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ISSUE 12 | VOLUME 10 | JUNE 2022

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

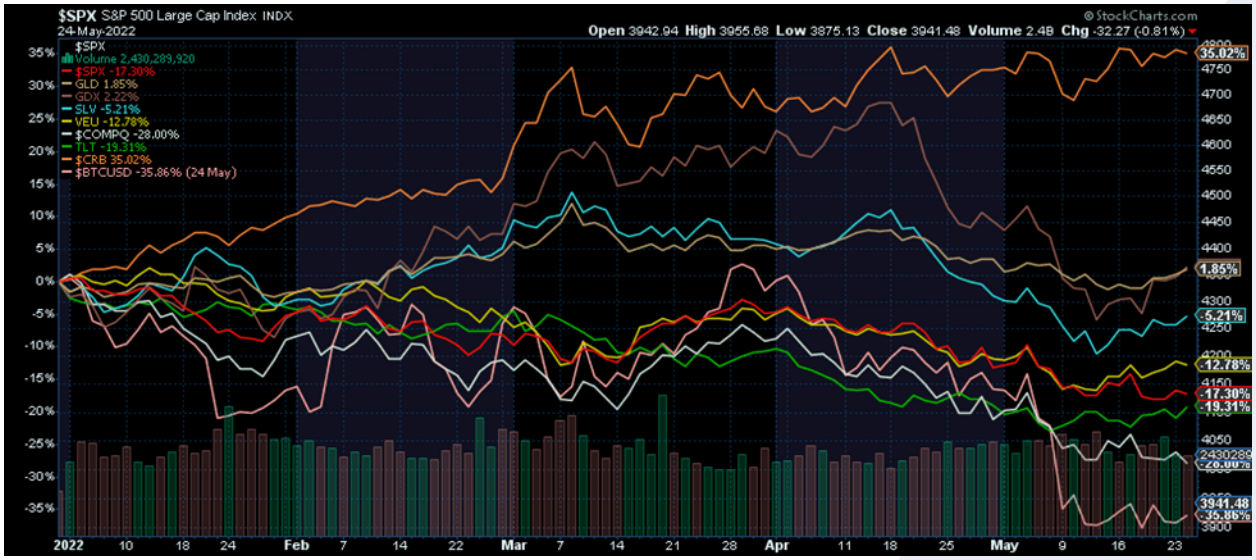
Deflationary Inflation

By Casey Clarke

And suddenly investing got hard again. Stocks stopped going up, bonds stopped going up, Bitcoin and cryptocurrencies stopped going up, and even most commodities stopped going up. Almost everything feels broken. Some are viewing this as an opportunity to reassess the risks they're taking while others reflexively recite comforting bits they've been told along the way like "well, we're in it for the long term". Neither reaction is ideal, the first in its timing, the latter in its lack of personal responsibility and blind compliance with the narrative. As convenient as the "long-term investor" rationale is, the reality is that extremely expensive markets can go down and stay down for much longer than people think. The ideal response to recent market events is to accept them for what they are and trust in the plan that you've already created and put significant thought into. If it's a good plan, it anticipated this. That which inflates eventually deflates. That which inflates a lot… You get the picture.

Markets are pretty simple to understand really. That which goes up can develop momentum, then a not-entirely-true supporting narrative, which causes it to go up even more. That which goes down can develop momentum, then a not-entirely-true supporting narrative, feeding even more downside. This cycle can last a few months or a few years, but one thing is constant - the more extreme the trend in price change and duration, the more extreme the counter trend when change occurs. Dramatic inflation of asset prices eventually leads to deflation of those asset prices. What we're witnessing now in some markets – stocks, bonds, and crypto – is mostly that. But there's another component as well that has helped to serve as a catalyst. Skyrocketing consumer price inflation is devastating the middle and lower-income classes which not only impacts spending and corporate profits, but also forces the Federal Reserve to finally get serious about "easy money" and its ramifications. So, in this respect, price inflation is also leading to deflation. First asset deflation, then if we're lucky, consumer price deflation shortly thereafter.

