical cost*
[10]*Data from MPI*
[11]***Russell 1000® Value Index*** *measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.*
[12]*The Value indices are the correlations between Russell 1000 Value and MSCI EAFE Value. The Growth indices are the correlations between the Russell 1000 Growth and MSCI EAFE Growth.*

2017 Tax Saver's Credit

Participants may be eligible for a valuable incentive, which could reduce their federal income tax liability, for contributing to your company's retirement plan. If they qualify, they may receive a Tax Saver's Credit of up to $2,000 ($4,000 for married couples filing jointly) if they made eligible contributions to an employer sponsored retirement savings plan. The deduction is claimed in the form of a non-refundable tax credit, ranging from 10 percent to 50 percent of their annual contribution.

When participants contribute a portion of each paycheck into the plan on a pre-tax basis, they are reducing the amount of their income subject to federal taxation. And, those assets grow tax-deferred until they receive a distribution. If they qualify for the Tax Saver's Credit, they may even further reduce their taxes.

Participants' eligibility depends on their adjusted gross income (AGI), tax filing status and retirement contributions. To qualify for the credit, a participant must be age 18 or older and cannot be a full-time student or claimed as a dependent on someone else's tax return.

The chart below can be used to calculate the credit for the tax year 2017. First, participants must determine their AGI –total income minus all qualified deductions. Then they can refer to the chart below to see how much they can claim as a tax credit if they qualify.

Filing Status/Adjusted Gross Income for 2017			Source: IRS Form 8880
Amount of Credit	Joint	Head of Household	Single/Others
50% of amount deferred	$0 to $37,000	$0 to $27,750	$0 to $18,500
20% of amount deferred	$37,001 to $40,000	$27,751 to $30,000	$18,501 to $20,000
10% of amount deferred	$40,001 to $62,000	$30,001 to $46,500	$20,001 to $31,000

For example:

- A single employee whose AGI is $17,000 defers $2,000 to their retirement plan will qualify for a tax credit equal to 50 percent of their total contribution. That's a tax savings of $1,000.
- A married couple, filing jointly, with a combined AGI of $38,000 each contributes $1,000 to their respective company plans, for a total contribution of $2,000. They will receive a 20 percent credit reducing their tax bill by $400.

With the Tax Saver's Credit, participants may owe less in federal taxes the next time they file by contributing to their retirement plan. Accompanying this newsletter is a memo you can distribute to your employees regarding the 2017 Tax Saver's Credit.

This illustration is hypothetical and there is no guarantee that similar results can be achieved. If fees had been reflected, the return would have been less.

IRS/DOL Plan Error Self-Correction Programs

In the event that a plan discovers a practice breach based on IRS or DOL regulations, they may be well advised to attempt to apply for one of the self-correction programs identified below. It is typically advantageous to self-correct prior to the error being discovered by the IRS or DOL, as penalties and consequences may be significantly more severe.

<u>IRS Self-Correction Programs</u>
Plan errors can be corrected though the IRS Employee Plans Compliance Resolution System (EPCRS) to avoid the consequences of plan disqualification. There are three ways to correct mistakes under EPCRS:

1. Self-Correction Program (SCP) – permits a plan sponsor to correct certain plan mistakes without contacting the IRS or paying any fee.
2. Voluntary Correction Program (VCP) – permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of plan failures.
3. Audit Closing Agreement Program (Audit CAP) permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit

<u>Department of Labor Self-Correction Programs</u>
DOL programs for correcting reporting and fiduciary issues;

The Delinquent Flier Voluntary Compliance Program (DFVCP) assists late or missed Form 5500 filers in coming up to date with corrected filings.

The Voluntary Fiduciary Correction Program (VFCP) affords plan sponsors the chance to identify and fully correct certain transactions such as prohibited purchases, sales and exchanges, improper loans, delinquent participant contributions and improper plan expenses.

Disclosures

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ACR#232966 03/17