▶ Don't Let the Possible Overshadow the Probable 1-5

▶ Stoking Wealth Inequality - Enough Is Enough 5-8

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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Don't Let the Possible Overshadow the Probable

We have written many times how when it comes to planning and investing, human brains are the biggest hindrances to the owners of those brains. The possibility of large investment gains is so seductive, especially with financial news programs showcasing stocks that have absolutely taken off and investors who have made obscene amounts of money from large moves. Even our friends and acquaintances at times seem eager to share the bets they've made that paid off. It's easy to think of the possibility of large gains if enough money were put in the right place. However, the financial news programs are not interviewing those who have lost big on large moves, nor are our friends and acquaintances as eager to share the tales of their bad bets. So it's understandable if we can't see sometimes that the probability of large bets paying off is low, and we are tempted at times to invest for the possibility of large gains as opposed to the probability of "large enough" gains. We let the possible get in the way of the probable, and in times like this it can be tempting to consider getting more aggressive with your investments.

Even though the terminology is simple and familiar, especially compared to those months when we're discussing the Japanese bond market, we need to get the definitions of "possible" and "probable" straight. When it comes to the probability of certain outcomes, every outcome has a probability. However, when we say that something is "probable", we usually mean it "has a high (or at least above average) probability of occurring". When it comes to "possible", however, we mean something is possible in the same sense as it's possible you'll win the lottery tomorrow. I mean, we all know it's possible, but is it probable? No. Not at all. So when we say something is "possible", we frequently, if not usually mean something is "not likely", i.e., a low probability; a fair amount lower than average.

For example, is it possible you could flip a coin ten times and it would be heads every time? Yes, it is possible. You would have about a 0.1% chance of flipping a coin ten times and have it be heads every time. So yes, it is possible, but it is not probable.

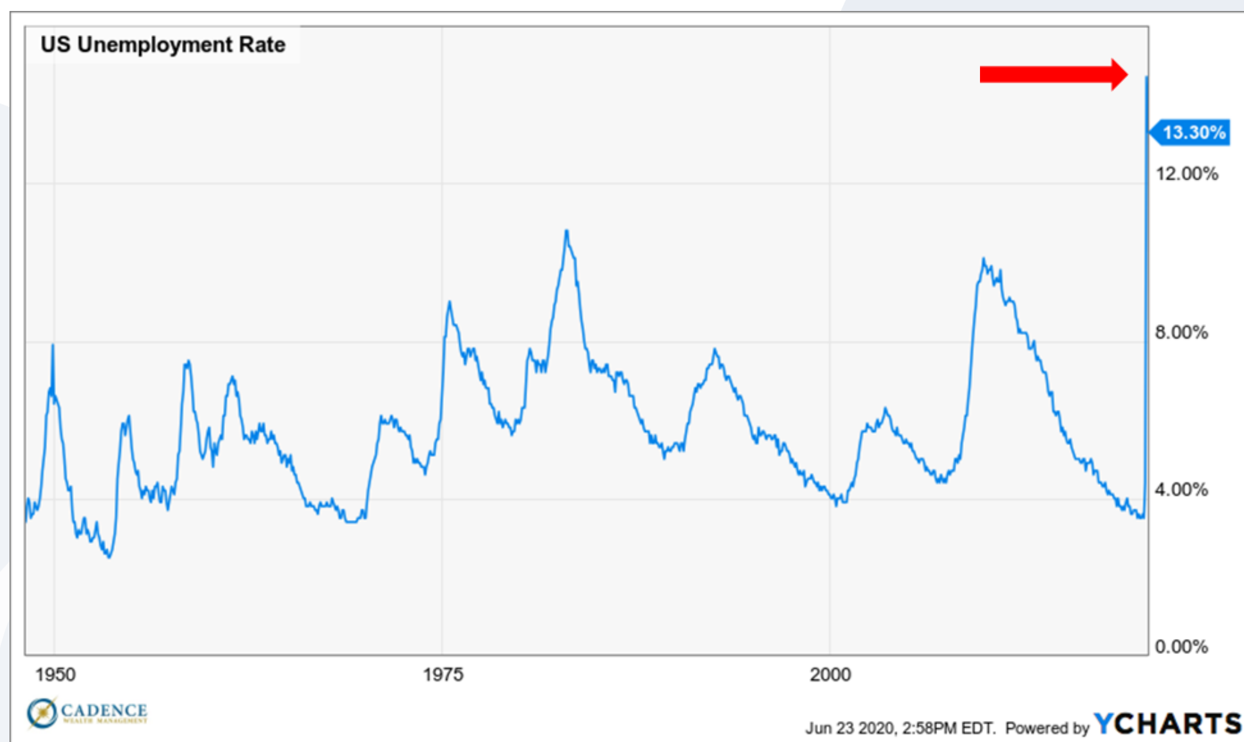
When it comes to investing, especially during times of runaway market growth like what we saw from March

