



The more things change, the more they stay the same: A perspective on what life might be like in a post-pandemic world.

One year into the global coronavirus pandemic, daily life is just beginning to resume. We expect consumers will resume many pre-pandemic activities but that some of the behaviors learned during the pandemic will remain.

In this report we provide an update on the coronavirus and show that vaccinations are likely to bring herd immunity some time in the coming months but chances are that the coronavirus or its variants are likely to be with us for years to come. We consider what life might be like in a post-pandemic world from the perspective of the three main sectors of the US economy:

- **Consumers** - Consumer spending comprises about two-thirds of the US economy and there are likely to be long-lasting impacts on how and where consumers spend their money. We show how spending and employment have changed over the past year.
- **Businesses** - Corporations were about evenly split between winners and losers last year and pandemic shutdowns hastened the secular changes that were already underway, changes that are likely to improve profits for a large section of companies. Among the losers, higher debt burdens may hobble them for years to come.
- **Government & the economy** - Federal stimulus blunted the edge of the pandemic recession, with deficit spending adding nearly 20% to US GDP over the past four quarters. While federal finances might be strained in the short-term, there is little immediate cause for concern and we show that deficits can be beneficial from a financial perspective.

March 2021



Introduction

As we enter the twilight of The Great Coronavirus Pandemic of 2020, we offer a perspective on what life might be like for the three main sectors of the US economy - consumers, businesses and government. While the duration of the pandemic is likely to lead to scarring within each of the sectors, many behaviors learned during the pandemic are likely to persist. There will continue to be winners and losers (Exhibit 1).

For consumers, a large part of their day-to-day existence has shifted to the virtual world during the pandemic with shopping, working and even dating taking place online. We expect some level of retail activity to return to the real world but the pandemic merely accelerated the trend towards e-commerce that was already occurring. Consumers will end the pandemic greener than ever (70% of electricity capacity added in 2021 will be from renewables) and more suburban (an estimated 80,000 people left New York City each month of the pandemic). Overall, consumers will exit the pandemic in relatively healthy financial shape thanks largely to the three rounds of stimulus payments that were made directly to consumers. On the employment front, the US has lost over 9 million jobs, many of them concentrated in just a few sectors. Unfortunately, it may take years for those jobs to return.

Pandemic impacts on business were mixed with the winners continuing to win and the most impacted sectors facing an uncertain future. For the winners, the questions surround the degree to which future demand has been pulled forward. Those that saw pandemic revenue bumps may see short-term revenue declines but we expect they will continue to benefit from underlying trends. The most impacted businesses look nothing like how they did when they entered the pandemic with high debt loads hindering investment, possibly for years to come and making them 'zombie-like' businesses. Overall, the pandemic provided a real world laboratory where businesses could experiment with cost cuts, optimal real estate footprints and employee location. Overall, these experiments largely appeared to supplement earnings with higher margins evident in many cases. If 'work-from-home' truly allows employees to work from anywhere, they may face a shock when their New York and San Francisco salaries are adjusted downward to account for local cost of living.

It has been said, "In a crisis, everyone's a Keynesian" and governments around the world directed massive amounts of aid to populations impacted by the virus. In the US, this resulted

in a sharp increase in government debt that many fear is likely to lead to higher taxes in the future. Indeed, President Biden campaigned on a platform that called for higher taxes on high earners but tax professionals don't see much chance of any tax legislation passing in 2021. On the municipal side, state and local governments have seen pandemic hits to their finances, but the implosion of local budgets that was widely expected at the start of the pandemic never materialized. Tax receipts have been higher than anticipated due to better performance of the economy and capital gains arising from the soaring stock market. Overall, government finances are strained but the US government has an almost infinite capacity to issue debt and faster economic growth will reduce debt ratios in the years to come. Finally, inflation is likely to be somewhat higher than pre-pandemic levels due to the Fed's monetary easing and this will reduce debt burdens in the years ahead. Overall, government finances are strained but not stressed.

Before life returns to normal, of course, the pandemic itself must end. When is that likely to happen? We attempt to answer that question first.

Coronavirus status in the US

After spiking sharply around the November-January holiday period, new virus cases in the US have plunged since. This plunge coincides with the widespread administration of vaccinations that began in early January (Exhibit 2).

Confirmed cases today are about where they were last October, before the holiday-induced spike. Fatalities have also fallen sharply from an early February peak. The pace of fatalities provides a clue that undocumented coronavirus cases have also declined. We've believed that fatality trends have been more telling about virus spread in the past few months than confirmed case counts as the vast majority of virus-related fatalities are likely to be counted while testing only identifies a portion of those who have contracted the virus. This cohort of undocumented cases is a large and probably immune one and it is an important pillar in the move towards herd immunity.

