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FOCUSED ON WHAT MATTERS MOST.

It's Time You Updated Your Financial Plan

By Steve DeBoth

A financial plan is often described as a road map. With all the different options available to get from where you are, point A, to where you eventually want to be, point B, what is the fastest, or the safest, route? If you had to use an old-fashioned road map to plot your journey, you would take into account the known and measurable details like how much gas you currently have in the tank, how likely the car is to make it to the destination safely versus break down for some reason, time of day, and other known and observable details. Other details will have an impact on your journey but have to be assumed, like how bad traffic is along the way, where gas stations may be along the route if you do not already know, and even where you may be able to get out and take a bathroom break, which anyone who has traveled with children knows is not to be ignored. You take all the inputs, both the known and measurable, as well as the assumed, and you consult a road map to plot the best route.

A financial plan is similar in that there is a starting point, today, and a destination, the goal. There are known and measurable details, like how much you are saving, how much you already have saved, when the goal is to be achieved, and how much the goal will "cost", for lack of a better word. Like not knowing how bad traffic is, there are also important data points that have to be assumed for a financial plan, like how much your investments will make along the way, how bad inflation is going to be over time, and where income and capital gains tax rates will be in the future. After taking into account all those variables, we are then able to identify the potential courses of action and decide which will be most likely to have you achieve your goals on time, not at all unlike choosing between different roads to a destination.

If a financial plan is able to do all that, with all that different information, then why do you ever need to do more than one? If the financial planning process is so good, why would you ever invest in another one?

Well, because things change. Your asset values, your expenses, and your other financial realities change over time. The variables for which we needed to make assumptions become known over time. Lastly, your goals can change over time. Wouldn't it be nice to know you could retire earlier, or pay more toward a child's education, or donate more to charity? If your most recent financial plan was plotting the best route to a destina-

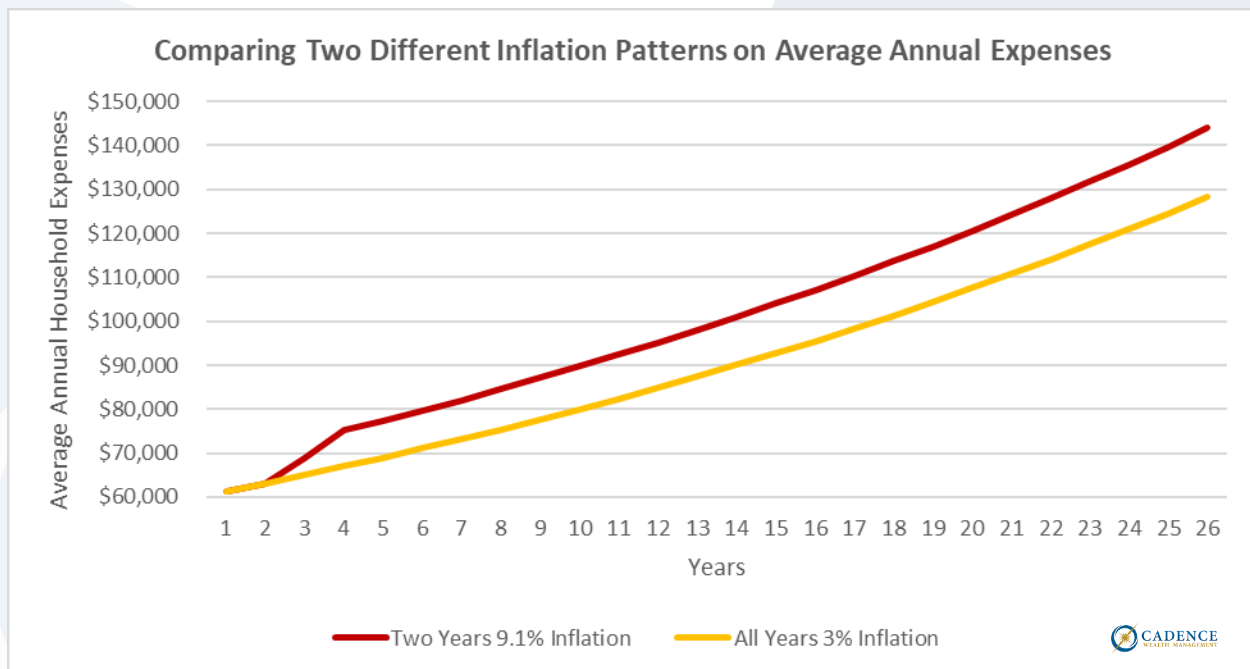
tion, wouldn't it be nice to know you could reach somewhere even more desirable? You should be looking at your financial plan as something that helps protect your ability to achieve your goals from the threats out there that may derail you, as well as something that helps you take advantage of the opportunities that you may not be embracing to achieve your goals.

