Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Could Tax Reform Help or Hurt Your Portfolio?

By Mitch Zacks
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Stocks have continued to rally in spite of no major legislative accomplishments coming out of Washington D.C. As I've written before, this outcome is somewhat intuitive – markets prefer gridlock over sweeping policy changes, particularly changes that affect property rights. So, in a sense, the fact that no major legislation has passed is a positive economic event in and of itself.

This calculus changes a bit when it comes to tax reform. In my view, the market would be highly receptive to tax reform and there could be some major winners to emerge if politicians manage to reach a compromise that streamlines the tax code and lowers effective tax rates for most individuals and corporations.

Tax reform is still a big "if" at this stage, but some change to the law (even if minor) seems more likely than unlikely at this stage. In preparation, investors should consider screening their portfolios and the market in search of sectors and companies that could benefit from lower rates. At Zacks Investment Management, by using our databases, software, models and completely unbiased research powered by Zacks Investment Research, we are able to run multiple screens based on the criteria I'll describe to you below.

To note: below, I'll just discuss investment ideas on a high level, but if you want specific recommendations, please do not hesitate to reach out to us.

A Quick Look at Proposed Changes

This column is focused on how tax reform could impact *corporate* America, so we'll look only at proposed changes to the corporate tax code. Here is a quick summary of what's on the table:

- Drop the tax rate for small businesses to 25% (currently small businesses are generally taxed at the individual level).
- Lowers the corporate tax rate from 35% to 20%.
- Repeals the corporate alternative minimum tax.
- As an incentive to increase business investment, it allows

businesses to immediately write off the cost of new investments over five years.
- Partially limits interest deductibility.
- Keeps the research and development tax credit, along with the low-income housing credit.

Who Might Benefit?

Let's focus on the lower corporate tax rate. If that were to pass, we could technically screen companies based on their effective tax rates. If we did that, we would take a close look at those companies with the highest rates, as they would arguably benefit the most from a cut.

Another beneficiary could be small-cap indexes, for a couple of reasons. First is that regional and small banks make up a significant percentage of domestic small-cap indexes, and these small banks tend to have high average tax rates. Second is that small-cap stocks tend to be more domestic-oriented companies, meaning they generate a higher share of their revenues in the U.S. versus abroad. It follows that since last year's Presidential election, a basket of high tax banks has outperformed the S&P 500.

Companies with large shares of profits overseas could also see a major benefit from tax reform, assuming that some sort of repatriation clause is included in the new law. Thereby, giving incentive for these companies to move some of their overseas profits back to the U.S. - knocking out their tax liability while also seeing a large influx of cash available for buybacks, dividends, and/or capex could boost shares.

Bottom Line for Investors

There is largely consensus among Republicans on the need for tax reform, but how to accomplish it is a different ballgame altogether. For example, the original House Republican plan called for using a border adjustment tax to generate revenue needed to finance lower rates for other sectors. This idea had legs amongst many Republicans and analysts, but it was essentially nixed by two Senators from Arkansas (the home state of Walmart). The point is: tax reform is quite a bit more complicated than most think, and the process could get ugly.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.