On the following page is a chart of the performance of some key asset classes this year. You'll notice there are a bunch that are down more than -12%, then a bunch that are hovering around 0%, then one that's up a lot. The first group is most of the major stock market indexes along with bonds. These traditional asset classes have been hit hard and have been on a relatively steady decline all year. The group hovering closer to breakeven consists of precious metals and fared much better up until recently. The clear price winner has been energy, which is the largest weighting in the Reuters Commodity Index.



For investors with cookie-cutter portfolio allocations, it's been difficult thus far. For those with a good helping of precious metals and commodities, it's been a different story. Our view is that this will continue to be the case throughout the rest of the year and beyond. The largest bubbles with the most people trapped in them will most likely continue to deflate while those asset categories that have been largely neglected for many years and are relatively cheap simply don't have the same amount of hot air to release. If anything, they have tremendous capacity to attract air that leaks or escapes from other, increasingly unappealing assets. These things happen over time and are anything but linear. Over weeks and months any investment regardless of its merits can look infallible, just the same way it can look hopeless. Sometimes there are reasons for behavior that doesn't seem to fit. When it comes to treasury bonds for example, if they generally perform well in slowing growth environments but aren't now, one reason could be that inflation is scaring investors off and winning out over the slowing growth factor. Another reason could be that treasury bonds went up a lot earlier and so poor recent performance is just the other side of that volatility. Up leads to down and vice versa. Nothing is linear. In other cases, we just don't have a viable reason why something isn't acting the way we think it should. In these cases, it's most important to fall back on our process and either stay the course because the misbehavior is likely temporary, or cut losses and move on. Feeling like we need to have an answer for everything by assigning causation isn't productive. As investors, it's best to act on those handful of big things that we know and avoid focusing too obsessively on why something might be happening when the "why" might simply be unknowable.

There's significant risk to markets over the remainder of the year. With the Federal Reserve and other central banks somewhat handcuffed due to inflation, it most likely comes down to good old fashioned market forces and animal spirits. A good part of what's propped up the economy in recent years has been the "wealth effect". Asset prices are up, people feel well-off, and so they borrow and spend. Between eye-watering inflation at the grocery store and fuel pump, and 401(k) and investment account balances being down significantly, the wealth effect has made a big move in the opposite direction. People feel poorer and are less inclined to spend and more inclined to panic. Losing lots of money quickly changes things, not the least of which is confidence in the future. As we know, confidence is critical when it comes to markets, economic performance, and personal mental health. I won't drift off on a tangent on that last bit, but suffice it to say that we need to be paying attention to things going forward if markets continue to struggle. When something that people have put so much faith in and have come to depend so greatly on for their financial well-being suddenly fails to deliver, this has real consequences.

As for successfully navigating the remainder of the year, we'll focus on what we know rather than obsessing over the unknowable. Over centuries of history and countless crises and market events, investing in something at a fair price allows one the luxury of riding out volatility over reasonable periods of time. Having a medium to long-term horizon can truly work if we own assets at fair prices. Our clients know what those assets are currently, but we'll generalize here by saying that most commodities and a short list of traditional assets are priced attractively right now. Own these things in a diversified way and the future will likely be kind to us with some unavoidable and totally normal scary moments along the way (the last couple of months). However, owning what everyone else owns at high prices and expecting to be just fine in the "long term" isn't an informed point of view. History is littered with really long time periods where investors in expensive stuff would have been underwater for way longer than they could afford. Owning the right stuff at the right moment is crucial as we head into difficult times. Embrace the uncertainty with a sense of hope and optimism, but only after embracing the concept of proper preparation and planning.

