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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

# Redefining "Planning"

By Casey Clarke

As our clients know, there are two services Cadence Wealth provides to its clients; comprehensive financial planning and a unique and robust approach to investment management. The two go hand in hand and really can't be separated from one another without running the risk of falling well short of our clients' goals and objectives. The reason? Well, if we offer investment advice to our clients without truly understanding their financial situations, wants, needs, and ambitions, there's a good chance that expectations won't be met in one way or another, and the strategy chosen not the most ideal. Probably more important however, is what happens when planning advice is offered without a differentiated investment strategy. Every plan makes assumptions around how much money is saved over time and how much that savings is growing. A common assumed rate of growth over the life of a retirement projection (accumulation and distribution phases) is 7%. Seems reasonable, right? Of course it does, given that the equity markets over the last 40 years have returned closer to 10% and bonds not much below that. But it's not ALWAYS reasonable. Let's dig into why.

*"Probably more important however, is what happens when planning advice is offered without a differentiated investment strategy."*

**More History, Please**

First, let's take a look at the 40-year period I referred to above; the one that gave birth to the modern financial services industry as we know it complete with endless numbers of mutual funds and ETFs in which investors can "buy and hold" whatever their hearts desire.

After all, with markets averaging 10% per year, what financial plan wouldn't benefit from being perpetually fully invested? In support of "Buy and hold, can't time markets, no need to overthink it, just keep buying investment products", I'd like to submit to the court as evidence exhibit A, the chart on the following page…


As you can see, from 1982 on, it's been a very successful run for the Dow Jones Industrial Average as well as for all other categories of U.S. stocks and bonds; one of the best periods in U.S. history. For everybody under the age of about 60, this is the only market environment we know from personal experience, and despite the two bear markets between 2000 and 2010, it's been a very rewarding one.

May it please the court, we'd like to introduce a bit more historical context as to what might be considered more normal stock market investment returns. Although the experience over the last 40 years has been roughly 10% per annum price appreciation of the Dow, the chart below shows quite clearly that there have been long periods of time since 1900 where the stock market returned closer to 2% per annum. In fact, this experience accounts for somewhere around 90 of the last 122 years. Further, the 82-year period of time from 1900 to 1982 experienced an average annual return of just over 3%. We would argue that the 10% annual return from stocks that most investors have come to expect and view as normal is actually an aberration and an exception to the longer-run rule. In addition, and as a result, most of the investment mantras, rules of thumb, and heuristics will likely prove false over the long-run as well. Buy and hold at your own risk.

Now to be clear, the figures above do not account for dividends or inflation. To some degree, the latter will tend to offset the former and the point remains that a longer look at history reveals a much different experience than modern day investors and advisors have come to expect.

## Starting Point

Another reason that assumed (conservative) 7% rate of return used in most financial plans likely isn't reasonable is because we may not be at a point in the larger market cycle that supports strong returns going forward. As we can see from the last chart, really good market return periods tend to be followed by poor ones and vice versa, and so it would stand to reason that after a very long period of above average market performance, one could and probably should expect below average market performance. The irony is that it's very much human nature to extrapolate recent experiences forward and thus do the exact opposite. The better the returns have been lately, the more we tend to expect that to continue. I can remember many financial plans in the late 1990's and early 2000's that incorporated 8-10% return expectations indefinitely. Needless to say, the decade that followed fell well short of those assumptions. As we've spoken about countless times before, eventually valuation matters a lot and dictates returns over longer periods of time.