of 2009 to February of 2020, or even during this most recent rebound starting in late March this year, many people are tempted to reach for what seems like relatively easy large gains by adjusting their allocations away from less volatile assets to those that are more volatile, mainly stocks. After all, it is possible that the stock market will continue to climb in the coming months. There are forces pushing it higher right now: investor optimism, the continued belief created during the most recent bull run, the longest in history, that the market will just keep going up, and the US government and Federal Reserve both taking unprecedented actions to help prop it up. But is it probable right now?

Deciding What Is Possible Versus Probable Right Now

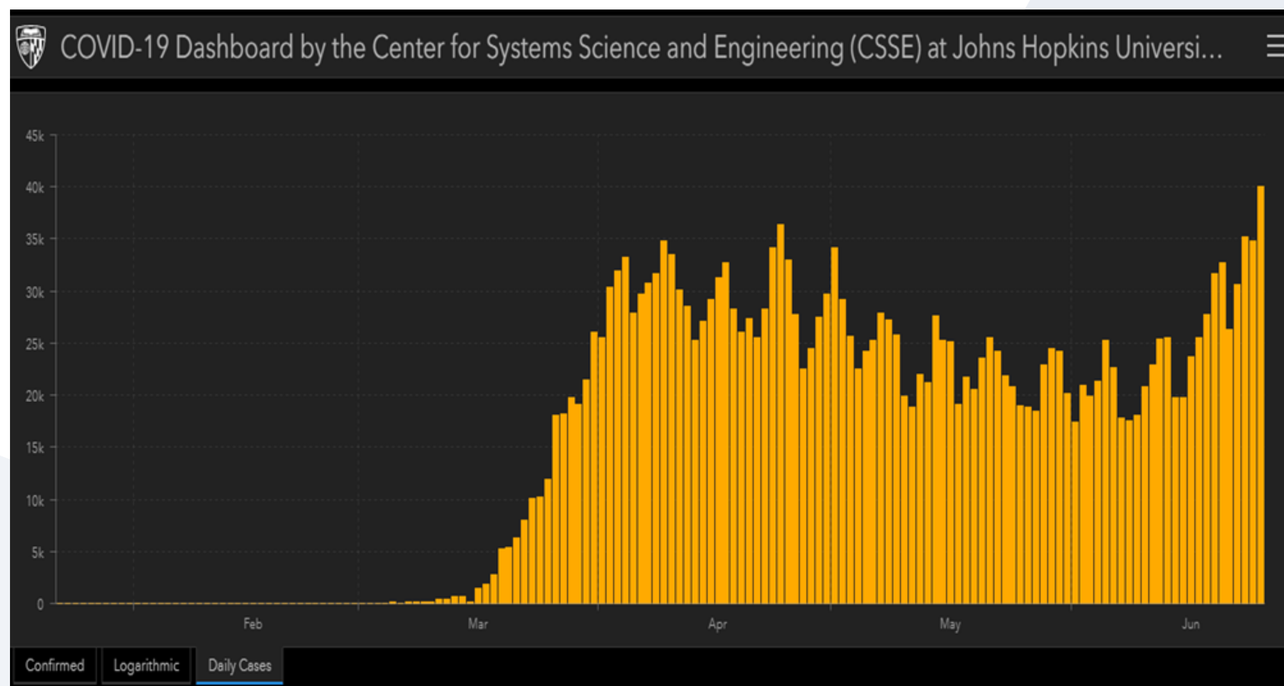
One of the more difficult aspects of determining the probability of a given outcome, like how much your investments might make over a given time period, is measuring the starting conditions. If a stock market is peaking, it is much less likely that an investment made into it at that time will lead to a large gain over the short to medium term. Conversely, if the stock market has fallen and has reached its lowest point, an investment made into it at that time has a much higher probability of leading to large gains, even in the short to medium term. So what are some of the factors right now that may impact a riskier investment to lead to large gains or large losses?

