Wealth Management

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"I worried terribly that I might end up being too clear."

—Former Federal Reserve Chair Alan Greenspan
The Age of Turbulence, published 2007

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Dear Friends,

They call it Fed Speak. Which is a fancy term for total ambiguity. Our best Fed Chairs have been artists who can answer questions in such a way that two informed persons hear two different messages. A variation on this theme is, "leave 'em guessing." There are times we envy this approach as we communicate with you. If no one is entirely certain what we said, despite the fact that it sounded coherent, we have laid the ground work for plausible denial should the need arise. We just have to be careful about being too clear in the meantime.

Things We Do Not Understand

- Why young people pay *3x* the price of a regular pair of Levis in exchange for a pair which has been beaten to the point of becoming an immediate candidate for the rag bag.
- How an online site can sell a replacement cartridge for a string trimmer for a third less than Home Depot and deliver it overnight. Talk about a race to the bottom.
- How it is that Argentina, which has defaulted on its debt twice in the past thirty years, just issued a *100-year bond* with an interest rate of 7% and change.
- Why it is that literally trillions of dollars worth of bonds in Europe and Japan are trading at negative interest rates. As in, you give the government $1,000 for a 20-year bond and at the end of that time they give you back $960 after paying no interest in the interim.
- Why US stocks have traded up sharply in recent months while falling interest rates are busy predicting a slowing economy and meaningfully lower corporate earnings growth.
- Beyond Meat: For those of you who are not familiar with the latest white hot IPO, Beyond is a meat substitute which already has attracted huge established competitors with massive resources. Despite that, the stock came public in May at $25 and promptly traded to $200. Brings back memories of the dot.com IPO bubble in 2000 which heralded an 18-month bear market.
- Federal Reserve rate cuts are coming at a time when there are labor shortages and the economy is hitting on at least seven of eight cylinders. What *are* the economists at the Fed thinking? And when was it that the Federal Reserve became cheerleaders for the stock market?

What this translates to us as investors is that the Federal Reserve needs to be careful what it wishes for. The Wall Street Journal editorialized it thusly in today's paper: *"Indeed, the high level of stocks along with the strength of the jobs market make the Fed's plans to ease monetary policy a bit curious... Stocks already don't look cheap. The S&P 500 trades at about 17 times expected earnings... That is above the average of 16 years of data available, some of which included extremes of valuation such as the dot-com bubble... By the time the Fed gets the economic stimulus and higher inflation it is aiming for, stocks could be seriously overvalued. If stocks fall sharply after that, the Fed could have a real problem on its hands."* Since we do not begin to fully understand these conflicting currents, we are reducing our speed and are looking for where we put the caution flags away back in 2009.

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Serial Purchases

This is not a typo. We are not referring to a box of Cheerios (though as General Mills holders we think this is a perfectly good idea). We are speaking of our practice of purchasing a modest amount of stock initially with the intention of acquiring additional shares in the future should prices decline. In terms of numbers, this initial purchase is generally in the range of 1.5% of your account's overall value. Does this imply that we believe a newly acquired stock will decline? We never know. The fact of the matter is that as "value buyers" we are drawn to stocks which have gone on sale. Is there a risk that the target stock may actually be on the bottom, turn up and we will only have a 1.5% position in a stock which is appreciating nicely? Yup. It happens. More commonly stocks seem to stumble along the bottom for a while or even become significantly cheaper than we could have imagined. Examples that come to mind are Intel and Apple among others. The end result of taking advantage of the markdowns was a lower average cost per share and a much larger than 1.5% position in what have become among our most rewarding holdings.