Narratives Don't Have to be True

By Casey Clarke

One of the hardest things about investing is figuring out which information is most valuable and trustworthy. There are numbers, stories, projections, opinions, an almost endless supply of data and inputs with which to make decisions. How does one sort through all the information and determine what's useful and what's not? We're not going deep on this topic today, but we're witnessing in real time lives being changed for the worse because what some thought to be true turned out not to be. Whether Bitcoin, other cryptocurrencies, meme stocks, or more traditional stocks, many investors have lost far more money than they thought possible because they bought into a narrative. This short bullet-pointed note aims to provide a quick reminder in a narrative-driven world how important it is to be able to spot them and how to react once you do. First, our simple paradigm for viewing the (financial) world:

1) Are there any conflicts of interest present that bias the presenter/author of this information?
2) What financial incentives exist relating to this information?
3) Are there regulatory capture issues present that allow for potential misinformation to go unchecked?

Let's briefly revisit some financial history and have a look at how narratives drove investor behavior.

<u>Financial Market Narratives</u>

- ➲ Stock Bubbles
    - Tech Bubble 2000
        - ⇒ Internet Transformation
        - ⇒ Unlimited Profit Potential

- Nifty Fifty in the 1960s
  - ⇒ Market dominance through conglomeration
  - ⇒ Profit durability
- Roaring 20s
  - ⇒ New technologies in oil, music, autos offer unlimited growth potential
  - ⇒ Unit investment trusts make investing possible for the masses
- Real Estate Bubble
  - ⇒ "They're not making more land" argument around limited supply, leading to perpetual price increases
  - ⇒ Low interest rates will create lasting demand for homes
- Bitcoin
  - ⇒ Decentralized money that governments can't control
  - ⇒ Will replace the dollar and other fiat currencies in the future
- Today's Stock Market Bubble
  - ⇒ The Fed won't let markets crash (assuming it's always up to them)
  - ⇒ There's no better alternative
- Most investors at the time bought into these narratives

<u>Who benefits/profits from these narratives?</u>

- Financial Institutions
  - "As long as the music's playing, you've got to get up and dance" - Chuck Prince, CEO Citigroup post-housing collapse, July 2007
  - Bull markets lead to bigger profits providing clear incentives to keep them going and/or convince investors of their existence
- Business Owners
  - Whether a corporate CEO or a Bitcoin entrepreneur, there are financial incentives to convince customers or investors to keep buying
  - This can lead to stretching the truth, creating hope through story-telling, or outright fraud in an effort to keep the good times going
- Investors
  - People want to believe a good story, especially when:
    - ⇒ Most of their friends and family also believe it
    - ⇒ It involves the potential for personal financial gain

- ⇒ It aligns with existing beliefs
- ⇒ They fear missing out (FOMO)
- ⇒ When "experts" are the story tellers

- Governments/Politicians
  - Campaign finance/contributions drive behavior
  - Employment opportunities for ex-government officials

<u>Regulatory Capture</u>

- Regulators become close with those they regulate. There is a human factor.
- There is also a financial component. Oftentimes employment opportunities await regulators once they retire from public service.
- Corporate executives become regulators for their own industries.
- Even after tips to the SEC, Bernie Madoff still wasn't discovered/looked into by securities regulators early on.
- Big banks often breach investor trust and end up quietly settling with government regulators without admitting fault.
- Small firms can be treated much more harshly. This is regulatory capture.
- This creates the perception that the narrative perpetuated by industry is truthful and accurate. It allows for its destructive build-up.

As you can see from the short list of market bubbles above, each one of them had its own dominant narrative that helped drive it to extremes. Whether a stock market bubble or some other extreme social movement in society, narrative is the primary tool driving it forward without fail. Sometimes it's fact-based and accurate, but many times, as it grows, morphs, and matures, it becomes anything but. It gets further from fact and closer to whatever vision serves the purposes of the storyteller. Whether it's dotcom companies in the 2000's not needing to make money to change the world or Bitcoin going to $1 million in a couple years and taking over fiat currencies, the end result is failure of the host to think critically about the issue at hand. The narrative becomes parasitic. It controls our every move.