Unemployment. Though how the unemployment rate is calculated is subject to much debate, with many economists saying it is understated for many reasons, the sheer scale of what has occurred this year can be compared to past years and is a useful marker.



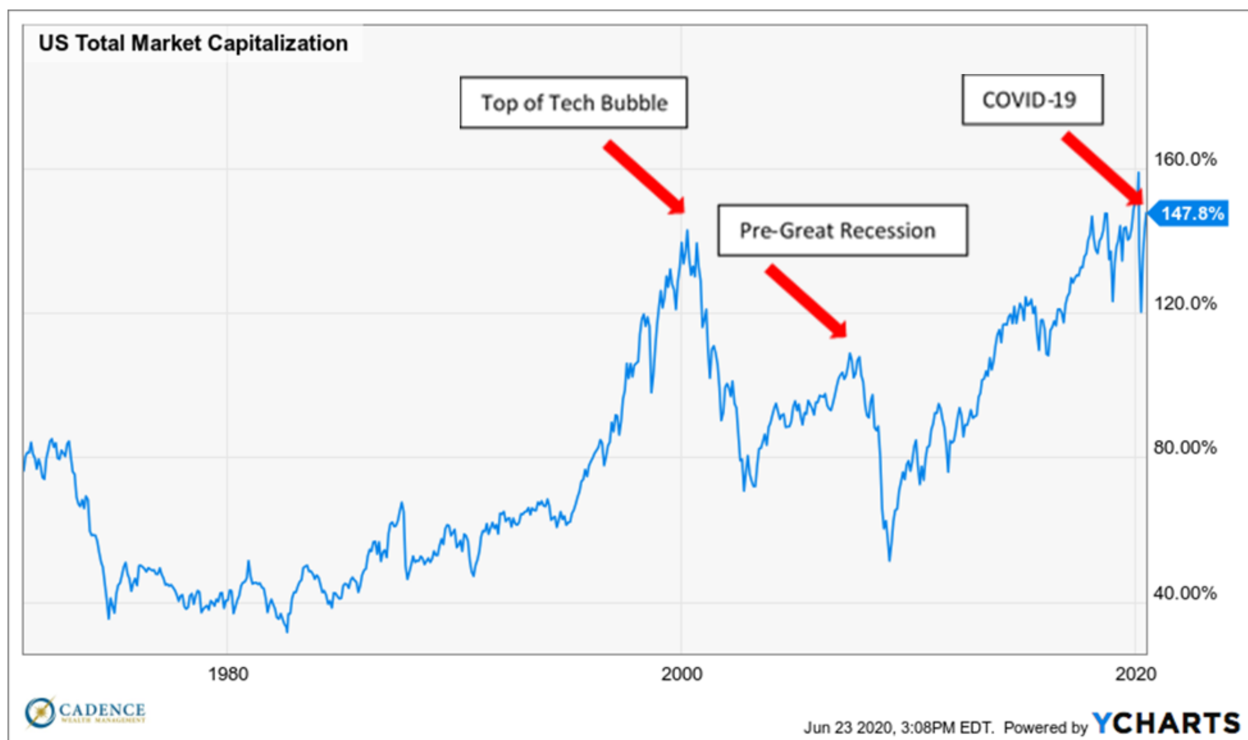
The arrow was added because the rate went up so high so fast that it almost looks like the vertical border on the chart. Our current level of unemployment, though it has come down from its high, is still worse than what we experienced during the height of the financial crisis of 2008. If it took the stock market years to recover during that environment, what is the probability of the stock market reaching and maintaining a level above where it started this year before record unemployment?