After accounting for confirmed cases, fatalities, undocumented cases and vaccinations to date, which makes up the immune population, we can then identify the portion of the US popu-

Ex. 1: Pandemic-era winners & losers

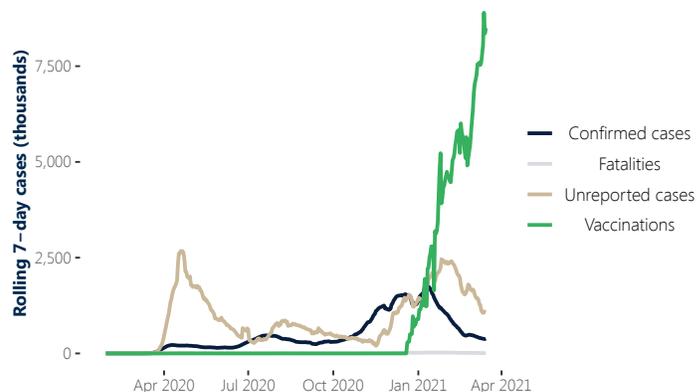
Winners

- Renewables
- Amazon.com
- Employers
- Stock market
- Air Freight
- Florida

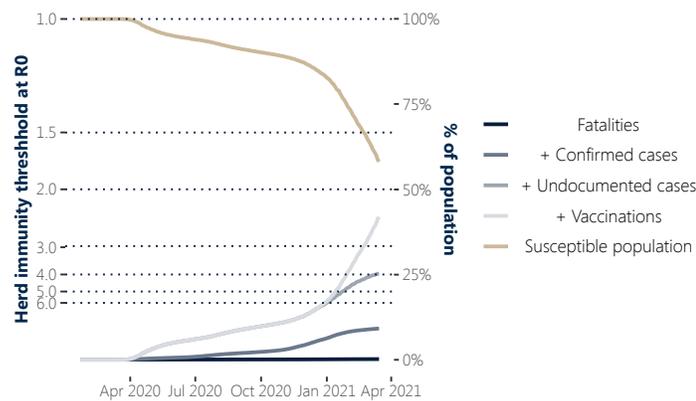
Losers

- Fossil fuels
- Macy's
- Employees
- Bond market
- Airlines
- New York

Ex. 2: US virus cases



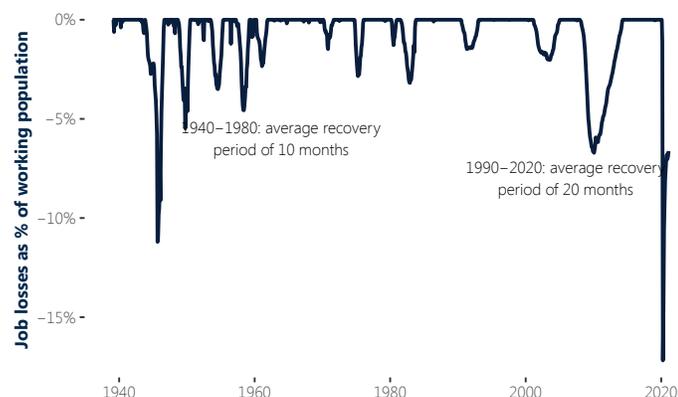
Ex. 3: US herd immunity thresholds



lation that remains susceptible to infection and compare it to herd immunity thresholds. This analysis is shown in Exhibit 3 and shows that the immune population could be approaching 50% of the total US population as of March 2021. The coronavirus is thought to have a basic reproduction rate (R0) of between 2 and 4; herd immunity occurs at $1 - (1 / R0)$. If the virus has an R0 of 2 then the herd immunity threshold of 50% of the population is rapidly approaching. The R0 is probably higher than two so additional vaccinations will be needed but the US announced on March 11 that it was ordering states to make vaccines available to all citizens by May 1. We would estimate that process will be complete perhaps sometime in Q4 of 2021.

Will the virus disappear after mass vaccinations are delivered? We would guess the virus has probably become endemic and we will see flare ups in the future. First, vaccines are not 100% effective. Efficacy rates vary between 90 - 95% for the three approved vaccines so some portion of the population will not gain immunity even though they have been vaccinated. Second, many eligible vaccine recipients will choose not to be vaccinated leaving a relatively large non-immune population. Third, the US is far ahead of most of the rest of the world in delivering vaccines so coronavirus will continue to spread among unvaccinated populations. Finally, viruses routinely mutate which is likely to ultimately weaken immunity. Follow-up immunizations are likely for years to come.