Reason #1 for periodically updating your financial plan – protecting you from the financial forces outside of your control, in this case, INFLATION.

Financial planning software does a great job of helping us estimate variables that will affect our ability to achieve our goals, but they are still assumptions. One of the most important assumptions we make, especially over the long term, is how much the cost of what we buy will increase every year on average. Expense inflation had been relatively low for so long that many financial plans have used 3-3.25% or so annual inflation assumptions. That means that over the course of a 25-year retirement, expenses will double, but it is still a relatively low rate by historical standards.

It takes a shockingly short period of high inflation to increase the average annual inflation rate, and even a small change to the long-term average has incredibly meaningful, and potentially problematic effects.

To illustrate this, I am going to use some data from the Department of Labor. According to the DOL, the average household in America had $61,300 worth of expenses in 2020, which is estimated to grow to $72,900 in 2022. For those two years, that is an average annual expense inflation of 9.1% per year. Let's compare a couple of different possibilities. One is that the average annual household expenses keep inflating by 3% every year for 25 years. The other is that the average annual household expenses keep inflating by 3% every year for 25 years, except for years 2 and 3 when they increase by 9.1% like they did recently.

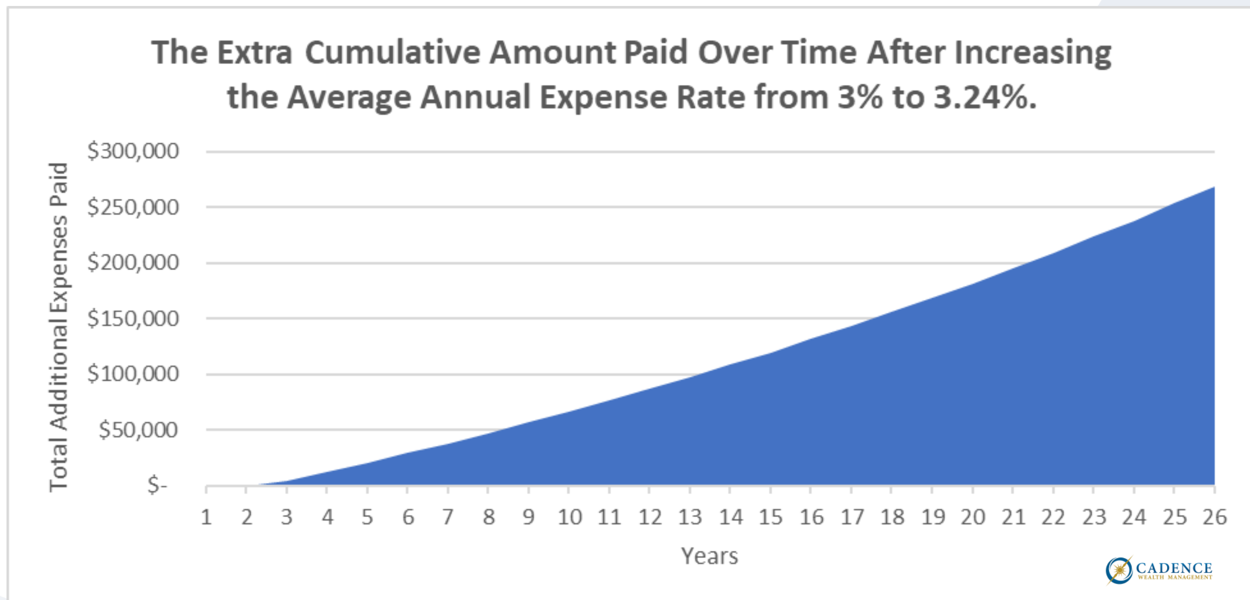


You can see the average expenses jump up a bit as expected (red line), and then continue growing at a rate of 3% per year just like the sequence that had a uniform rate of growth (yellow line). Over the full 25 years, the 2 years of 9.1% inflation only increase the total average annual rate from 3% to 3.24%. That's a pretty small difference, possibly meaningless.

Or is it? You can tell by my asking it like that, it will not end up being meaningless.