Global Pandemic. If this were a normal recession and unemployment were due to the natural cycle of economic expansion and contraction, then that would be one thing. However few of us, possibly no one reading this, has lived through a market collapse, recession, and global pandemic all at the same time. Obviously, we're in uncharted waters here. If the US had been able to get on top of the virus and put procedures in place to keep the spread low while continuing to open more and more of our economy, then perhaps we would be able to create models to increase our confidence around what to expect from this most recent recession. However, with the confirmed case counts in many states increasing again, in part because the rate of positive tests are increasing as opposed to it being just from increased testing, there is no clear indication of what the regional economies around the country will be able to do. The daily positive confirmed COVID-19 tests from the Johns Hopkins website shows the slow decrease during the month of May, with a gradual and as of late more sudden increase since the beginning of June:



If we're allowed to eat in restaurants and go shopping like the pre-virus days, even with masks on, are enough people going to feel comfortable out and about spending money to keep the economy growing and stock prices rising? Is it possible enough Americans will have jobs and be willing to carry on as normal to keep the economy expanding? Sure, it may be possible, but is it probable?

Current Stock Market Valuations. The last chart shows the market capitalization of US stocks, which is the value of all public companies in the index, divided by US Gross Domestic Product. The higher the number, the more likely stocks are to be expensive relative to their future prospects. In this case you can see even after a historically fast stock market decline earlier this year and historically bad unemployment figures, this measure of stock valuation is showing stocks are more expensive today than they were at the height of the Dot-Com bubble:



If a normal measure is 75-100 for this ratio, this suggests that stock prices are 30-50% overvalued relative to the size of the economy right now. Is it possible that with record unemployment and positive COVID tests trending in the wrong direction, the economy could grow enough to bring this number closer to its long-term average? Like every other time this question has been asked so far, yes, it is possible. However, at some point what is probable is going to win. Even without record unemployment and a global pandemic, we'd be saying probability is going to catch up with the stock market. Factor just those two things in and ignore the shape the rest of the world is in, or how much money the federal government will have to borrow to keep this all going, or that the Federal Reserve is acting in ways to prop this all up that may not even be legal, and the probability of runaway positive stock market returns going forward start decreasing further.

So what is an investor to do when faced with this data? If an investor is going to focus on what is possible right now, it should be how much they could possibly lose by getting more aggressive, not gain. The possibility of a large gain appears too small and the probability of a loss, large or otherwise, appears too great at this time. Over the long term, the avoidance of large losses is mathematically the better way to proceed than trying to reach for large gains. Yes, there are times and situations where exposing some percentage of a portfolio to an opportunity that could lead to outsized earnings can be beneficial, but always within a larger framework of what the probable range of outcomes is for your portfolio such that you never expose yourself to the possibility of too large of a loss. When you feel like you are missing out on large gains, you have to maintain your discipline and remember that you are also reducing your chances for large losses. By managing the risks in your portfolio around the possibility of large losses, and by managing the growth prospects around the probability of large enough gains over time, an investor can create a winning process that has a higher probability of success than exposing him or herself to the large losses that come with reaching for large gains at the wrong time.

So for now, though there are variables that can push the stock market higher, it appears like there is still a high enough probability of stock market losses to make taking more risk seem akin to betting on 34 red. We are probably not yet in the part of the economic and market cycle where the possibility of large gains is high enough to warrant the extra risk, but that day will come. At some point, the possibility of large gains will become the probability of large gains, but it is unlikely during historic unemployment, a newly surging pandemic, and extremely high stock market valuations. If you gear your pre and post-retirement investments around a large percentage of volatile assets are you

never going to run out of money? Possibly. If you gear your pre and post-retirement dollars around reducing risks and use a saving and a spending strategy that can work with a lower risk portfolio are you never going to run out of money? Probably.