Ex. 4: US payrolls drawdown



In some senses, then, it is possible that coronavirus never goes away and that we will just become accustomed to containing it. Belief-scarring, or a persistent change in probability expectations for extreme, negative shocks, is likely to be one consequence of the pandemic and that could be an economic headwind in the future.

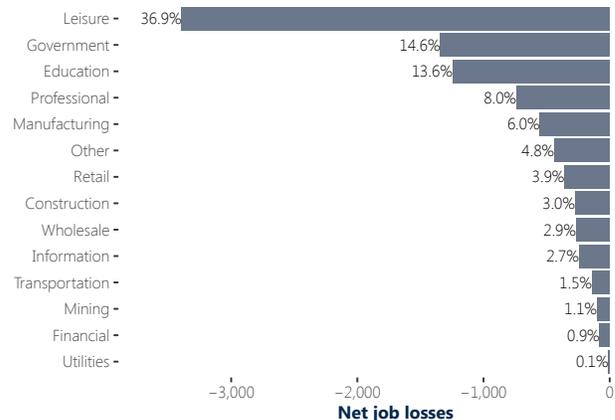
Consumers

Despite bearing the brunt of the virus both physically and financially, consumers will exit the pandemic era in pretty good shape with job creation the potential weak link. Job losses at one point totaled over 20 million or 17% of total payrolls before recovering through the year. (Exhibit 4). This drawdown in employment is still currently the largest in US history and it could take years for a full recovery. Recoveries in payroll drawdowns have been lengthening since the 1990s. The US has experienced twelve periods of large job losses since 1939 and through the 1980s, recovery usually took about 10 months, regardless of the depth of the job losses. Since 1990, the recovery period has doubled and jobs lost during the financial crisis took about 4.5 years to recover. The current jobs drawdown is larger than the one experienced during the financial crisis.

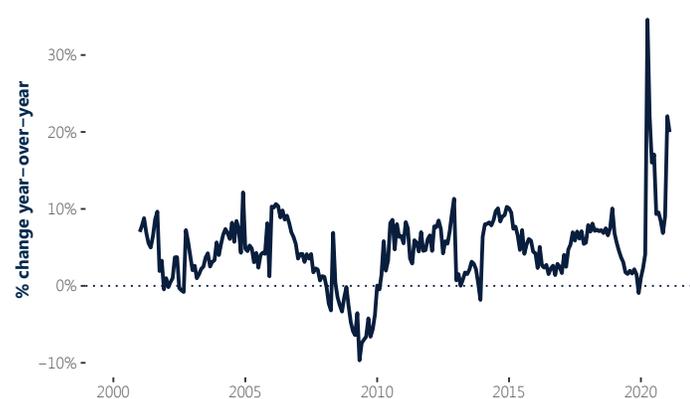
Job losses have been concentrated among a few sectors. Leisure, government and education / health care absorbed nearly two-thirds of the nine million net job losses since the start of the pandemic (Exhibit 5). The degree to which these jobs return depends largely on consumer behaviors in the post-pandemic world. Will consumers travel or go to the movies as they did in the past? Will children return to in-person schooling at the rates they did previously? The answers remain to be seen.

Apart from issues in the job market, however, consumers are exiting the pandemic in healthy shape. Federal stimulus has offset impacts of job losses and resulted in an increase in personal income of nearly 15% since January 2020. Home prices appreciated 9.7% and job openings have recovered sharply suggesting employers have resumed hiring. Consumers have been cautious with their stimulus payments and have actually saved most of the payments they've received. Spending fell by about half a percent and credit card balances declined as well. Rising incomes and falling expenditures means consumers

Ex. 5: Job losses by sector



Ex. 6: Consumer comfort index



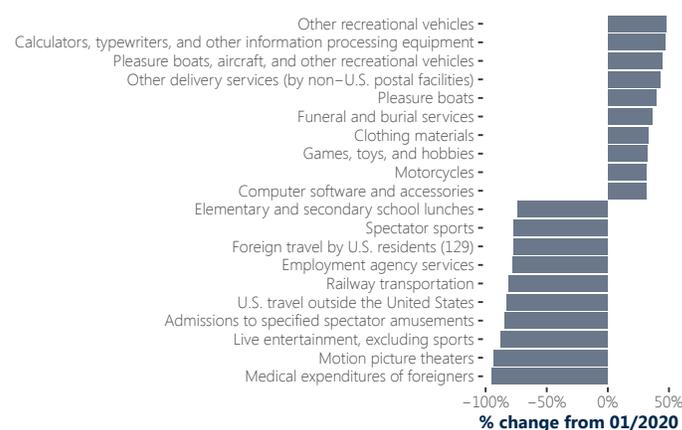
have seen their savings increase by over \$4 trillion since the onset of the pandemic and stock market gains provide another \$6 trillion of savings. The March 2021 stimulus bill will add \$1.9 trillion to these amounts and they collectively amount to about 100% of GDP.

