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Quarterly Newsletter - July 2018

July 15, 2018

Dear Client,

It is becoming ever more difficult for us the write these letters.

All we really want to do is rant and rave about the current political scene in the U.S.

But we are not in the ranting business. We are in the financial planning and investment management business. So ? what are investors to do when faced with the Trump administration and its likely course of action ? whatever that may be.

Whatever that may be. That is exactly the problem. Trump's financial policies are both chaotic and unstable. It is therefore hard to understand or predict them.

However, there is one general principle we can apply. All large-scale government economic policies are either inflationary or deflationary. Moderate inflation is good for stocks and basically neutral for bonds. High and especially unexpectedly high inflation is bad for both stocks and bonds. And very low inflation, or outright deflation, is bad for equities and good for most bonds.

So, are Trumps policies inflationary or deflationary?

We would say that, so far, his policies have been moderately inflationary. And markets have responded by doing quite well. But this is very short term.

What about the longer term? That is harder. The signs point in both directions.

The longer-term inflation threat is clear to see. His policies are stoking it. A huge tax cut not balanced with any fiscal restraint is inflationary. Expelling migrant and immigrant labor is both immoral and inflationary. Tariffs and trade wars are very inflationary. One hears rumors that labor shortages are appearing ? in trucking, farm labor, and construction among others. Bidding wars for labor can arrive quickly and can lead to fast moving inflation. The inflation threat is very much out there and the Federal Reserve is well aware of it. They have accelerated their schedule for rate hikes this year and may do so again. Rates are rising, which itself adds to inflation and makes the interest burden on the gigantic government debt ever greater. None of this is good for stocks.

The longer term deflationary threat is more subtle. Trump is not fond of international co-operation, to say the least. Nor are we especially popular in the world just now. But international cooperation is vital for dealing with a large-scale recessions and market failure. The 2008-2009 bear market and following recession would have been much worse without the cooperation of all the big central banks. It seems very unlikely that Trump would even ask for such aid, much less get it.

Thus, the uncertainties are large. But our investment method is equipped to deal with them. We ride both the inflationary and the deflationary horses.

Consider the following investment scenario: Start January 1, 2000, with a portfolio of $1,000,000. Pretend this is your retirement portfolio. Your goal is to take $50,000 per year from this portfolio, adjusted for inflation, for the rest of your life. Now compare two different hypothetical portfolio choices.

The first is all U.S. large growth stocks, namely the Standard & Poor's 500. On January 1, 2000 this might have seemed a tempting choice. The performance of the S&P 500 over the decade of the 1990's had been, after all, remarkable. The S&P 500 had done much better than international stocks, value stocks, small capitalization stocks or bonds. Many investors said, ?buy the assets that have done well, give me the S&P!?

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The second is a more or less standard professional portfolio ? 60% stocks and 40% bonds. But, and very unlike the standard portfolio, make the stock choices diversified. Not just U.S. large capitalization growth stocks but also value stocks, small stocks, and international stocks. And do an equal weighting of the all the equity asset classes, ignoring their previously poor or good performance. Don't just pick the recent good performers. And rebalance on a disciplined and regular basis. Trim the winners and buy the losers. Easy to say. Remarkably hard to do. This investment method is known to be very robust ? which is why we use it.

What happened? Well, the bear markets of 2000 and of 2008 happened ? that's what. Both portfolios went down. But, and here is the difference, the diversified portfolio had some asset classes that did not go down ? namely REITs and long-term government bonds. They went up, and by quite a lot. The diversified portfolio therefore had some assets that could be sold at higher prices to help meet the income need whereas the non-diversified portfolio could only sell the one asset class in the portfolio, growth stocks. And there were therefore fewer shares of this asset class to go up when the markets recovered, as they eventually did.

And the result: The first portfolio,100% S&P, was entirely out of money ? bust ? by March 2016. Entirely broke. Not around to fund anyone's retirement. The second portfolio, diversified and rebalanced, was very much still around. As of March 2016, that portfolio was worth substantially more than the initial $1,000,000. It was there to fund a retirement for many years to come.

The lesson we draw from this is to use diversification and calmness to deal with uncertainty. None of this is original with us. We are just very disciplined practitioners.

The future is beyond prediction. Ride all the horses in the race and stay relaxed. That is the best advice we can give.

Jim John Richard & Ryan