Stoking Wealth Inequality – Enough is Enough

By Casey D. Clarke

For years we've been raising the issue of the systematic increase in wealth inequality in America. Whether monetary policy from the Fed or crony capitalism in Washington, the end result has been a widening gyre between the haves and the have-nots. Although there are very specific reasons for some of the protests taking place around the country today, wealth inequality is an overarching cause of much of the angst. What's most unfortunate about this is that we didn't just wake up to the highest level of wealth inequality since the Great Depression this morning. It's been bad and getting worse for years and politicians and public officials have been questioned about it along the way, so we know they've been aware - yet the problem persists. Over the years Wall Street and Washington have cheered low unemployment rates knowing full well that a historically high number of discouraged workers were no longer participating in the jobs market and that an equally high number of those who were participating were holding down multiple jobs to make ends meet. In other words, the quality of the unemployment rate has been lousy and didn't equate to a good quality of life for most. The fact that it looked good on the surface however reduced the urgency to address the issues beneath the surface. There's been a conspicuous absence of leadership on this issue from those at the top. Lip service – some. Action – almost none. One's politics should have nothing to do with his or her ability to see that a huge swath of people in this country are being left behind economically.

There are many reasons for this and we don't attest to have a simple solution. Corporate greed, corrupt politicians often tied at the hip to those corporations, and the Federal Reserve (Fed) all play a very large part in taking inequity to the extreme, but the Fed has a special role at the top of the heap because its manipulation of money and interest rates set the stage for everything financial and wealth related. Its policies drive incentives and behavior, and as we've learned over the last three decades (and far beyond that for the historically erudite), this often leads to greater access to money and financial assets for those at the top and a reduction in savings and accelerated debt accumulation for the rest. In other words, the manipulation of money is intentional and designed to protect and serve those who have the most of it. It may get carried out under the guise of protecting the economy and those workers within it, but the reality is the people pulling the levers rarely have the objectivity and integrity to pull them in a direction that hurts themselves or the people they're closest to. More often, they are manipulated to maintain the status quo, the pecking order of things, and the wealth of those at the top. The Fed is the man behind the curtain in this respect. Others have a role in wealth inequality, no doubt. Government policy plays a role, corporate behavior plays a role, technological shifts can play a role. But Fed policy sets the stage and provides a platform for bad behavior.

Case in point; Ben Bernanke after the financial crisis in 2008 talked openly about creating a wealth effect in order to stimulate economic recovery and growth. This is where the specific objective of the Fed is to drive up the stock market to make people feel wealthier so they in turn buy more stuff even if they aren't making more money at their jobs. What Bernanke admitted implicitly is that those with the most wealth (in stocks and bonds) would grow wealthier from the Fed's actions, while those with less or no wealth would receive no benefit other than whatever ended up trickling down from the wealthy. This was official policy. It was intentional. Whether one agrees or disagrees with it, it served to increase wealth inequality directly. Amazingly, when asked recently if the Fed had a role in growing wealth inequality, Jerome Powell, the current Fed chair, answered "absolutely not". It's certainly easier politically to answer

the way he did and probably much easier for Fed Chair Powell to sleep soundly at night if he convinces himself that his response is true, but it's not true, and he likely knows it. It reminds me of what Jean Claude Juncker, the president of the European Commission said in 2011 when discussing the Eurozone crisis; "When it becomes serious, you have to lie."

Paul Volker was the last Fed Chair to make the hard choice and do what was right. It's not because he was the last to raise interest rates – others have as well. It's because he was the last to raise interest rates despite the negative impact it would initially have on the capital markets and those benefiting most from them. To Volker, it wasn't all about keeping markets elevated to protect investors, bankers, or cronies. It was about lowering the inflation level so that Americans could afford a decent standard of living. When is the last time you've heard a Federal Reserve official talk about inflation making life more difficult for the average American? A politician? If anything, we hear them talk repeatedly about how inflation hasn't yet achieved their target of 2%, when in reality, everyone who pays for normal everyday things such as health care, food, rent, college tuition, etc., knows that inflation is running well above that ridiculous and arbitrary 2% target anyhow. It really is insulting to those struggling to make ends meet when comments are repeatedly made about how inflation isn't yet high enough and more must be done to increase the cost of things. Enough already.