Constructing a simple consumer comfort model consisting of payrolls, job openings, savings, credit usage and home prices shows consumers are in the strongest shape they've been in since at least 2000 (Exhibit 6). Consumers have ample firepower to satisfy pent-up demands which should support continued economic recovery but we expect some caution will remain until the pandemic has been clearly halted.

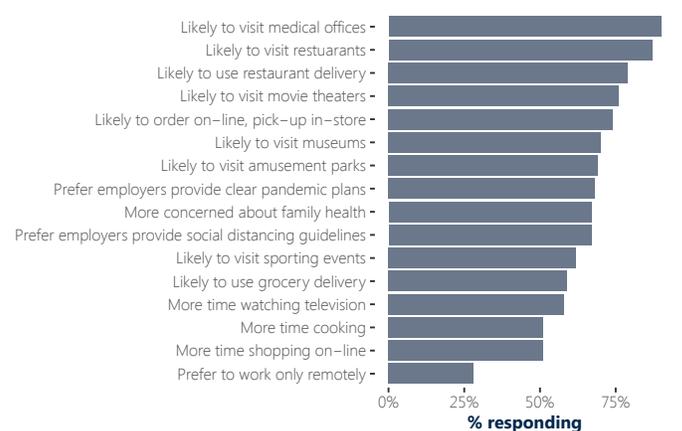
Despite widespread lockdowns in 2020, consumer spending fell only 0.5% but the spending mix changed dramatically. An examination of detailed Personal Consumption Expenditures reports from the Bureau of Economic Analysis shows homebound consumers sparked a boom in home refurbishment and spending on 'carpets and other floor coverings' rose 27%. They prepared to work at home and two of the categories seeing the largest increases were 'calculators, typewriters and other information processing equipment' and 'computer software and accessories'. They indulged hobbies and spending on things like film supplies, sewing equipment and 'games, toys and hobbies' all rose more than 28% since the pandemic began. Products were likely purchased online as spending on delivery services rose by 43%. The tragic toll of the virus is also evident in consumer spending data; expenditures on 'funeral and burial services' increased by 36% while fear of group travel resulted in increased spending on pleasure aircraft, automobiles, and the category that saw the largest increase, 'other recreational vehicles' which rose 47.6%.

On the negative side of the spending ledger were some obvious categories: spending on 'motion picture theaters' fell 93.7%; live entertainment dropped 87.3%; and 'US travel outside the United States' was 82.9% lower than 2019. But some less obvious sectors also saw large declines. The category covering medical tourism, 'Medical expenditures of foreigners' showed the largest decline in spending, falling over 95%. Exhibit 7 shows the top and bottom percentage changes in PCE spending categories through January 2021.

Ex. 7: Pandemic consumer spending by category



Ex. 8: Consumer survey results



The average of the nearly 400 categories tracked in the PCE reports changed by nearly 17% on an absolute basis, nearly four times greater than any change over the past 20 years. Even if consumers resume previous behaviors, it will take time for categories to return to previous trend values and our best guess is that some of these consumer spending shifts are likely to be permanent. If that occurs, the normal we return to won't be the same as the normal we left.

Some insight into post-pandemic consumer preferences can be gleaned from a survey conducted in September 2020 by IBM (Exhibit 8). The survey queried consumers about a range of issues related to work, transportation and activities. Survey results showed consumers are either using or likely to return to places such as medical offices, restaurants and movie theaters. Work attitudes show employees feel most comfortable when their employers provide clear pandemic planning guidelines. Interestingly, only about 28% expressed a desire to exclusively work remotely; opinion was about equally divided about working from home, working in the office or spending time at home and in the office. The survey showed consumers are also likely to continue behaviors learned during the pandemic such as spending more time at home and using on-line services.

The survey did yield some interesting data. Consumers are more concerned about the health of their families and, although most consumers will return to previous behaviors,

some 9-10% of respondents stated that they would never return to amusement parks, movie theaters, live sporting events or fitness centers. Losing 10% of a customer base could result in structural shifts in these industries and consumer concern about health suggests caution will persist long after the pandemic has ended, especially if coronavirus has become endemic.

Business

Like consumers, businesses have also experienced profound shifts as a result of the pandemic. Many sectors were completely off limits during the pandemic and those such as airlines, casinos and hotels saw revenues decline by over 50% in 2020. There were winners, too, with Internet & Direct Marketing (mainly Amazon.com), Health Care Technology and Gold miners seeing revenues up to 24% higher over the year.