Over a 25-year period starting with expenses of $61,300 inflating by 3% per year, the average expenditure per year for the full period is $92,800. After just two years of 9.1% in the early going, that average expenditure is $102,800 instead.

That means over the total 25 years, that extra 0.24% per year increase results in nearly $270,000 more in household expenses that would have to be paid over the total time period.



That seemingly insignificant 0.24% increase just cost you nearly 3 years' worth of average expenses. $270,000 cumulative additional expenses divided by $93,000 average annual household expenses equals 2.9 years. And guess what? Tacking on a third year of 9.1% inflation increases the cumulative additional expenses paid for the 25-year period to $409,000, which is nearly 4 ½ extra years of average annual expenses to pay. That's like having to pay for more than 29 years' worth of household expenses over the next 25 years. Do you know if you can afford that?

If you are not concerned about having to maintain your lifestyle for at least 25 years, that doesn't fully insulate you from the effects of elevated inflation for a couple years. If you did a plan a couple of years ago and used a 3% rate of inflation, then consider doing a new plan with the increased cost of the goods and services as your expense estimate going forward. Looking at the chart above, were your annual household expenses around the national average and if they increased at a comparable rate, then you would have to pay around $130,000 more than you'd planned on over the 15-year period. If we get another year of 9.1% inflation, that will balloon to nearly $200,000 more you will have to pay to maintain your lifestyle over the next 15 years than you'd planned on. Maybe it's time to update that road map.

The inflation rate, income tax rates, investment returns, and other assumptions, can all deviate from what we used for the financial plan. Additionally, family situations change all the time. Any one of these can change in a seemingly small way, yet like a small change to the rate of inflation, it may dramatically affect the paths you should be taking to achieve your financial goals. There are more opportunistic reasons to update your financial plans, though. Just like the plan assumptions potentially being worse than originally estimated, they can also be better, or you may have been able to save more than you'd thought you would.

Reason #2 for periodically updating your financial plan – taking advantage of better-than-expected progress.

Consider a situation where a retired couple, both 70 years old, did a financial plan right before retiring five years ago. At the time, they were given a 95% probability of success. Since then, they have spent less than they thought they would. As a result, they would like to know if they would be able to maintain their current retirement lifestyle were they to buy a second property on a lake. They don't want anything big, but even small homes in desirable locations have increased in price significantly over the past ten to twenty years, so they are willing to use $200,000 of their total $1,300,000 in investment assets for a down payment, and then take out a mortgage up to $100,000 for a total purchase price of $300,000. They estimate their monthly expenses will increase by $1,500 should they buy this second property.

When they do a new financial plan to help them figure this out, their current assets, assumed rates of growth over time, assumed inflation of 3.25% going forward, their $72,900 in annual expenses just like the DOL says, and their $66,000 in social security income gives them a:

That's great progress! Five years ago that was 95%, and now it looks even better. That helps give them the confidence to consider increasing the quality of their retirement lifestyle by seeing if they can afford a second home.

If they use $200,000 of their $300,000 non-IRA investments, acquire a mortgage, and subject themselves to any of the potential real estate taxes, insurance, association fees, etc., that would add to their monthly expenses by an estimated $18,000 per year to purchase a second home on a lake in their price range, the plan would give them a:

That is probably a strong enough probability of success for this couple to move forward with this new course of action. For some retirees, better-than-expected results may cause them to do nothing, or it may cause them to give more to their children and grandchildren, or charities, or whatever makes them happy at that point in their lives.

Had they not updated their financial plan, though, they'd never know those additional things that would bring them more happiness are in reach.

Both the threat that something has happened to knock your financial plan off track, as well as the opportunity that something has happened to make your goals more achievable, or to make *better* goals achievable, are reasons why you should periodically update your financial plans. The recent bout of inflation alone should be enough to concern us all. However, the financial planning process is also there for you when you just want to consider a different course of action and all the moving parts are too complicated for you to just wing it.