What's even worse than intentionally acting to increase the cost of everyday goods and services that people need is reducing savings rates and holding them there for long periods of time. We've talked about this probably more than you care to read about it, but the impact of this policy is real, pernicious, and far-reaching. It may seem insignificant to most, but here are a few of the longer-term consequences of rate-meddling:

- Low interest rates discourage saving and encourage borrowing. This may help goose economic activity in the short-run, but it's not sustainable. Longer term, lending is dependent on banks having savings deposits to actually lend out. No savings, no lending; at least not in a healthy financial system.

- This incentive to borrow rather than save leads to too much debt and eventually insolvency. It's good at first since we can buy more stuff with lower interest rates. At some point though, we're left with lots of debt and no more capacity to borrow regardless of how low interest rates are. We simply can't add another payment to the heap. What's often forgotten is that on the other side of this equation is a bank or investor who isn't being fairly compensated for the risk of lending to us. They're not getting the return they need to stay solvent when those saddled with debt can't repay.

- Low rates encourage greater risk-taking by more people and institutions than would otherwise be the case. Since risk always leads to loss at some point (it wouldn't be called risk if it didn't), these losses when they arrive are spread across far more investors leading to larger economic and societal impact. CALPERS, the California pension system for public employees, lost more than $60 billion in the stock market crash this past March; they were probably taking way too much risk due to low rates. They then recently proposed using more leverage to try and increase returns going forward stating that there's no other option. Think about this; this is a public retirement program serving as a fiduciary for its pensioners looking to borrow money (use debt), then invest that borrowed money in risky stuff to try and achieve higher returns. This is insane and a breach of fiduciary duty. There is virtually zero probability that this proposition leads to anything other than pensioners receiving a fraction of what they otherwise would have. Although it's true that the alternative choices are difficult ones – reducing pension benefits for all and/or raising pension contributions – they are the responsible ones. Getting a slightly reduced pension payment is far better than getting a significantly reduced payment due to huge losses from excessive risk-taking. By keeping rates artificially low for too long, the Fed has robbed pensioners, pension managers, and all other prudent investors of reasonable investment choices. Safe asset classes that have historically generated decent rates of return and bond investments offering interest rates that more accurately reflect the risk being taken

simply don't exist anymore. As a result, so much money has been forced (remember the Fed's overt wealth effect policy) into stocks driving up prices that returns going forward over the next 10 to 20 years are likely to be among the worst we've ever seen. If you think the social upheaval is bad now, just wait until pensioners have the benefits they were promised and are counting on cut significantly because the responsible investment choices normally available to pension managers were taken off the table by our central bank.

- Low rates incentivize corporate malfeasance. Over the years, it's become commonplace for corporations to issue debt in order to raise funds to buy back their own stock. In reality, these share buybacks have largely been used to offset the issuance of employee stock option grants, which essentially means that the issuance of debt has been used to compensate employees at the top of the corporate hierarchy. Is there any question why those "other" employees depending solely on salary or wages may feel a little left behind by all this?

- The fact that we went from some of the "best corporate earnings in history" to corporations being on the brink of failure three months later speaks volumes about how corporations are run today – despite Covid-19. What we know and have been talking about for quite some time is that earnings have been manipulated to look better than they actually are by use of adjusted earnings per share figures (EPS) rather than GAAP EPS (generally accepted accounting principles). In addition, a systematic reduction of share counts via corporate share buybacks has also propped up perceived earnings somewhat artificially. Rather than building up cash for a rainy day, many corporations not only kept very little cash, but borrowed to execute share buyback plans. This is completely irresponsible and carried out on the stage set by Fed policy where saving is discouraged and speculation rewarded. Again, should it be surprising if the masses get a little upset when these corporations and the executives who've been benefiting from stock incentives over the years are thrown a life-line by the government?

