Building long-term relationships with long-term investors

July 15, 2022

Dear Client,

We found it difficult to write a letter this quarter. Or perhaps better to say it was difficult to decide what to write *about* since there are so many headline topics to address, each seemingly as impactful as the next on the economy and markets and hence your portfolio. We could go on for pages! So, allow us to touch on the issues we think best tie back to how we're managing your portfolio.

Let's start with the "R" word. Recession is being brought up a lot again and it is a distinct possibility. A common definition of a recession is two consecutive quarters with a decline in the Gross Domestic Product (GDP), a measure of economic growth, but other factors come into play as well. The first quarter saw a drop in GDP and the second quarter report is projected to be flat or slightly negative. While that might meet the criteria, we may not be declared formally in a recession because the unemployment rate continues to be very low. But, as economic theory goes, as interest rates continue to rise spending generally tapers off which may cause the unemployment rate to uptick.

And then there's the "I" word. The inflation report for June was not good, registering at a 40 year high of 9.1% year-over-year. We've talked about inflation in our last few letters, so we won't dwell on it here other than to pass on some food for thought. The primary measure of inflation is the Consumer Price Index, or CPI, and there are many variants of CPI. The one most widely cited is the CPI-U, or CPI for "All Urban Consumers" (this is what we show on our reports). The CPI-U is comprised of 18 categories that measure a broad range of costs from personal things like housing, household expenses, clothing, and food to broad things like energy and transportation to non-essential things like recreation and alcohol. Also included is medical and education. Roughly one-third of the index is the housing component using a measure the folks at the Bureau of Labor Statistics call "owner's equivalent rent." We mention this because CPI-U inflation impacts everyone differently and while the headline is not good, investors need to put it in context of their circumstances. For instance, if you have a mortgage, your housing costs are relatively fixed (your mortgage payment doesn't change) so one-third of CPI-U has no impact on you. On the flip side, medical and higher education often outpace CPI-U so if you're in a situation with those components, you're experiencing a higher impact.

What if it is determined we are in a recession and inflation continues, a condition known as stagflation? You could add this as the "S" word also in the news. What does it mean to you as an investor, what do you do? Our answer is to stay within a disciplined plan. These are backward looking measures and as we have often said, markets are forward looking. Changing your investments because we are in a recession or inflation, or stagflation is like looking at last week's weather report to determine what you will wear tomorrow. Not very helpful. For instance, the last recession we were in was not that long ago – 2020. It was determined we were in a recession in June 2020. By that time the markets had already bottomed out in March and were starting to climb upward for what would end up being a very strong year. Before the 2020 recession, there were fifteen others in the last century. In 11 out of those 15 recessions, stocks were positive within two years after the recession began.

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What makes current markets unique and stressful is we are seeing both stocks and bonds down at the same time. We also touched on this in our last letter. From March 1979 through March 2022 only 8% of quarters have experienced negative returns for both US stocks and US bonds. Bonds are falling in price because they have an inverse relationship with interest rates. As rates go up, bond prices go down and vice versa. But the flip side is often ignored which is while bond prices may fall in the short term, in the long term the income component you receive from bonds will increase. When you invest in bonds using mutual funds as we do, every day new money becomes available in the fund, and it buys new bonds with higher interest income. We've already seen a 30% increase in monthly dividends since January in some of the bond funds we use, as high as 36.8% in the Vanguard High Yield Corporate fund. Over time, the increase in income is a counterbalance to the immediate fall in price.

We say all this to encourage you to keep news in context. The press likes to sell headlines and politicians like to make waves while we prefer to go under the hood to understand what's happening and how it impacts our clients. Your enclosed performance reports show negative returns over the last twelve months and year-to-date. Emotions can become strong during a down market but remember we were in a similar situation in the early part of 2020. You might want to act, get out before the markets go down further, but you should focus on what you can control. You cannot control what the Fed does. Or what Russia does. Or the price of oil. Or any of a myriad of other things. Rather, you can control how you react. The future is uncertain. Fortunately, lessons learned from past markets should bring comfort to those who stay invested. Our investment method is simple, but not easy. It requires you to sit when you want to get up and leave but reacting emotionally to volatile markets can be more detrimental to your portfolio's performance than the drawdown itself.

Investment returns are made up of two components – expected return and unexpected return. The expected return is the best guess of what will happen based on all the information currently available. The unexpected return is the surprise, the difference between what actually happens and what was expected. In the long-term, stocks have a positive expected return, but in the short-term there will be a lot of variability and losses should be expected from time to time. If you are concerned about the markets and your portfolio, please contact us. We can discuss your allocation in detail and review why it was built for your situation.

If you are looking for an alternative investment to hedge against inflation you might consider I bonds. These are also issued by the US government and need to be purchased directly through the Treasury Direct website (**https://www.treasurydirect.gov/**). The interest rate for bonds purchased now is 9.62%. This rate applies for six months and is then reset based on inflation. For example, if you purchase the bond in July, you will receive 9.62% interest until December when the rate will adjust based on inflation in December. While the rate is nice, there are some constraints. The maximum investment amount is $10k per person, per year and you are not able to withdraw the funds for one year. If you sell the bond before five years, you will be penalized three months of interest.

Please don't hesitate to reach out if you have any questions or concerns.

John, Richard, Mary, and Ryan

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