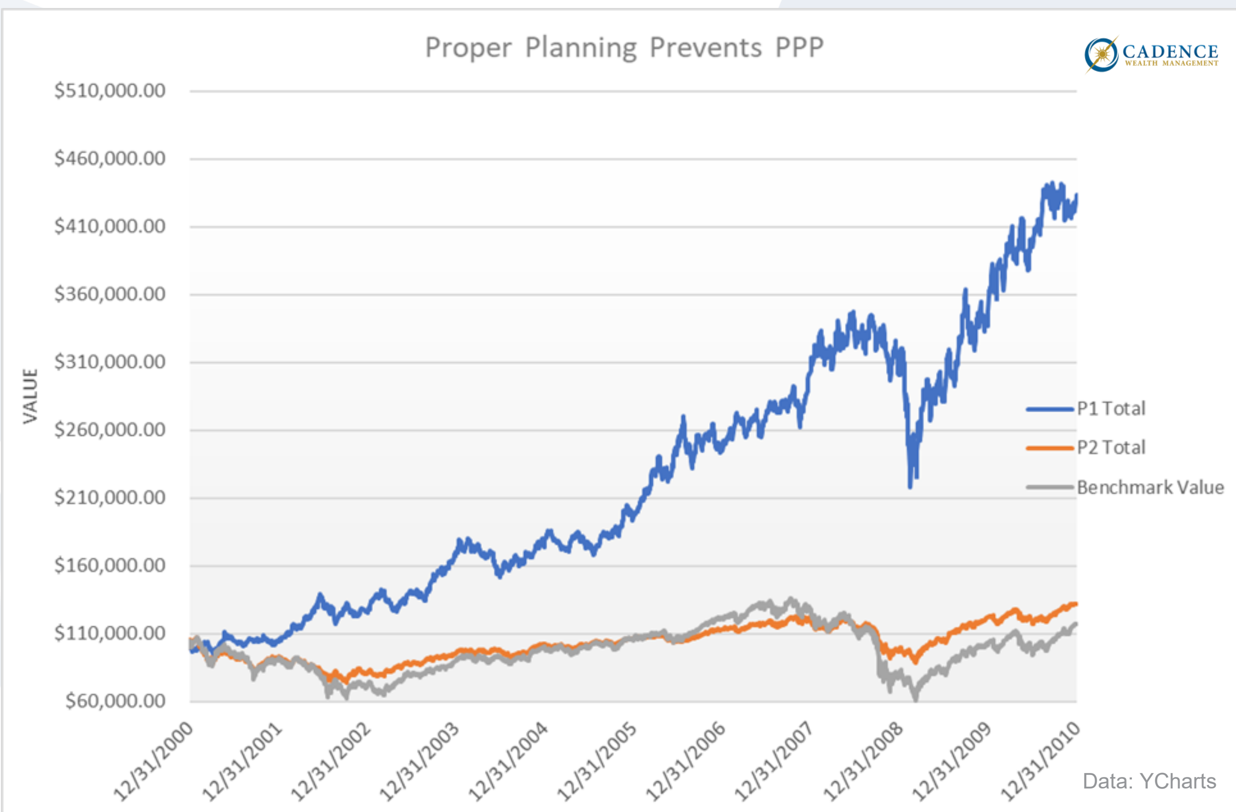
If your eyes can make out the years on the horizontal axis in the last chart, take note of what happened to the market subsequent to reaching the highest valuations of the 20th century; 1929, 1965, and 2000. It went down a lot and struggled for years afterward. For context, the valuation level of the market today by almost every measure is well beyond all three of those prior periods. So, if the longer-run history is any guide, there will be countless financial plans falling well short of their return expectations over the coming years. This is why planning cannot be done in a vacuum and investing cannot be cookie cutter in its approach if advisors and clients have any intention of reaching their goals. We must redefine planning to mean more than just crunching some numbers and assuming markets will deliver them. At market valuation extremes at the end of cycles, unrealistic assumptions and the financial goals that are dependent on them simply don't stand much of a chance of being met with canned investment solutions. Instead, the financial plan must consider intelligently the plausibility of the return assumptions and craft a cycle and valuation-sensitive investment plan to go along with it.

A question we often get from clients after discussing our outlook for stock and bond markets going forward is, "so is the 6 or 7% return assumption we have in our financial plan realistic then?" Yes, it is, but it wouldn't be if we weren't adopting a dramatically different investment game plan going forward. The only way we have a chance of achieving that typically run-of-the-mill return is by investing most heavily in the asset categories that haven't spent the last 10 years going straight up. By focusing on valuation with an eye on whether we're likely entering a point in the various cycles that favors those cheaper investments, we increase the odds of success. By approaching it this way, we have a margin of error to some degree in how much we could lose based on the fact that what we're buying is already relatively cheap, and we're increasing the chances of making money over time by investing in things that are reasonably priced. We always need to maintain diversification, but diversifying across a handful of expensive assets is diversification in name only and offers little benefit. There is no rule saying we have to own some amount of everything. We'll look to allocate to what makes sense and do the best we can spreading our capital out amongst those asset categories that offer compelling value. Slight exceptions can be made if short-term growth cycles allow, but only at the margins. Sky high valuations at the end of a 40-year debt super cycle with the added inconvenience of monetary authorities forced to fight runaway inflation is akin to juggling bottles filled with nitroglycerin. Pretending investors can continue doing what they've recently done with perpetual success is anything but "planning".