Amazon is an example of one of the clear winners during the pandemic. Its revenue rose to \$386 billion, more than \$100 billion, or 37.6%, higher than it was in 2019. The company hired over 500,000 employees, about 3.7% of the total jobs added during the year. Amazon’s massive investment in its Prime delivery service paid off in spades as Americans purchased nearly everything on-line in April and May of last year. The company’s ability to grow into that demand surge kept consumers fed, medicated and clothed and surely saved lives by keeping people out of stores.

The stock market didn’t appear to be entirely efficient in allocating returns in 2020 with many of the hardest hit sectors ending up to be some of those with the highest returns. The casinos and gaming industry, for example, saw revenues plunge by 52% in 2020 and yet the average stock price for the ten companies in the group rose by 37% (Exhibit 9).

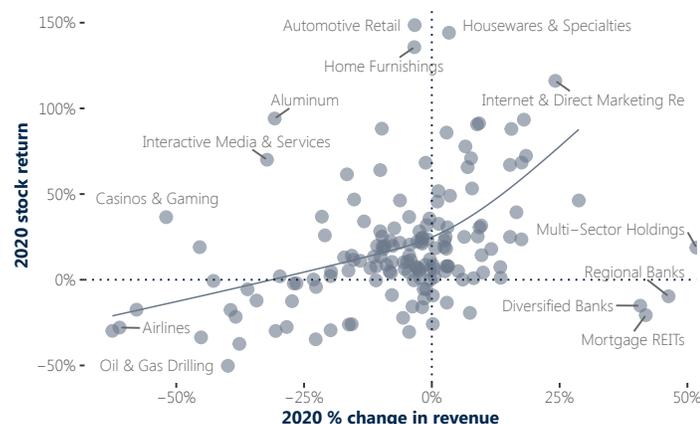
The pandemic provided a real-world laboratory that allowed companies to discover which were truly variable expenses and which were fixed. Companies often viewed occupancy costs as being fixed, for example, but many companies were able to reduce costs by not renewing leases, consolidating space or by simply not paying landlords who often faced eviction moratoria that kept them from enforcing lease provisions. Companies in many industries were able to quickly slash travel, entertain-

ment and professional services expenses to match declines in revenue and they were able to maintain or even grow margins without shedding employees. They issued as much debt as they were able to and preserved cash by halting stock repurchase programs, cutting dividends and postponing capital investment. Larger companies were able to use size to their advantage by generating positive cash flow from their working capital. In all, companies saw long-term debt balances soar but they largely held the proceeds in cash. At the end of 2020, US companies held \$3.8 trillion of cash on their balance sheets, an increase of 46% from 2019 year-end balances.

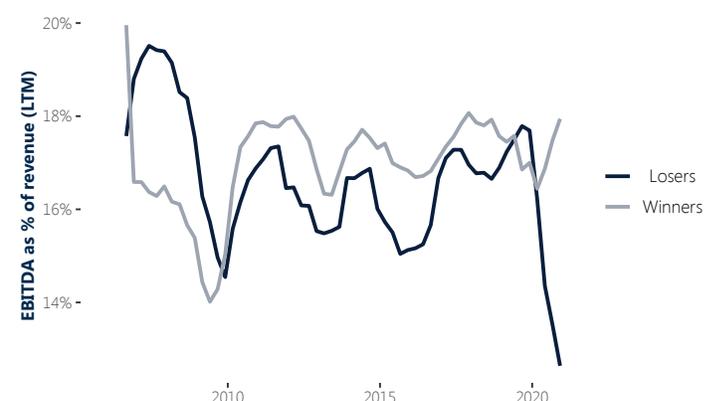
Looking ahead, we believe pandemic lessons learned will be margin accretive for many companies. If they allow some employees to work from home, employment costs are likely to decline as compensation levels fall to adjust to the local costs of where employees live. Recruiting will be enhanced as companies can recruit employees from anywhere in the world. Many companies adopted direct-to-consumer (DTC) strategies to power their on-line presences thereby eliminating distribution costs. The advent of Zoom meetings is likely to reduce at least some business travel as meetings can still be conducted via video. Reduction in these expense items will improve EBITDA margins and we have already begun to see this impact. In Q4 2020, less pandemic-impacted companies saw their EBITDA margins fully recover to pre-pandemic levels and those earnings helped to fuel equity prices.

