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The Opening Bell

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October 2018

Do You Have a Bias Against International Small-Cap Stocks?

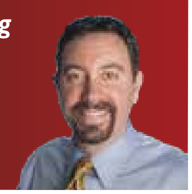
by Forrest Bell, CFP®, Senior Investment Advisor, Financial Planner

With the S&P 500 fully recovered from the correction earlier this year, and hovering near its all-time high, the current bull market in U.S. large-cap stocks remains one of the longest in history. The reasons for this bull market are still in debate. Skeptics suggest the rise is a product of artificially low, government-suppressed interest rates. Supporters, on the other hand, point to an ever-strengthening U.S. economy and impressive stock-earnings growth. Whatever the cause, there's no debating that there's been a long rise in U.S. large-cap stocks.

When one type of investment performs especially well, it becomes easy to believe that other types of investments aren't worth considering. The 2017 Bitcoin euphoria that lured some investors into making untimely and aggressive bets serves as a case in point. When something goes up and up and up, people tend to overlook the virtues of other investments. Take small-cap U.S. stocks, for example.

Last year, U.S. small-cap stocks (as measured by the Russell 2000 Index) underperformed their U.S. large-cap counterparts (as measured by the S&P 500) by 7%. This kind of divergence often happens. But it doesn't mean that small-cap U.S. stocks are broken. If we examine their performance over a longer period of time, we can get a better understanding of what happened in the last year. When we compare the five-year rolling returns of the Russell 2000 with the S&P 500 since 1996, the U.S. small-cap stocks perform well:

> ***Despite the merits of international investing, it ranks among the hardest things an investor can do.***
> — Forrest Bell, CFP®



Index	Average 5-Year Rolling Returns, 1996-2017
S&P 500	6.19%
Russell 2000	8.16%

As the chart suggests, the good years for U.S. small-cap stocks outweigh the bad ones. The same can be said for international small-cap stocks as well. Take the same time period starting in 1996. That's the year that the Russell Global ex-US Index — the index that tracks international small-cap stocks — came into being. The chart below shows the five-year rolling return of international small-cap stocks, as measured by the Russell Global ex-US index:

Index	Average 5-Year Rolling Returns, 1996-2017
S&P 500	6.19%
Russell Global ex-US	8.43%

Tougher Markets, but Higher Quality

The performance of international small-cap stocks may come as a surprise. After all, many international small-cap companies operate in countries that are not as business-friendly as the United States. And their home countries may not have a sufficient customer base for the company to really grow. Whereas plenty of U.S. small-cap companies can thrive without having to sell their goods and services outside even their home state, much less outside the U.S., many international small-cap companies don't have that luxury. But this initial disadvantage creates some great companies. To succeed, international small-cap companies often have to be world leaders in what they do. Their goods and services must be attractive to people living all over the globe. That requirement leads to some fairly innovative companies.

Even so, U.S. investors neglect international small-cap stocks. Only 1% of U.S. mutual

(continued on page 2)

MORE COVERAGE INSIDE

Do You Have a Bias Against International Small-Cap Stocks?

(continued from page 1)

fund assets, for example, are invested in international small-cap stocks. Exploring why institutional investors ignore international small-cap stocks is beyond the scope of this article, but it is worth commenting on why individual investors commonly exclude them.

Look Out for Familiarity Bias

Despite the merits of international investing, it ranks among the hardest things an investor can do. For one thing, it means confronting something known as "familiarity bias." Familiarity bias describes the tendency people have to prefer what is familiar to them. Marketing departments spend a lot of time and money on establishing their brands because of the familiarity bias. Familiar things feel less risky, even when they aren't, and consumers will buy what they recognize.

The familiarity bias doesn't just influence what type of cereal we buy for breakfast, though; it even influences how we invest. Studies show that citizens of any given country (not just the US) tend to invest more in companies from their home country. So for most U.S. investors, international stocks (including small-cap) feel riskier than U.S. stocks — even when they're not.

The overwhelming majority of publicly-traded international small companies are profitable. In fact, of the constitutive stocks in their index, 83% of them pay dividends. By the same measure, less than half of U.S. small-cap stocks do the same. Only about 10% of constitutive international small-cap companies lose money. In the U.S., the percent of constitutive small-cap companies losing money is closer to 30%. Despite the financial health of international small companies, familiarity bias still works against them. When U.S. stocks suffer a short bout of poor performance, disappointment is ameliorated by the accepted wisdom of taking a long-term perspective. A similar short bout of poor performance from international stocks is often taken as evidence that they should be avoided.