## An Example of a Different Plan of Action

Let's look at a simple and relatively crude example of how this redefined and more proactive planning could have created a different experience for investors over the course of the 2000s. What we've been talking about over the last couple of years in terms of commodities being cheap relative to financial assets was also true back in 2000. The two were in opposite cycles for most of the 80's and 90's and both reached extreme valuations; financial assets at the high extreme and commodities, precious metals in particular, at the low. The chart below looks at a portfolio of precious metals investments and treasury bonds split 50/50 and rebalanced every six months (via the mutual funds FKRCX and VUSTX) compared to a portfolio of 50% stock and 50% bonds (via the ETFs SPY and QQQ and the mutual fund VBTLX) between 12/31/2000 and 12/31/2010. Both portfolios assume dividend reinvestment. What's clear to the eye is that the traditional approach to investing fell well short of almost any retirement plan assumptions for the full 10-year stretch returning 2.8% annualized, whereas the 50/50 precious metals and treasury bond portfolio exceeded even the most aggressive planning assumptions with an annualized 15.8% return. We would argue the former portfolio experience was representative of what most financial and investment plans delivered. The latter portfolio would be a good example, albeit slightly extreme for illustrative purposes, of an investment plan that is forward thinking rather than rearward looking, informed by cycles and valuations, and consistent with the assumptions that are factored into the broader financial plan. A friend of mine who spent a good amount of time in the U.S. Marines used to have an expression – "Proper Planning Prevents Piss Poor Performance". That mantra seems applicable here. Although we would take issue with a portfolio consisting of only two investment holdings, this hypothetical scenario illustrates just how big an impact an investment strategy can have on our long-term personal financial planning at extreme points in market cycles. We'd argue that a financial plan that doesn't take this into account when it comes to investment implementation really isn't a plan at all.

*(In the chart below, "P1 Total" represents the metals and treasury bond portfolio, "P2 Total" represents the more traditional stock and bond portfolio, and "Benchmark Value" represents the S&P 500. All take into account dividend reinvestment.)*



**Conclusion**

There's an expression that someone uttered at one point that stuck; "10% of life is what happens to you, 90% is how you respond to it". As true as this old saw is, the reality is that we have more control over certain things than we might think. When it comes to our investments, we don't have to just accept that long periods of bad returns, when they arrive, are unavoidable. There are always alternatives even if those alternatives aren't viewed as conventional or typical. It's important to remember how the conventional and typical approach (a slew of stocks and bonds at all times) came to fruition in the first place. When looked at within the context of the last 40 years, it's fairly clear that performance drove a good amount of that process. Adding yet more context by going back to 1900, it's also clear that there are periods of time when an alternative investment approach may have worked better. The important point is that things change, and we need to be keen to anticipate that change in a way where our financial plans, goals and lives don't get unnecessarily adversely effected. There is always a plan B, and deciding to implement that is fully within our control. Financial planning as most have come to understand it involves a series of projections filled with assumptions driven by a well-diversified portfolio of stocks and bonds. Although better than nothing, there are points in time where those financial plans are almost certain to fail. By being more aware of market cycles, valuations, and the longer-term risks associated with both, one has a much better chance of building an investment plan that will actually deliver. Implementing that requires one be comfortable standing out and being different. Given that our clients' goals and financial health depend on it, we're okay with that.