Does this story always end well? No. There certainly are cases over the years where adding to a non-performing holding has compounded the problem. We attempt to mitigate this risk by adding to holdings where we believe the balance sheet is satisfactory and there is more cash coming in the door than going out. Sorting all of this out is challenging as a result of both known unknowns and unknown unknowns. (Thank you Vice President Dick Cheney for this inspiration.) GE is a good case study. In late 2017 the chairman and CEO of the company, Jeff Immelt, pronounced the company was forecasting earnings for 2018 of $2 a share. Instead, he lost his job and the company reported billions of dollars in losses both from operations and from restating their financial results from prior years. The "averaging down" we did as GE declined in value before coming clean on their financial condition clearly proved to be unwise. If you will, one of the unknown unknowns. With this said, serial purchases have done far more good than harm over the years if for no other reason than the long term direction of the stock market and the quality companies that make up the market is… up.

Purchases of Another Kind: Corporate Stock Buybacks

It seems a day hardly goes by without a company announcing a large scale stock repurchase plan. On the surface, it makes perfect sense to put its excess cash to work by reducing the number of shares held by investors. If overall profits remain the same but the number of shares outstanding are reduced, doesn't this have the effect of increasing the earnings *per share*? Yes. Warren Buffett only purchased outright about 5% of Apple shares but his holdings are now reported at being in excess of 6%. What form of alchemy was at work here? Actually none. When Apple had the opportunity to bring vast amounts of cash trapped overseas (for tax reasons) back home at a reduced tax rate they did so. Much of that cash was put to work by reducing shares outstanding by simply retiring the shares. Countless other corporations are doing the same. Is this a good thing? In our view, yes. But a qualified yes. What about the need to invest in research and development? New manufacturing capacity? Technology? A bargain acquisition? Shouldn't boom times be used to reduce debt? Maybe some of those funds should be spent on employee bonuses instead of share repurchases. Clearly a corporate good is achieved when employees hold their employers and jobs in high esteem. It is also worth noting that "your cash is trash" in the sense that cash earns very little in the form of interest these days.

Compounding these tensions is the possible interpretation that buybacks are essentially an admission by management that they cannot find a more productive place to put this money to work. Our conclusion? Yes to all of the above. Especially with stock prices approaching record levels, as a general statement, we hope and expect to see managements of the companies we own slow the pace of purchases. If for no other reason that a fixed sum of cash simply acquires fewer shares. Some extra dry powder may come in handy the next time minus signs come before the stated percentage of growth for the quarter. (Now there's an interesting oxymoron… negative growth). All in, as stated earlier, repurchases can make a

great deal of sense and serve to create value for the shareholder. But purchases to excess or over paying are certainly not the pathways to the creation of value for the owners of the business. Boards of directors and managements simply need to be cognizant that too much of a good thing is too much.

End of the IRA Era?

Last week *The Wall Street Journal* ran an article entitled *Congress Is Coming for Your IRA*. The article began thusly: "Like grave robbers opening King Tut's tomb, Congress can't wait to get its hands on America's retirement account assets. The House passed the Setting Every Community Up for Retirement Enhancement Act, known by the acronym SECURE. The vote was 417-3." If there was a requirement in law along the lines of truth in advertising, Congress would suffer from serial fines. Large ones. The act would do nearly everything but making your retirement assets secure.

One feature of IRA accounts that is not widely understood is the ability to pass along the entire account from your generation to the next without suffering from immediate income taxation in the process. The fortunate recipient then must continue withdrawing annually from the account but at a much reduced rate determined by their age. (Younger people are required to take out smaller percentages than older folks.) In this regard, it is also possible to pass along retirement assets to grandchildren as well. This generation skipping ability *really* stretches out the life of the IRA. The Secure Act would require non spouse beneficiaries to withdraw all funds within ten years. The tradeoff Congress offers is the ability to defer the mandatory start of withdrawals from 70½ to 72. Some trade. Even more insidious is the rate at which the subsequent generation will be paying on the distributions. Stay with us here... Let's assume the surviving spouse passes at age 82 with a $750,000 IRA leaving it to a 52-year-old offspring who just happens to be coming into their peak earnings years. For demonstration purposes, assume the survivor takes out 10% a year or $75,000 and presently earns $125,000 a year on the job: combined reported income = $200,000. That jump in combined income could push their tax bracket for 2019 from 24% to 32%. Congress gets your money earlier, in larger amounts and labels this process SECURE. A trifecta!