Familiarity bias seems to be a part of human nature. In his book *Thinking, Fast and Slow*, Daniel Kahneman — winner of the 2002 Nobel Prize in Economic Sciences — wrote: "A reliable way to make people believe in falsehoods is frequent repetition, because familiarity is not easily distinguished from truth." In every area of our lives, including money matters, we should be conscious of how familiarity can affect our decision-making. ■

Reaping the Harvest

(continued from page 4)

still healthy, has much to offer, and has a chance to "give back." She asks *Do you do retirement coaching?* I answer:

Yes, as a matter of fact, I do. I have coaching clients from ages 25 to 75. Every age and stage presents another transition, and transitions are hard — and usually painful in unexpected ways. It's wise to have a knowledgeable companion for the journey — a coach. Transition is a time to grieve what we're losing, celebrate what we've accomplished, and plan for what's next.

Embracing Transition

What an incredible first session we had — this woman who called about retirement coaching and I. It became obvious that our work will lead us to the greatest harvest of all: the harvest of a rich, deep, purposeful, meaningful life; one that is well-lived and deeply appreciated.

This is the time to come into your fullness, I say, *to come into your wisdom, power, and peace! But that usually doesn't arrive all at once or all by itself. You have to clear everything up, take charge, "reflect and capture" what you think, claim who you are. And then to actually be who you are: know what you care about, what you believe, and what your most important gifts and talents are; and decide how you want to live and what you want to do with the many years ahead.*

Winter will come eventually, but not just yet. ■

NEW TEAM MEMBER SPOTLIGHT:

Antonio Mercado, Relationship Manager

When we set out to hire a new Relationship Manager this year, we took our time, and that proved to be worth it when we found Antonio Mercado! In his own words, "I have an inner drive to make each day a better day than the previous day." He describes himself as a "people person", who is fascinated with learning more and more about a client's background and history, which makes working directly with clients ideal. To top that off, Antonio has an impressive 25 years of experience in financial services, including trading, operations, and relationship management. Welcome, Antonio!

UPCOMING EVENT: 12/19/2018

WEBINAR

Investment Committee Update

Wednesday, December 19, 2 – 2:30pm

Our team will share economic and market commentary, discuss the potential impact of today's political climate on markets, and present the most recent thinking from the Investment Committee as it relates to strategy or specific asset classes.

The final Investment Committee webinar of 2018 will be presented by:

Jim Bell, CFP®
Founder, Chief Investment Officer

Corinne Salera Bedford, CFP®
Portfolio Manager, Investment Advisor

This webinar is open to members of the public as well as our clients.

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Bell Investment Advisors Financial Planning ▪ Investment Management ▪ Career/Life Coaching

California Taxpayers vs. the New Federal Tax Law

by Jim Bell, CFP®, Founder and Chief Investment Officer

On September 1, 2018, the California State Legislature adjourned without conforming the California State Income Tax to any part of the Republican Federal Tax Law, known as the Tax Cuts & Jobs Act, passed last December. Consequently, the federal law will not cause Californians to pay more in *state* income tax for 2018 (more below on what they could have changed), but the new tax code will nevertheless have a substantive impact on many Californians — they will be paying a lot more in *federal* taxes come April 15, 2019.

State and Local Taxes (SALT)

One of the biggest changes from the new federal law is a severe limit on state and local tax (SALT) deductions. Under the previous federal law, SALT deductions were unlimited for individuals and families — Californians could deduct all of their state income taxes and all of their property taxes on their federal returns. Yet under the new federal law, SALT deductions are limited to $10,000. This can have significant consequences for taxpayers in states with high state taxes and those with high home values. These circumstances might just sound familiar to some Bay Area residents.

Let's take Oakland residents John and Sally as an example. For their joint income, they owe $95,000 to the state. They also owe $20,000 in property tax to Alameda County, so their SALT total = $115,000. Before the new federal law, John and Sally could deduct all $115,000 from their federal income tax. Now that the limit has plummeted to $10,000, John and Sally have $105,000 in non-deductible state and local taxes and will consequently owe an additional $40,000 in federal income tax. That is quite a leap from what they would have paid in 2017.

The federal law will not cause increased CA state taxes, but Californians will pay a lot more in federal taxes.

— Jim Bell, CFP®

Capital Gain, Standard Deduction, and Personal Exemption

There are several ways that the California income tax code does not conform to the new federal law. California taxes long-term capital gains as ordinary income; federal law taxes long-term capital gains at a lower, or "preferential", rate. Congress nearly doubled the standard deduction to $24,000 for couples and $12,000 for singles. At the same time, they eliminated the personal exemption, which amounted to a $4,050 deduction for each person listed on the federal return including dependents. However, California state taxes will not conform to this elimination of the personal exemption; even though Congress killed it at the federal level, California taxpayers can still claim that $4,050 exemption deduction for themselves and their dependents on their state return in addition to the new, higher standard deduction on their federal return.