We expect that while many of the winners will continue to win, the pandemic losers will face a long road of recovery ahead. Consider the plight of just three companies, American Airlines (AAL), Boeing (BA) and Carnival Cruise Lines (CCL) who saw their revenues plunge by a collective 43% during 2020 with negative free cash flow of over \$35 billion. Like other companies, they were able to draw upon available credit facilities to increase their cash and they offset negative cash flow with new net long-term debt. Those debt balances now stand at over \$80 billion, however, nearly four full years of the free cash flow they generated prior to the pandemic. Those companies will see future flexibility restricted, foregoing dividends, capital investment or stock repurchases as they pay down debt; they will also be vulnerable to any future economic shocks while their

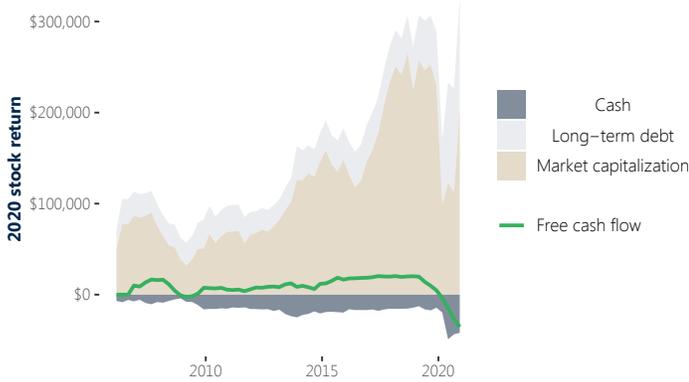
Ex. 9: Change in revenue vs 2020 industry group return



Ex. 10: EBITDA margins of ‘winners’ and ‘losers’



Ex. 11: Capital structure of potential zombies



debt remains high and their balance sheets heal. We counted nearly 200 companies who increased their LTD in 2020 by more than one year of operating cash flow.

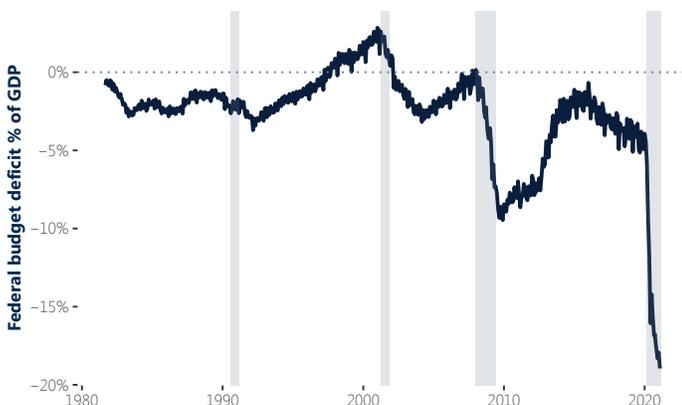
For these ‘zombie-like’ companies, we haven’t seen much overall change in enterprise value since the start of the pandemic. But for AAL, BA and CCL, there has been a pronounced shift in value from equity holders to debt holders (Exhibit 11). The reversal of that shift may provide investment opportunities but investors could also invest in companies that don’t face these issues and perhaps experience lower return volatility.

Government

If there was one benefit of the timing of the pandemic it was that it occurred so soon after the financial crisis when lessons learned from that episode were still fresh. The US government moved quickly to support the economy, passing three stimulus bills that added a total of about \$5 trillion, or 15%, of gross domestic product (GDP). The Federal Reserve also swung into action, implementing quantitative easing that expanded its balance sheet by \$4 trillion and pledging to purchase corporate bonds, high yield bonds, mortgage bonds and treasury bonds, all of which had the impact of thawing credit markets that had become frozen.

There has been much hand-wringing about this support with investors and prognosticators predicting everything from stock

Ex. 12: Federal budget deficit as a % of GDP

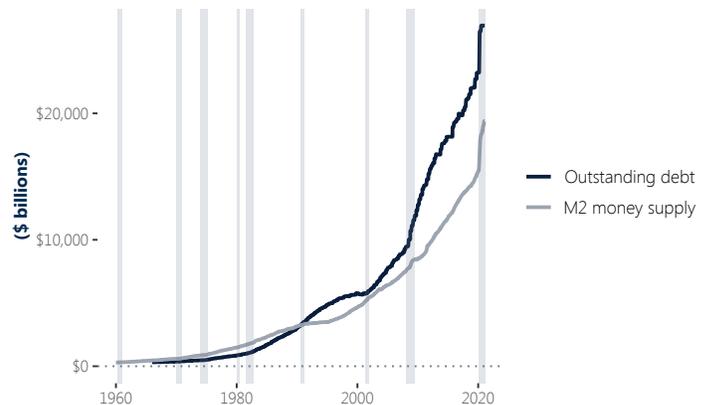


and bond market crashes to hyperinflation and massive tax hikes to pay for government bounty. We don’t expect any of those outcomes.