Some IRA holders may be in a position of being in a lower tax bracket than their offspring and could conceivably benefit from taking more money out of their IRA than required during their lifetime and simply giving the excess away to the beneficiaries. Best practices will evolve should the law pass and we will work with you to determine what those alternatives may be.

This is a sober way to end a Summer Client Letter... certainly not our tradition. Based on higher taxes in the future and the fact that some of us are pushing the envelope age wise for a European biking vacation, let's blow the budget and do that bike trip! But just be certain to sign up for an electric bike. Did I mention we are getting older?

Best regards,

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The Klavins Report – Thoughts From Outside the Corner Office ***(July 10, 2019)***

"A good plan today is better than a perfect plan tomorrow."

—Paraphrased from General George S. Patton

As you know, investing is something we are passionate about, something we love to do, and it lays claim to the largest portion of our time. And while the purpose of investing is to earn a reasonable return on your capital over time, the return itself is not the ultimate goal. The ultimate goal is whatever it is that you want your money to do for you and your family over the course of your life, and beyond. Money earned through investing is exchanged for a safe and comfortable place to live, schooling that enriches the lives of you or your children, security during difficult times, delicious meals with friends and family, fun in all of its many forms, and so much more. Every client's hopes, dreams, and aspirations are different, but each of you has them.

Helping our clients to articulate and define their various financial goals, and helping to determine whether they are on track to achieve those goals, has become an important component of what we do. As Marcia once said (and you know it is good because Steve routinely plagiarizes her without attribution), the ultimate question people care about is, "Am I going to be OK?"

In our attempts to address that question we have used different tools over the years. Retirement Funding Sensitivity, or RFS, models were our primary tool for many years and we still use them for some clients today. More recently, however, we have embraced a new and more powerful tool, RBC WealthPlan, which has more flexibility and expanded capabilities as compared to RFS.

WealthPlan is a goals-based modeling tool within which you define your various spending goals with regard to amount, timing, and duration. There is no limit to the number of goals. We then inventory existing assets and incorporate assumptions about future savings rates (for instance to 401(k)s, IRAs, taxable accounts, etc.), as well as anticipated cash flows from Social Security, pensions, illiquid investments such as rental properties, or inheritance.

Once all of the assumptions have been made, WealthPlan runs a Monte Carlo simulation for each scenario, meaning it runs 1,000 trials using return assumptions that are randomized around a mid-point, and generates a probability of success (POS). For instance, a 78% POS means that in 780 of the 1,000 trials the client was able to fund all of their spending goals and was left with at least $1 of liquid assets at life expectancy. The goal is to get the POS into the "Confidence Zone," which depending on one's age is typically a POS of 75-90%. Alternatively, if the plan suggests the client is not on a sustainable path (POS below the confidence zone) the goal is to identify that and provide alternatives. Those might include saving more while working, working longer, or spending less in retirement.

So where am I going with this? The purpose of this note is to remind each of you that this financial modeling capability is available. There is no additional cost aside from an investment of time and effort on your part. In particular, you will need to spend time gathering information, and thinking deeply about and defining your goals, a process we cannot do for you. We are fond of telling people that the only thing we guarantee about the model is that it will be wrong. Why? Because we don't really know what you will save or spend, what returns will be, when you will retire, or how any of the assumptions will compare to reality. Despite all of that, it is the only way we know to relate your assets and savings rates to long-tailed financial goals.

If you would like to create a WealthPlan to evaluate your current path, please bring it up with us and we will be happy to get the process started. If you find yourself hesitant, either because you dread the process of building the model or because you dread what the model will tell you, fear not. The process is not that difficult, and if actions need to be taken or expectations reset, it is better to address that earlier as opposed to later. As General Patton suggested, we'd rather get an imperfect plan in place and dial it in over time, rather than wait and wait in hopes of someday creating the perfect plan. Perfection does not exist, so don't let perfect be the enemy of good.

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