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# Cadence clips

FOCUSED ON WHAT MATTERS MOST.

## Q&A with the Investment Team

### 1 When central banks around the world inject money into the financial system, how does that impact stock and bond markets?

There are a number of ways for central banks to stimulate the economy, the most common of which is the adjustment of short term lending rates. By lowering rates, central banks seek to entice borrowing within the financial system in an attempt to increase economic activity. When this mechanism isn't enough, central banks can attempt to lower lending rates by buying large amounts of longer-term government debt (bonds) in order to keep prices high and rates low. Where do they come up with the money to make these purchases? Well, they essentially print it.

The net effect of these monetary policy actions is more money floating around within the economy which either leads to increased spending, business profits, and ultimately employment, or investment in financial markets. With low interest rates on cash and bonds, investors may be forced to take additional risk within the stock market in order to make a return. This can provide a push for stocks as investors make the switch from safer investments. The impact on bonds is a bit more complex. The direct effect of lower rates as they're on the way down means that bonds will typically rise in value. However, when rates finally reach their low point and begin to move upward, bond prices can fall. Additionally, the strength or weakness of a country's currency while under loose monetary policy can impact an investor's demand for bonds, thus affecting the price of them.

### 2 What are the risks of excessive central bank intervention?

In our opinion, there are two potential issues when central banks intervene aggressively. The first is the possibility of inflation rising rapidly as the newly introduced money in the financial system gets put to use. This hasn't been a problem during this latest round of easing since the 2008 crisis, but that's mainly because economic growth hasn't really picked up in a meaningful way. All the new money in the system isn't really changing hands fast enough to cause any change in economic activity or prices of goods and services – economists refer to this as velocity of money. If and when velocity does pick up, inflation would likely be soon to follow. Rising prices can be dealt with if the economy is strong, but battling inflation in a weaker environment can present a serious dilemma to the long term health of the economy and markets.

The other issue is one that is more fundamental in nature. By making money cheap and plentiful within the system in an effort to prop up financial markets and avoid an economic recession, central banks effectively change investor's perception of risk. If authorities step in to support the markets whenever they fail, then why not take risk? This is the thinking by some. Although it can work for a while, when mass complacency sets in and risk is no longer being properly evaluated, danger can ensue. This is essentially what happened leading up to the financial crisis in 2008 with the introduction of overly complicated debt securities that were designed to squeeze out yield with minimal risk to the investor. We were reminded by that episode that there is always risk and it tends to unfold during periods of complacency. This is exactly the type of environment that can be created by aggressive monetary policy. Markets always find a way to fair pricing in the end regardless of how badly its players want to control them.

## 3 If interest rates on bonds are low, how might that impact them as an investment going forward?

When interest rates rise, bond prices fall. The longer the bond has to mature, the greater the decline in price. Here's how this works. If Joe has a $1,000 bond that's paying him 3% interest, but similar bonds are now paying 5%, there won't be as much demand for Joe's bond if he wants to sell it. The only way it would make sense for me to buy his bond and collect the 3% instead of 5% is if I paid him less than $1,000 for it. The longer I have to settle for the 3%, the greater the discount I'm going to demand before taking the bond off Joe's hands. If Joe's bond matures in 10 years, I may only be willing to pay $800 for it in order to end up in a similar situation as if I'd bought the 5% bond. If instead Joe had a 5 year bond, I may be willing to pay him $900 for it if rates have jumped up by 2%. So in a rising interest rate environment, the closer the maturity date, the more protection one has against declining bond prices.

It's important to keep in mind however, that this dynamic only takes place when market rates begin to rise. Just because rates are low now doesn't necessarily mean that bonds will lose money – one just has to be careful in selecting the right types of bonds, then monitor carefully.

## 4 So if there are risks in both stocks and bonds, where should I invest my money?

The answer to this question depends on a lot of things – tolerance for loss over the short term, investment objective, and specific financial circumstances to name a few. That said, if we assume that one is seeking growth over time with minimal volatility, the mix would still likely be a combination of stocks and bonds with the addition of investments or strategies that are managed to minimize losses in down markets. Although we currently see risks to investing in stocks, over a 5-10 year period, most of those risks would probably be washed out and it's likely that the stock market will be higher by then. So if you have a stomach for roller coaster rides, there's a good chance you'll be rewarded down the road.

Bonds on the other hand carry most of their risk over longer periods of time. Since it typically takes years for interest rates to rise significantly, losses resulting from falling bond prices would most likely be a long, somewhat drawn out process. In the short term, bonds can still provide some benefit by helping to offset any volatility in the stock market, making it easier to stay the course and realize those longer term stock market gains. So even though both hold risks, their risks are different. When they materialize will also most likely be different, preserving the benefits of basic diversification across stocks and bonds.