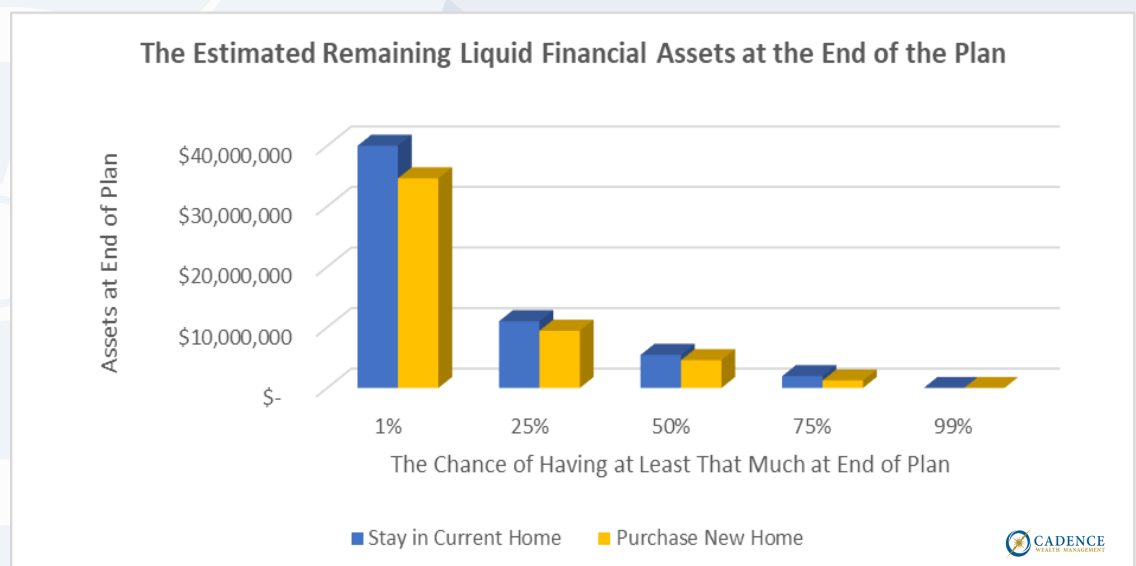
Reason #3 for periodically updating your financial plan – because it allows you to dive deeper into any area of your financial life that you would like.

Let's face it, there are a lot of moving parts to your financial life. Your home value affects your real estate taxes, your real estate taxes affect how much you can save toward your goals, how much you save toward your goals. . . and on and on and on. Pretty much every financial decision you make affects nearly every other financial decision you make. There's no getting around that. Therefore, you should not make any financial decision, especially a large one, without understanding how much it affects the rest of your finances and goals. Annual financial planning allows you to answer any number of "what if" questions over time: "What if we traveled more?" "What if we retired earlier?" "What if one of us loses our job and cannot find another one for a year?"

Consider a situation where a married couple, each 50 years old, just wants to know if they can buy a bigger house. They have ten years left on their current mortgage and they're unsure if extending those payments another ten years, even though they'd be able to pay less per month for the situation they are considering, will work. There are too many moving parts there to look at simply swapping one house for another, so they update their most recent financial plan.

When they completed their plan five years ago, they took steps that increased their probability of success from 65% to 80%. The preliminary result of their new financial plan shows an 86% probability of success, and they are very pleased with their progress. This allows them to seriously consider taking advantage of the home purchase opportunity that has arisen, which they wouldn't have considered had they still had an estimated 65% probability of achieving their other goals.

Working with their financial planner, they want to see what would happen if they liquidated their $100,000 investment account, used that to augment their assumed net home sale proceeds of around $450,000, and took out a 20-year, $200,000 mortgage to buy a bigger home with a better view. They keep everything else the same for now, and are given an 82% chance of success after "buying" the new home. They review the estimates of how much they would have in liquid financial assets at the end of the plan time period, and buying the new house doesn't seem to drastically change those projections relative to staying where they are:



They like the fact that buying the new home gives them a better probability of success, 82%, than what their plan estimated they would have 5 years ago in their current home, 80%. However, before moving forward they and their financial planner will see if there are steps they could take to improve that probability of success.

A benefit of frequent financial planning is the ability to consider new courses of action that may not have existed during the last planning cycle.

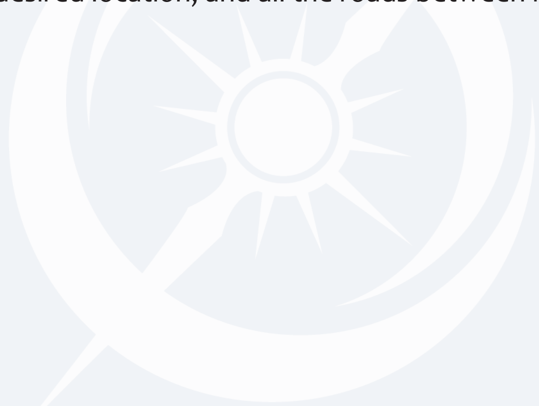
Obvious changes like a new job with new benefits or a large increase to social security income could be the catalyst for a new planning cycle, but even seemingly small things like a workplace retirement plan that now offers a Roth 401(k) option could be a reason to update your road map. While this couple is investigating whether or not to buy this house, they know that anything else that has changed in their financial lives, whether it be something they have control over or not, will be factored into this new planning cycle to give them an even clearer picture of what their best courses of action are.