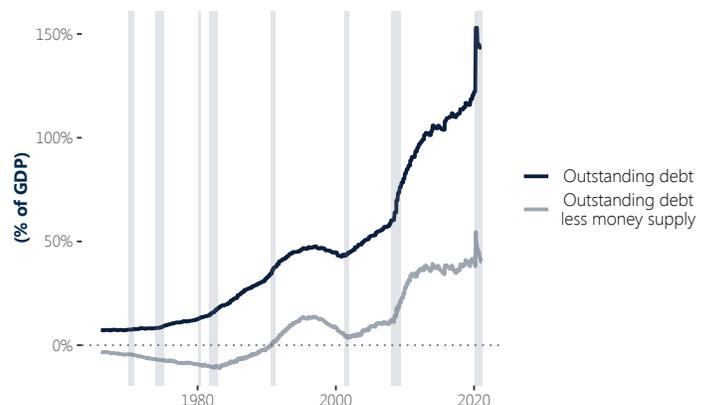
The federal budget deficit has soared as a result of massive stimulus and lower tax receipts and that has led to an explosion of outstanding government debt. This has caused much concern, perhaps due to the US’ puritanical heritage that views debt as sinful. But US government debt exists for a simple macroeconomic reason - the US dollar is the world’s reserve currency and the US budget deficit (and trade deficit) absorbs excess global liquidity. In times of crisis, investors demand more dollars and the budget deficit creates the supply to meet that demand. As a result of the three US pandemic stimulus bills, the budget deficit has swelled to over 25% of GDP and federal debt now stands at 143% of GDP.

Because the US finances itself entirely in its own currency, it can issue virtually unlimited amounts of debt. It can issue debt as long as investors demand it, to be more precise. Much of the pandemic stimulus involved direct payments of cash to consumers. These cash payments swelled the money supply (Exhibit 13) which rose along with debt. That liquidity ultimately reinvests in assets which include government bonds. In many ways, the government is creating monetary velocity by issuing debt that results in greater cash holdings that eventually get reinvested back into debt.

Ex. 13: Federal government debt & money supply



Ex. 14: Federal government debt / GDP



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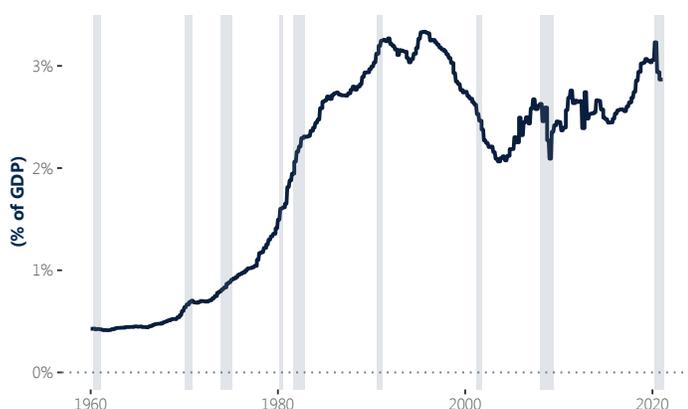
If we think of net debt, or debt less cash holdings, as we do when looking at corporate credit, the debt / GDP ratios look much less scary with the net debt-to-GDP ratio standing at about 40% of GDP, a hundred points lower than the ratio calculated using gross debt (Exhibit 14). This idea is controversial, flirting with Modern Monetary Theory and Keynes' 'paradox of thrift' but the fiscal responses to the financial crisis and the pandemic show that the explosion of government debt did not cause currency devaluation (the US dollar has appreciated 12% since 2009), hyperinflation (CPI has averaged 1.8% since 2009) or a market collapse (a stock/bond blend has generated average returns of 9.3% since 2009).

Moving away from macroeconomic controversies, we can look at a much simpler measure to show why the higher government debt balance isn't crippling the economy. Interest rates have plunged in recent years and that has dramatically reduced federal borrowing costs. Government cost of debt was 4.5% in 2007 and is 2% today. The US Treasury could issue more than twice as much debt as it did in 2007 and interest costs would be the same. Exhibit 15 shows this trend clearly; federal outlays for interest expense as a percentage of GDP are back to where they were in the 1990s despite a five-fold increase in the debt balance so by debt service measures, the level of federal debt isn't particularly concerning.

The other typical concern about high debt balances surround the potential for tax increases to be instituted to pay for government spending. Indeed, in March, the Biden Administration announced that it was seeking higher corporate, high income and estate taxes in its next economic plan, due presumably in 2022. While there may be tax increases, those will be made for political reasons, not economic ones.