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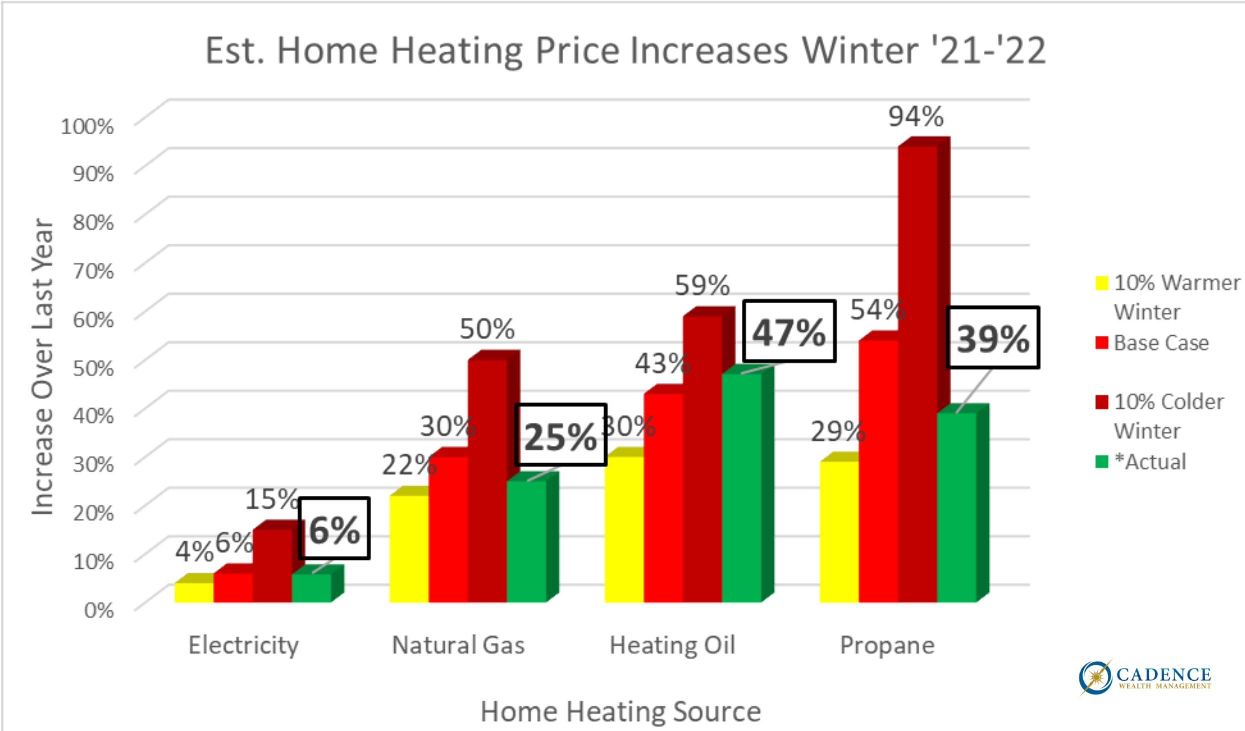
# Home Heating Fuel Price Follow-Up

*By Steve DeBoth*

In our November newsletter, we reported on the predicted range of prices for the various home heating fuel sources as reported by the U.S. Energy Information Administration, using the ominous and borrowed tagline, "Winter is Coming". Looking backwards toward the winter and forwards toward the summer from this point, it seems we have a good news/bad news situation.

The good news is that for three of the four home heating fuel sources, the estimated price increases were either at or below the USEIA's estimates this past winter. Granted, it may be a bit of a stretch to say that the 25% price increase for natural gas is "good news", because after all, the price was up 25% over the year before. However, considering the baseline estimate was that natural gas was going to be 30% more expensive, it could have been worse. It seems like those forces that could have propelled fuel prices higher were subdued enough, and/or those forces that could drive fuel prices lower were strong enough to keep the price gains from getting truly out of hand (see propane's potential 94% increase had winter been colder). Only heating oil's increase was above what the USEIA initially estimated, and only by a little.

Reviewing the November Cadence Clip's chart with the base case and estimates for price increases factoring in warmer or colder weather, and then adding what the average fuel price increases were for the United States this year as reported by the USEIA, you can see that the price increases in most cases were not worse than feared, and were certainly not close to the worst case scenario for most. Heating oil's price increase being the only one that ended up higher than its base case. We must keep in mind, though, that these are national averages, and our local markets more than likely differed.