- And here's the vicious cycle of the whole thing…The more risk big investors take, and the longer they take it for, the greater the implications when the whole thing unwinds at the end of the typical and totally normal business cycle. Those with the most financial assets have the most to lose. They are also the ones either in power or most connected to those who are. And so, it's no surprise that at the first sign of trouble, we get actions out of the Fed, Washington, and Wall Street that are designed first and foremost to keep capital markets up. The Fed concocts a magic monetary solution, the government borrows and bails out those at the top, and Wall Street obscures the truth and controls the narrative to keep investors buying. It's not until things get bad enough for everyone and the social backlash loud enough that attention gets turned to the "have-nots".

We're not surprised people have reached their breaking points. The upheaval we're witnessing now is about more than what the narrative would suggest. The wealth divide is as great as it's been in almost 100 years. Most people in our country are struggling to make ends meet, have almost nothing saved, and are watching the government and the Fed bail out the wealthy yet again.

Policy makers would tell you that if they don't rescue the capital markets and by extension, the "haves", then the "have-nots" will suffer as well. This may be true, but it would be fair. My guess is this issue of fairness is what's at the root of the anger we're observing today. Wouldn't it be great if the media did a better job shining the spotlight on public officials and policy makers for their role in all of this? It's hard, we get it. Policy affects outcomes over years and it's hard to prove and even harder for most to understand. It's not the instant cause and effect situation that the media would prefer to report on, but it's the truth. Media needs to step up and do a better job. Politicians need to step up and do a better job. People of means and in positions of power need to step up and speak out against those policies that may protect their interests, but are wrong.

We'll continue to do our part on this front. We're in the finance business. We clearly benefit over the short term from policies designed to benefit those with assets, but a system that only benefits some and leaves the rest behind is wrong. We'll succeed in managing our clients' assets by managing risk and investing with an eye on the full business cycle. We don't need any help from the Fed or anyone else. No special treatment. Success at somebody else's expense isn't success.

This has nothing to do with work ethic, grit, or one's willingness to get ahead. We're big believers in capitalism and everyone's choice to find their own role and play their own part in the grand scheme of things. This isn't that. We're talking about a system that makes it easier for those at the top and harder for those at the bottom.

The oversimplified solution to all of this?

- Don't manipulate money.
- Don't incentivize those with most of it to misbehave, and by all means, don't protect the worst actors by bailing them out when they get into trouble.
- Savers should have the ability to earn a decent rate of interest on their savings – 3,4,5% maybe.
- Those who want to borrow should have to pay a fair interest rate to do so. For those with good credit history, it should probably be higher than 0%-3%. (For those still building it, it should probably be lower than 20%, but that's more a regulatory issue and a topic for another day) Higher, more normal rates in a free market discourages borrowing too much for unproductive purposes and also compensates the lender fairly for the risks associated with lending.
- Corporations should have no incentive to maximize profits by paying their employees less. The amount of focus we see today on growing profits at all costs it deplorable. What ever happened to fostering a corporate environment where workers are treated and paid fairly, have a vested interest in the success of the company and take pride in the work they do by prioritizing customers and quality over shareholders? When it's profits at all costs, this doesn't happen.
- Oh, and it's no coincidence that when you have a Federal Reserve whose overt focus is to create a wealth effect by propping up financial markets, you see corporate executives shift their focus from employees and customers, to earnings per share and executive stock options. Without monetary manipulation, these greedy incentives fade away and better, fairer long-term behavior comes to the fore.

I guess what we're saying here is that the simplest solution is for the Fed to step back. They should go back to their original role of lender of last resort when the financial system seizes up and if they're doing this properly, we should only hear from them every 10 to 20 years or so, at most. No more pulling levers for the benefit of those at the top. This is anything but fair capitalism. People may not understand it, but they sense it. Enough is enough.

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