Our best advice is when reading a tasty morsel of information, think first about the three questions above; conflicts, incentives, capture. If the source of the info fails those three tests, it doesn't mean that it's not true, but it does mean that it's possible it's not. Take it with a grain of salt and don't weight it as heavily as you would information from a qualified source who hasn't failed those three questions. Use your own thinking and never delegate it entirely. You care more about you than anyone else does, and you are the one who will have to suffer the personal consequences of a bad outcome. We set off to form Cadence to free ourselves of as many conflicts as possible and to be able to spot them and call them out for our clients. We're good at spotting a bad narrative. We have your back. Remember that it isn't just the financial industry that's good at spinning them. Use the three questions, don't delegate critical thought, and make the best decisions for you.

Getting Your Beneficiaries in Order

By Tom Shiffer

We've touched upon different aspects of estate planning in the past, but in light of recent data from CDC.gov and Census.gov, we've noted that the US has experienced a 16.4% increase in all-cause mortality in 2021 over 2020. Given these numbers and other recent legal developments, it's time for an update. This article will be a refresher on what has changed in the past few years and a reminder to make sure your beneficiary designations are who you want them to be and that they will achieve what you intend them to. As a reminder, we are not estate attorneys and you should definitely meet with an attorney for your family's specific estate planning documents, but here are some areas to be aware of and to consider.

Beneficiary designations and ownership supersede instructions left in a will. What does that mean? For example, let's say I was married to wife #1 and got divorced. I had wife #1 listed as the beneficiary on my life insurance policies (work and individual) as well as my work 401(k) plan and Rollover IRA's. We also shared property and bank accounts. After the divorce and splitting of the assets, I married wife #2 and put wife #2's name on the house and bank accounts. I also updated my will to leave all of my other assets to wife #2. All is good, correct? Not quite. If I pass away in the scenario above, wife #2 gets the house and bank accounts (ownership) and then contents of the house and other tangible assets (will) but wife #2 would NOT receive my life insurance proceeds nor my 401(k) and IRA assets (beneficiary designations) because I neglected to update the proper account documents. Those assets would go to wife #1, which after the divorce settlement wasn't the intent. So be very careful and make sure your beneficiary designations and asset ownership reflect your current wishes.

Another consideration involves the use of trusts as the beneficiary designation of an IRA. There are many reasons to use a trust as the beneficiary designation (such as legal protection of assets, spendthrift provisions, special needs, etc.) and your estate attorney can make sure the correct trust is set up for you and determine if that is what you and your family need. However, If the intent is just to leave the assets to a surviving spouse, a trust listed as the beneficiary of an IRA may not be the way to go. With the passing and signing into law of the SECURE Act on 12/20/2019, IRAs can no longer be stretched out over the beneficiary's lifetime. Non-spousal beneficiaries, like a trust, now have to empty the account within 10 years. A spouse however, along with a few other exceptions, is allowed to rollover the assets to their own IRA and the Required Minimum Distributions (RMDs) would be calculated based on their own life expectancies – not over the 10-year period that applies to inherited IRAs after January, 1, 2020. Check with your estate attorney and financial advisor if you last set up beneficiary designations a long time ago to make sure everything is listed the way it needs to be for your intended outcome.

Finally, some tax planning may also play a part in how you decide who is best to inherit which assets or accounts. For the new SECURE Act Inherited IRA RMD rules, the prior thought was you had those 10 years to empty the accounts and you could take as much or as little out each year as you wanted as long as the account was emptied within the 10 years. However, to muddy the waters further, in March of this year the IRS issued new guidance for the SECURE Act's Inherited IRA changes. In a surprise move, the regulations require most designated beneficiaries to take annual RMDs within the 10-year distribution period if the original account owner died on or after the required beginning date. In other words, the beneficiary can't simply wait until year 10 to empty the entire account. Of course, the new rule would mean that clients would generate added tax liability in each year of the 10-year period — rather than waiting to pay the entire tax in year 10. The comment period for the proposed regulations ended May

25th and the many comments the IRS should receive may result in changes to the final regulations, so stay tuned! It may be best that beneficiaries who would still be in their higher income-earning years inherit taxable accounts (which currently get a step up in basis at death) and IRA assets go to people not in their peak earning years. This is where the art and science of financial planning come into play, so meet with your advisor and together you can come up with a gameplan that allows you to most efficiently pass on your assets in the manor you intend.