Mortgage Interest

Starting in 2018, the new federal tax law limits the mortgage balance up to which taxpayers can deduct the interest to only $750,000 on a first or second home. The prior law set the limit at the interest on $1 million in mortgage debt. Homeowners who were at the $1 million limit prior to 2018 will be grandfathered in for deducting interest at that level. For anyone starting a new mortgage in 2018, the limit is $750,000.

In contrast, on their state returns a California taxpayer can still deduct interest on up to $1 million in mortgage debt used to buy or improve a first or second residence, along with $100,000 in home equity debt that was not used to buy or improve a home. The federal law allows zero interest deduction on home equity debt not used to improve a home.

Experts expect some breakdowns for people using software to file 2018 returns and even more trouble for people doing their own returns unassisted.

Acknowledgment to Pender, Kathleen. "Federal law won't raise California income taxes" SF Chronicle *8 Sept. 2018*

Our readers can find further analysis and explanation of these tax code changes in my multi-part series, "What is Relevant About the New Tax Law?" on the Bell Finance Blog. Those can be found on our website, www.bellinvest.com. ■

UPCOMING EVENT: 10/24/2018

THE WOMEN'S ROUNDTABLE

Film Screening: *RBG*

Wine & Cheese Gathering
Wednesday, October 24, 6 – 8:30pm
Bell's Oakland Office

RBG is a revelatory film that explores Ruth Bader Ginsburg's life as a law student, wife, mother, law professor, and the 107th Supreme Court Justice of the United States. Through interviews with colleagues, lifelong friends, and family, the film follows the span of her partnership with husband Marty Ginsburg and her prodigious career as a jurist who applied the law to dismantle gender-based discrimination statutes and advocate for women's rights.

There is no fee to attend this event.

Space is limited. Reservations for you (and a guest, if you wish) are required.

800.700.0089, ext. 100 or RSVP@bellinvest.com.

NOTE: While The Women's Roundtable is geared toward a female audience, Bell Investment Advisors will be presenting a screening in 2019 for both women and men.

Reaping the Harvest

by Bonnie Bell, MA, MDiv., Principal, and Director of Career/Life Coaching

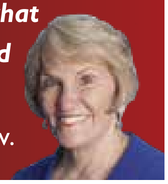
It seems like, every year, the very day after Labor Day I am ambushed by fall. While I am still holding onto summer, still wearing my white jeans, and still having barbecues, I don't want to even think about fall. This year the weather even joined the conspiracy in Berkeley, so we could have our patio doors open all day and the windows open all night. I could have sworn it was just the beginning of a long, hot summer.

As if the whole of nature's plan were to kick me unexpectedly into autumn, early September was dark and cold, making it harder than ever to get out of bed. The first thing I did after forcing myself from under the warmth of the blankets was to turn up the heat, after which I raised the kitchen blinds — and right there on the other side of the window was a flying Wallenda-type squirrel streaking through a pile of dried leaves with a walnut in his jaws. I swear those orange leaves weren't anywhere to be seen when we were tidying up the patio for the barbecue yesterday! Next, when I went out onto the driveway to retrieve the newspapers, I noticed the same frenzied squirrel digging a hole in the earth for his nut.

The Rush is On

Before I'd had a chance to put the water on to boil, reality came crashing in: *Back to school! Back to work! Here come the pumpkins! Here comes the turkey! The Christmas Tree! The New Year! So much to do! I'll never get it done!* When I get to the office, the phone seems to be ringing a little more urgently. Something has nudged people to feel the same way I am. They need to get busy finding a new job! That means a new resume, a new search, interviews, lots of anxiety. The rush is on. No wonder the squirrels are flying out of the trees!

Transition is a time to grieve what we're losing, celebrate what we've accomplished, and plan for what's next.
— Bonnie Bell, MA, MDiv.



The shorter days, longer nights, and darker mornings are getting me in the mood to pick up my pace and have me remembering the particular sights, sounds and smells of fall — every year, I forget how much I love these. I just took a moment to Google "Harvest Moon for Berkeley" and see that the gigantic orange ball will make its appearance on October 24, in case you are interested. I always am. Last year's was ridiculously huge and ridiculously orange and would have brought me to my knees had I not been in the car when I spotted it, hanging perilously close to a rooftop on a Berkeley hillside. Now, in writing this, my head is beginning to fill with *harvest thinking:* pumpkins on the vine, goblins, witches brew, apple cider, pumpkin pie, a festival of colors and smells, the fruits of our labor, Halloween.

What's Next?

This morning I woke up thinking about the new client I met with for the first time just yesterday. She is thinking about what's next for her and how to keep doing what she loves to do, but with a little less stress and a little more time to enjoy this next stage of her life — while she is

(continued on page 2)