But, what if stocks and bonds are both down over the next 5 to 10 years? Or, what if we have another crisis that suddenly takes both asset categories lower resulting in large portfolio losses? That's where alternatively managed investments come into play. Being able to step aside in risky environments and wait for a better opportunity can help to minimize the risk of loss over the shorter term as well as the risk of poor growth over the longer term. Be warned – the cost of investing in strategies or investments that are designed to operate differently is that they won't always be rising at the same time the markets are. The key to risk reduction and investment success over time is to stay disciplined and tune out what the best or worst performing markets or investments of the day are doing.

## 5 If the only way to earn a meaningful return on my investment is to take risk, how do I balance the different types of risk within my portfolio?

The most important thing to understand when building an investment portfolio is that all investments worth considering can and most likely will lose money at some point. Unfortunately this is just how it works. The key is to make sure that the different components of a portfolio possess risks that are unique and somewhat uncorrelated. This way, we decrease the chance of any one type of risk doing significant damage to our investment nest egg. By keeping this approach in mind, we're less likely to fall into the trap of chasing returns and building a portfolio with more loss potential than we realize.

Without naming all of the risks inherent in stock market investing, suffice it to say that most of the risk is present over the shorter term. A multitude of reasons can lead to falling stock prices, which is why holding different types of equities can help to protect against some of the more specific perils that a particular sector or class of stock can face. As is the case now, U.S. stocks can be up nicely while emerging market equities struggle. Since consistently forecasting which will be stronger over the next three months is virtually impossible, the best approach is to spread an equity investment across multiple categories.

The same goes for bonds. Holding short term bonds can better protect you from interest rate increases, while high quality longer term bonds generally do a better job of protecting your money in a falling stock market or weakening economic environment. Lower grade bonds that offer higher yields typically do well when the economy and markets are thriving, but hold greater risk of loss when things weaken. In a poor economy, the weaker companies run a greater risk of defaulting on their interest payments.

Alternative investments typically expose themselves to a different set of risks. One example would be trend investing. Trend strategies will typically struggle in environments that are choppy and volatile, but excel once a clear trend is established, either up or down. Typically other asset classes are doing fine when a trend model struggles, highlighting its diversification benefits. Other types of alternative approaches can take a longer term view of risk and can be either in or out of the market for longer periods of time in an effort to minimize risk of loss. The downside here can be two-fold. When stock markets are up, the model may not be due to it being early to exit a rising stock market. On the other hand, it could experience market losses as a result of being early to enter a falling market. However, these risks typically occur at different times than those inherent in other asset classes in the portfolio and can be a great diversifier over time.

So in seeking to achieve solid long term growth while minimizing the risk of loss over time, don't focus on avoiding risk. Rather, embrace many different types of risk without being overexposed to any one of them.  This rule needs to be adhered to regardless of how any particular asset class has performed lately or how we feel it should perform going forward. We just never know which risk will materialize next.

# Birthplace of Memorial Day

Although twenty-four communities nationwide lay claim to being the birthplace of the first Memorial Day celebration, Pres. Lyndon Johnson on behalf of the U.S. government sanctioned Waterloo, New York, as the "official" birthplace of Memorial Day in May of 1866 because that community's earliest observance 100 years earlier in 1866 was considered so well planned and complete. However, Boalsburg still strongly defends its claim to be the first, with stories of a remembrance that first took place in 1864, followed by a larger community observance in 1865 and succeeding years.

The Boalsburg Memorial Day story begins in October 1864 when three residents -- Emma Hunter, Sophie Keller and Elizabeth Myers -- met at the cemetery adjacent to the Zion Lutheran Church. Emma Hunter was there to place flowers on the grave of her father, Dr. Reuben Hunter, who had died of yellow fever while treating wounded soldiers while Elizabeth Meyer brought posies to put on the grave of her son, Amos, killed at Gettysburg. For the story goes that before the two women [Emma Hunter & Elizabeth Meyer] left each other that Sunday in October, 1864, they had agreed to meet again on the same day the following year in order to honor not only their own two loved ones, but others who now might have no one left to kneel at their lonely graves. During the weeks and months that followed, the two women discussed their little plan with friends and neighbors and all heard it with enthusiasm. The report was that on July 4, 1865 -- the appointed day -- what had been planned as a little informal meeting of two women turned into a community service. All Boalsburg was gathered there, a clergyman -- Dr. George Hall -- preached a sermon, and every grave in the little cemetery was decorated with flowers and flags; not a single one was neglected.

- Excerpt of an article written by Herbert G. Moore for the *National Republic Magazine* in May 1948.

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