Pinney&Scofield

Building long-term relationships with long-term investors

January 15, 2023

Dear Client,

Twenty twenty-two was a year to forget from an investment perspective. However, if you're a diversified, disciplined investor like us, the second half wasn't too bad. More on that in a minute.

For the year, every major index ended in the red making it the worst year for the markets since 2008 and the financial crisis. It was just the fifth time over the last 100 years where both US Treasury bonds and the S&P 500 ended the year with negative returns. It does not matter if you were an aggressive investor or a conservative investor, you saw your portfolio fall in value last year.

It is difficult to look at your portfolio value and see it down for the year and then look at the increase in your day-to-day expenses alongside it. You start to wonder if you have saved enough for the long-term. What if we have a repeat of the high inflationary years of the 1970's, is this history repeating itself? There are differences which give us cause for optimism, the biggest being the Fed's reaction time. During the 1970's there was political pressure for the Fed to keep rates low. The priority was low unemployment and avoid a recession. But after several years of higher inflation, unemployment also rose, and stagflation appeared. That was the lesson from the 1970's – inflation and unemployment rates can, in fact, go up together. Things changed quickly when Paul Volker became chairman of the Federal Reserve Board in 1979. He immediately raised rates and both inflation and unemployment slowly declined.

Current Fed chairman Jerome Powell has taken cues from Volker and has aggressively raised rates. Over the course of 2022, the Fed raised rates seven times to combat inflation. The year started with the Fed funds rate at 0% - 0.25% and ended at 4.25% - 4.5%, the highest level in over 15 years. Even with these increases inflation is still high with the trailing 12-month rate at 6.45% through December. The good news, however, is the increase in rates appears to be working because the month-to-month Consumer Price Index (CPI) reading has been trending downward. The annual inflation rate peaked in June at 9.06% and then declined every month of the second half of the year while employment numbers held strong.

Which brings us back to the second half of the year. As always, our report package includes the "Return Comparisons" report which shows a number of high-level asset class index returns for reference. You can see how every index is down significantly for the year (Previous 12 Months column). But this time we want to go a step deeper and have included a more comprehensive index breakdown, see the "Index Returns for 2022" insert. This ranks each index we regularly track from best to worst and we've separated by full year, first half and second half. You can easily see the change in performance from first half to second. In the second half, while the darlings of the past, growth and tech stocks led by the FAANG group we've talked about before (best captured in the Russell 1000 Growth and NASDAQ indexes), continued to decline, other assets classes did remarkably well led by international (the EAFE indexes), value in general and small cap (the Russell 2000 indexes), the very asset classes we use for diversification.

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You will also note that high yield bonds recovered well. These are the asset classes we were selling in the second half of the year as our clients needed cash, mitigating the negative impact on the overall portfolio. And note, 14 indexes did better than inflation in the second half and your portfolio had exposure to all of those underlying asset classes. This illustrates our method in the real world and why we've adopted it.

This shift in the market performance is still very short-term and could easily turn negative again but it is a reminder of why it is important to stay invested and to be diversified. These shifts come quickly and many times unexpectedly. The average investor had a much different experience in 2022. Most investors invest in what has done well lately and before 2022, nothing beat US growth stocks and especially the FAANG stocks – Facebook (now Meta), Apple, Amazon, Netflix and Google. Low interest rates and pandemic anomalies provided an environment for these stocks to surge in price. When interest rates rose and the pandemic faded, future profitability fell, and so did the stock prices. Meta went down 64%, Netflix 51% and Apple, Amazon and Google lost over 25%. And as a reminder not to listen to the talking heads on television, Jim Cramer from CNBC, stated in June that Meta had "nowhere to go but up." At that point the stock was trading around $160, down from $332 where it started the year. In October, when to stock was trading at $99/share Cramer apologized for his comments and admitted he was wrong. The FAANG stocks have succumbed to the same fate as the "Nifty Fifty" stocks of the 1970's and the dot.com stocks of the late 1990's. Like Icarus from Greek mythology, they flew too high and came crashing down. Not a pleasant investment experience. We prefer to heed Daedalus' advice and fly neither too low nor too high – that is what diversification provides.

One more related point. In our January 2022 letter, we discussed what is known as the "4% distribution rule." This is the amount it was determined you could withdraw from a portfolio each year without running out of money over the course of a 30-year retirement. This draw rate came under scrutiny in 2021 and early 2022 and many thought 4% was too high and 3.3% is more reasonable. At the time, low interest rates minimized the income generated from bonds and years of strong stock market performance reduced future expected returns. A year later, most bond yields are up more than 3% and lower stock prices means higher future expected returns. Now the claim is 3.8% is sustainable – not too far off from the original 4%. What we find most interesting, however, is the inventor of the 4% rule, Bill Bengen, recently revised his analysis and now uses 4.7% for his own portfolio. Why the increase? He added small cap stocks which he excluded from his original analysis back in 1994 (his portfolio was 50% US large stocks and 50% government bonds). We structured our portfolios over 30 years ago incorporating small caps stocks so it is surprising that Bengen is only coming to that conclusion now. We have a 30 year jump!

We want to make you aware of a change in the tax law that occurred in December. The Secure Act 2.0 was passed and it changed the starting age of required minimum distributions (RMDs) from retirement accounts. If you were born in 1951 through 1959, the new RMD starting age increases from 72 to 73. This means if you turn 72 in 2023, you do not need to take a distribution until 2024. If you were born in 1960 or later, the age increases again to 75. Other changes in the Act include Roth options for SIMPLE and SEP IRAs as well as an allowable transfer of assets from a 529 to a Roth IRA. There are several planning opportunities created from this Act which we will discuss in your plan reviews if they apply.

Note, the age change for RMDs does not impact qualified charitable distributions (QCDs) which are tax-free distributions from your IRA if the check is made payable to a charitable organization. These can still be done at age 70 ½. And as a reminder, if you made any QCDs in 2022, let your tax preparer know. Schwab records all IRA distributions as taxable, it is up to you and your tax preparer to correctly record the amount that was gifted to charities.

John, Richard, Mary, and Ryan