Another look at Exhibit 14 shows that there is little historical precedent for using tax increases to reduce federal debt because there is not any need to pay off the federal debt and to do so would be contractionary. The best method to diffuse debt is to grow the underlying economy with moderate (ie 2-2.5%) inflation. This serves to reduce debt / GDP ratios and the modest inflation decreases the future value of outstanding debt, especially over the long horizons over which federal budget decisions are typically made.

Ex. 15: Federal debt interest payments / GDP



Governments incur budget deficits to increase economic growth and, if they are successful, debt ratios will naturally fall. If the US economy grows at 3% on average for the next 30 years while outstanding debt balances grow at 1.5%, the debt / GDP ratio will fall from 143% to 92%.

Inflation is another means of reducing the future value of debt. The current \$29 trillion debt balance is worth \$15 trillion in 2050 at an inflation rate of 2%, for example. If a budget deficit spurs higher economic growth with some inflation, high apparent debt ratios begin to fade quickly.

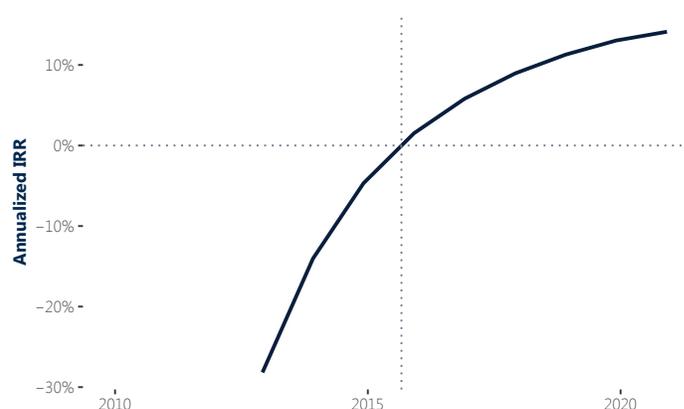
A more interesting question than the morality of debt or macroeconomic theoretical debate is whether deficit spending makes financial sense. Companies issue debt to fund projects that generate future cash flow. The returns on those growth investments are calculated using the standard financial metrics, net present value (NPV), internal rate of return (IRR) and payback periods. Do the same concepts apply to federal finances?

We can test whether government deficit spending generates positive IRRs by constructing a simple example using economic data from the financial crisis. Outstanding US debt balances increased by about \$3 trillion during 2008 and 2009. At the end of 2009, US GDP stood at \$15.3 trillion so the stimulus provided by deficit spending added about 20% of GDP. Without deficit spending, the economy would have been \$12.4 trillion.

Over the past ten years, federal tax receipts have averaged about \$2.9 trillion per year, or about 16.5% of annual GDP. We can measure the financial profitability of deficit spending by measuring the difference between what GDP actually was at the end of 2020 and where it would have been had it begun with a \$3 trillion smaller base (where GDP would have been without debt financing). We can then measure the difference in tax receipts to determine federal cash inflows that offset the 2009 increase in the deficit. Tax receipts average \$592 billion per year higher with deficit spending than without. Deficit spending generates positive IRR (14.1% after ten years, Exhibit 16), positive NPV (+\$1.7 trillion) and a payback period of about 6.5 years.

Deficits are misunderstood because government finances are not like consumer or business finances. The government is the

Ex. 16: Deficit spending cumulative 10y IRR



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lender of last resort and the economy grows faster with deficit spending than without it. That makes the economy better off overall, even if it looks worse for the government sector.

Conclusion

After a year of sickness, tragedy and despair, life for most Americans is about to return to normal but that normal is unlikely to completely mirror the lives we left a year ago. Consumers are likely to have ingrained some of the fears and behaviors developed over the pandemic and changes in job markets and spending preferences could become permanent.

Businesses have emerged from the pandemic and we saw pandemic consumer shifts reinforce many secular trends that had already been in place. Companies on the right side of that balance are entering the post-pandemic era with faster sales growth, higher profits and lower debts. Companies on the other side face a more uncertain future as consumers may not return in full and pandemic-incurred debts are worked off. Ultimately US businesses will resume with some mixture of pre- and post-pandemic norms. Some employees will continue to work remotely while other industries will continue to see a benefit to having a centralized employee pool.

On the government side of the economy, finances are strained but not stressed. The US government has a large, if not unlimited, capacity to issue debt and investors continue to demand large volumes of Treasury securities. Over time, debt / GDP ratios and other fiscal health measures will improve as pandemic deficit spending helps keep economic growth on track.

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