The best way for you to stay on course is to frequently check that you are still on course.

The best way to protect yourself from the potential threats out there is to gameplan for the threats before they occur. The best way to know you can achieve more financially is to identify as quickly as possible the moment your finances allow you to achieve more. Frequent financial planning is the only way these things occur.

If you made a road map five years ago to get from your house to the closest beach, the likelihood that your house, the beach, and all the roads are still in the same spots is extremely high. Unfortunately, the variables used in the financial planning process change a lot more frequently than roads, home and beach locations do. Five years after plotting your first course to the beach, if the roads, your house, and the beach itself could all shift around a bit, would it be wise to plot the course again? Also, assuming all those things could move, would you consider that maybe things have shifted around such that you can now reach a different beach you would enjoy even more?

Because your income, expenses, assets and liabilities change over time, not to mention tax laws, healthcare costs and options, and family situations, the last financial plan you created may now be out of date, and maybe you could or should, depending on what has happened since your last plan, adjust your goals. Retire earlier or later, move to a different part of the country or stay put, whatever it is, whether out of necessity or just because you want to. As good as a financial plan is, there is no way to predict perfectly the values of all the variables that will have a material effect on your financial future. Whether it is to protect yourself from the more expensive future caused by the recent high inflation, or to take advantage of really good progress, or just to see how any financial decision affects your various goals, frequent financial planning gives you a better chance of achieving your goals, and in some cases of achieving better goals, then planning once, liking the results, and never planning again. If your current location, desired location, and all the roads between here and there change over time, shouldn’t you update your road map?



The Moral Hazard Conundrum

By Casey Clarke

Too big to fail. Auto bailouts. Quantitative easing. Central bank financial market asset purchases. Fiscal stimulus. Paychecks in mailboxes. Without casting judgment on whether or not these concepts or actions are productive, they all share a common element. They condition behavior away from risk avoidance toward speculation, and oftentimes in reckless fashion. The belief that things will always be okay, that somebody will fix it, creates a mindset that risk doesn't matter. To some degree this mindset permeates every late stage economic and market cycle as risk is rewarded until the cycle turns, but the last two or three decades have taken that speculative mindset to new levels. In the late 1990's, one of the largest hedge funds in the world, Long Term Capital Management, was bailed out by Wall Street because the reckless behavior that brought it to the brink of collapse (behavior that was initially viewed as relatively safe and responsible) threatened to bring down financial markets and potentially other financial institutions in the process. Then came the housing crisis in 2007 and 2008 where more financial institutions and public corporations were bailed out. Since then, and only up until recently, the Federal Reserve has been easing financial conditions through low interest rates and financial asset purchases with only a few interruptions along the way. Investors and corporations have been operating with a sense of imperviousness and infallibility. These events have made this particular cycle, and likely its eventual decline, very different from those previous.

Moral hazard isn't when risks are taken because they've recently been rewarded by markets, rather it's when those risks are taken despite a knowledge that good times will eventually end and because losses or personal harm associated with similarly risky behavior in the past were ameliorated. If there is no downside to recklessness, then why not swing for the fences? Banks can take excessive credit risk to maximize profits, auto manufacturers can skimp on R&D and delay cost controls, consumers can continue to acquire large T.V.'s while missing loan repayments and slacking at work, and colleges can continue to raise tuition costs relentlessly since students continue to have endless capacity to borrow. The fact that few consider there to be limits to some of these extreme trends, and that even fewer are taking them seriously because of the conditioning of the last couple of decades, is the moral hazard conundrum.

Giving away free stuff, bailing out corporations and consumers, and making efforts to keep bad things at bay is always preferable to the alternative. In politics, it's really the only option if one seeks politics as a career. These things are politically expedient, which is why the more of it we do, the more of it we do. There's really no going back on free stuff and bailouts once the precedent has been set, else the people might get a little angry and vote another way. Anyone with kids very much understands this concept. If dad says no, mom's the new favorite parent. Sadly, if the kids voted on whether to keep dad based on how many "no's" he's dealt out recently, they may indeed send dad a packing. The more spoiled the kids, the greater the odds dad gets cast out. And if dad makes a late moral stand and there's a new dad? The new guy doesn't stand a chance. The precedent's been set.