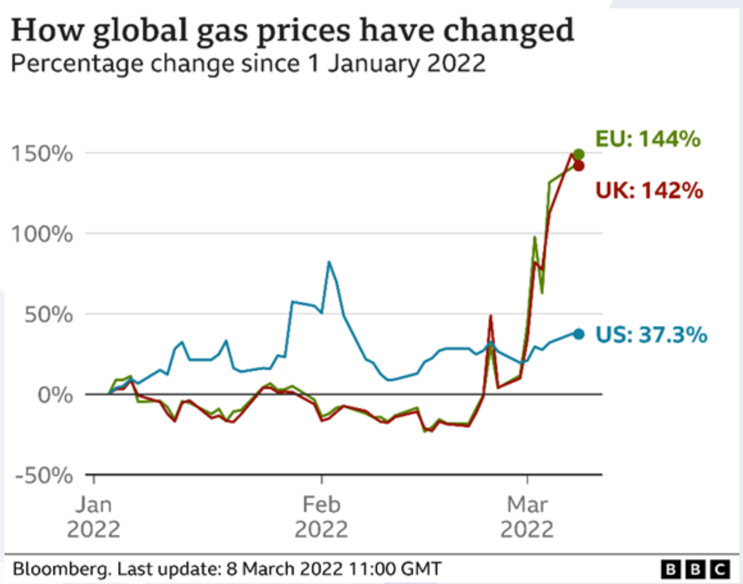

*U.S. Energy Information Administration, Short-term energy outlook – March 2022

The bad news is that there were still price increases, some of which were meaningful. Given the current state of some of the factors affecting fuel prices, going forward it looks like some of these prices will not only persist, but get worse before they get better.

One of the factors affecting home heating prices mentioned in the November newsletter was the fact that the fuels we buy are obtained from a globalized marketplace, and geopolitical factors weigh heavily on that marketplace. Obviously news for the past month has been dominated by Russia's invasion of Ukraine in what is now considered the largest military exercise in Europe since World War II. The economic and security concerns raised by this invasion were bound to have an effect on the stock and commodity markets around the world. Financial markets of all kinds do not like uncertainty, and when a nuclear power like Russia invades a country and motivates other nuclear powers to respond to that aggression, it creates enough uncertainty to make commodity and stock prices volatile as we have seen the past month, before we can even factor in the supply and demand effects.

Exacerbating this is the fact that Russia supplied an estimated 11% of global oil consumption and 17% of global natural gas consumption in 2021. Keep in mind, oil and gas prices were already trending higher before the invasion. Even though as of this week Russia was still allowed to sell its oil and gas in some places, the threat of future embargos on Russian fuel plus the fact that some importers, like the United States and the United Kingdom, have already banned Russian fuel supplies caused oil and gas prices to spike starting in late February. It is an inopportune time to ban fuel from any source, as continued economic activity growth and lower supplies going into this winter had already pushed prices higher. Add a supply side shock like a fuel embargo plus the uncertainty a large military action in Europe creates, and it's no wonder oil prices spiked 35% at one point.


And if we consider a fast 35% increase bad, then we can consider the increases to natural gas prices here and especially in Europe as practically horrifying.




The prices have bounced lower and higher again since early March, but all these factors point toward oil and gas prices staying higher than they otherwise would for an indeterminable amount of time. We are all aware of the increased price for oil, but the increased prices for natural gas will impact other energy sources even as home heating costs go down in the warmer months to come.

Case in point: natural gas and the knock-on effect to electricity. Much of the electricity in the US is made by burning natural gas. Natural gas consumption by households may drop as the weather gets warmer, but electricity usage's decrease is not as large in the spring, plus when the weather gets warm enough for air conditioning, electricity usage reaches its highest point in the hottest months. So the pain of increasing electricity prices has yet to be fully felt.

In the meantime, it is time to start considering how to save on energy costs in the warmer months. Just like tolerating a colder house this past winter, consider tolerating a warmer house this summer. Additionally:

1) Use fans where possible to cool.

2) Consider hanging clothes on the line instead of using your dryer, be it electric or gas.

3) Consider sticking closer to home so you can to avoid filling the tank a bunch.

4) Turn off your air conditioner when you don't need it.

5) Check for thorough home insulation, just like in the winter.

6) Clean your air conditioning vents and units.

7) Block the sun with blinds and drapes.

Though we made it through the most expensive months for home heating without having to pay much more than was estimated for home heating oil, and less for the other sources, the summer driving and air conditioning months will be here before we know it and more than likely, gasoline and electricity prices are going to be higher than last year.



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