The point is this – moral hazard has been a key contributor to the biggest and longest market cycle we've seen in history over the last 13 years. The kids never get punished for their indiscretions and are acting as impulsively as ever. What happens, however, if mom and dad stop enabling? Of course they wouldn't by choice, since they need their kids to continually approve of their parenting, but what if a change in the rules of the game forced their hands? If suddenly the kids were left to suffer the consequences of their actions, it would undoubtedly come as a surprise. Worse, if every kid in the neighborhood experienced the same sudden reality check, and ended up either grounded or worse, the streets would be quiet; possibly for quite a while.

This is the risk we're up against in the financial markets. Inflation has changed the rules of the game. More than two decades of politically expedient monetary and fiscal enabling was allowed to perpetuate completely unchecked due to inflation being low enough to not cause any problems. That has abruptly and unambiguously changed over the last year. Inflation now forces monetary and fiscal discipline because the societal damage and revolt if allowed to rise unencumbered would be greater than that inflicted by allowing markets to fluctuate freely and without intervention. For the first time in 13 years, the Federal Reserve cannot bail out markets without risking serious consequences. In addition, the federal government cannot continue to bail out consumers or corporations the same way it has without risking similarly serious inflationary ramifications. The idea that the age of moral hazard may be coming to an end after such a long run and at a time when many will feel the system is most in need of support, is the moral hazard conundrum. Central bank and to a lesser degree, government assistance may not come as readily as it has in the past. At least not without more immediate consequences or until inflation is the lesser of the evils. Investors should be keenly aware of this risk.

In terms of our current assessment of markets, it appears the bear market bounce (which as usual, had the financial media proclaiming a new bull market) is over and we're moving into another phase of the downturn for stocks. Below, we can see the downward trend in the Nasdaq 100 (QQQ) since the beginning of the year, along with the more recent bounce. The big picture still shows a very clear downward trajectory.

QQQ:

In the chart on the next page, when we look at 100-day price momentum (price relative to the 100-day average price), we can see the recent bounce took us to the intersection of two trend lines, then turned decidedly lower. Against the backdrop of continued deceleration in economic growth and a large, but typical bear-market rally, this provides a good technical turning point for markets.

QQQ Momentum:

In terms of government bonds, which typically hold up well against stock market weakness, we've seen prices stabilize after uncharacteristically falling with stocks for months. This, along with the continued economic deceleration ahead provides opportunity for the highest quality bonds such as long dated U.S. Government bonds to do well going forward. Both the macroeconomic scenario and price signals support a more promising outlook from here.

20-Year Government Bonds (TLT):

When looking at another typically defensive asset class, gold, we see similar relative stability. It is down -6% this year compared to the S&P 500 being down more than -16%. Although gold has struggled in recent months, on a relative basis it's been one of the best performing categories this year. This relative strength should also bode well for gold-related investments going forward such as silver and gold mining companies. It's not uncommon during the early

parts of equity bear markets for all categories of investments to fall. It wouldn't be surprising to see these defensive categories begin to perform better throughout the second wave of this stock downturn and beyond.

Finally, our view on energy investments over the short term is relatively ambivalent. On one hand, continued supply issues could raise the prices of energy and associated investments while on the other, falling demand associated with economic contraction over the coming months could outweigh supply pressures. This uncertainty has us erring on the side of caution for now, especially given the sharp run-up in prices already. Longer term, our view is unambiguously bullish. We'd just rather wait until we're on the other side of this global showdown before taking meaningful positions in energy investments once again.

On a related note, the energy crisis in Europe is real. As the months get colder, we'll see just how severe and far-reaching this crisis becomes and how global authorities respond to it. We just hope that they fully appreciate the human aspect of this situation rather than viewing it solely as a geopolitical one. It's fair to say, we're expecting anything in markets, and we're positioned accordingly. Expect volatility along the way. There's really no way to avoid it as no asset class is immune. If you've made some deal with someone (or some company) to eliminate volatility and uncertainty, you've traded away control and opportunity; it's that simple. We can only hope that as a result of thinking critically, our volatility is less and shorter-lived than for others. The former has been and we think the latter will be. Hang in there.

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