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Cadence clips

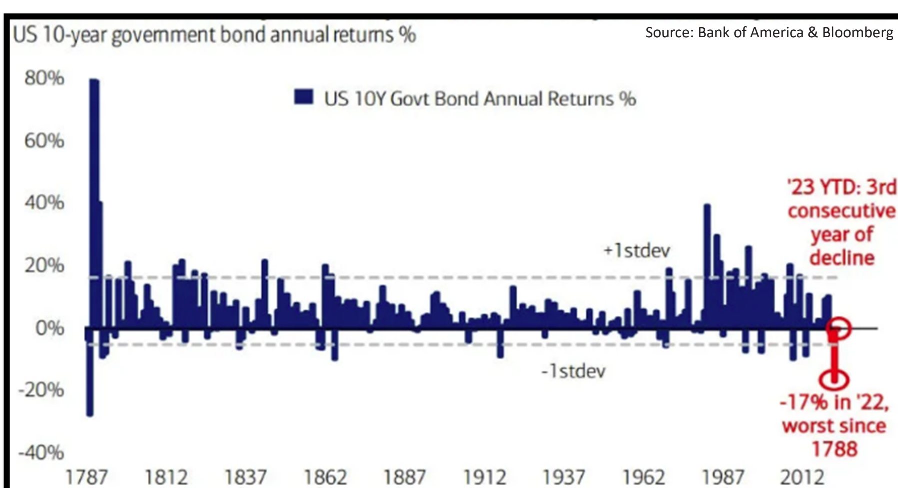
FOCUSED ON WHAT MATTERS MOST.

Winning on the Downside

By Steve DeBoth

In the earliest days of the United States, tender and weakened from the 7 years of fighting to free itself from England, the debts acquired to fund the Revolutionary War had piled up with only troublesome methods of repayment left as options. Many who supported independence from England did so because they did not like paying the taxes England had levied, so raising money through taxes was not an attractive option for the newly minted Treasury. Issuing currency to pay those debts was also tricky, as with a mostly barter economy back then, any kind of liquidity injected into the system was feared to cause hyperinflation. Lastly, borrowing money to pay back money that had already been borrowed was only as successful as being able to find new lenders allowed. It's not like the United States of the late 1700's was seen as a safe bet for good reason, as the country did default on many of its early obligations.

In the end, dollars were issued leading to the predicted hyperinflation, and new debt was issued at interest rates that were attractive enough for lenders to be willing to take the risk on such a young, cash-poor, overly indebted nation. Both the hyperinflation as well as the relative scarcity of lenders resulted in interest rates rising fast enough to crush the value of outstanding US debt. The early days of the US Treasury are fascinating, extremely messy, and feel about a million years away from where the US Treasury activity is today. Yet, recent returns on 10-year US Treasury bonds have not fallen so quickly since Alexander Hamilton was begging for money. In fact, if 10-year treasuries don't post a positive return this year, it will be the first time ever, even including those difficult early years, that their value falls three years in a row:



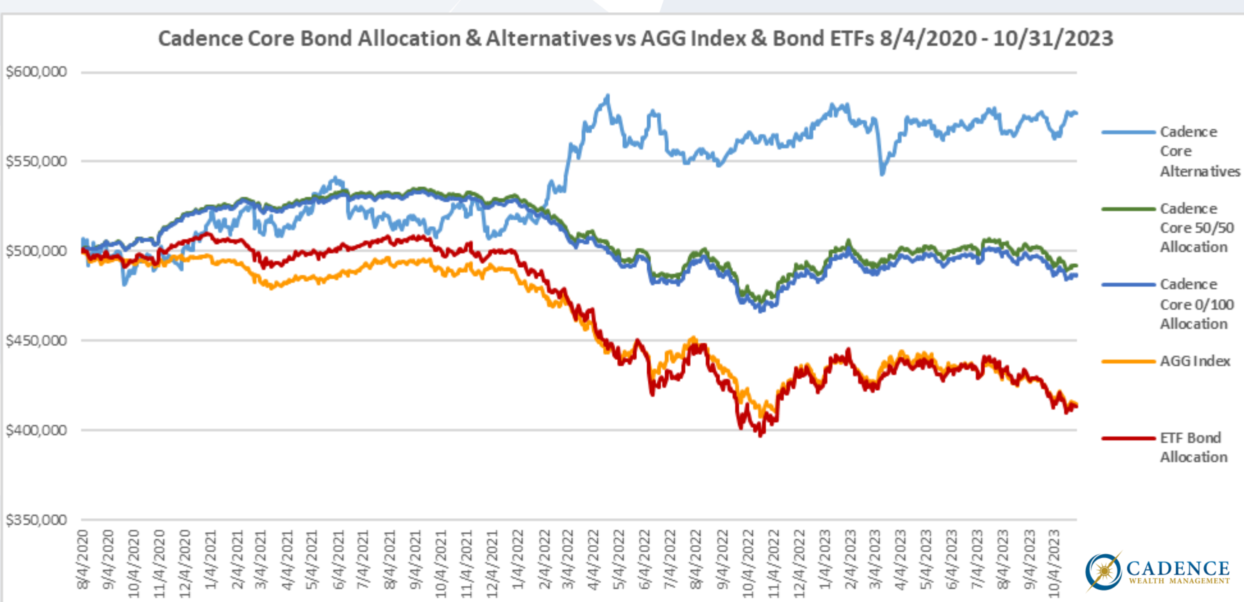
Whether you knew it or not, we have lived through the worst bond market since America was brand new. It is showing up in clients' investment returns to an extent, but not to the extent you would think given how historically bad it has been out there. If the stock market suffered its worst loss since the Continental Congress, you would certainly be aware of it. So how can bonds have performed so badly without your knowing just how bad it's been?

The Outperformance of Cadence Portfolios' Conservative Investments

Most investors consider stocks to be the "risky" parts of their portfolios and bonds to be the "safe" parts. The more bonds you own versus stocks, the less volatile your portfolio usually is. The past few years, especially 2022, have challenged that assumption a bit. It turns out that safe bonds can perform like risky stocks if the environment is just right, and years of kicking the can down the road by keeping interest rates artificially low, injecting the financial system with liquidity that had to flow somewhere, and emergency pandemic funding, justified or not, have cooked up a perfect environment for both stocks and bonds to be over-valued by historic standards.

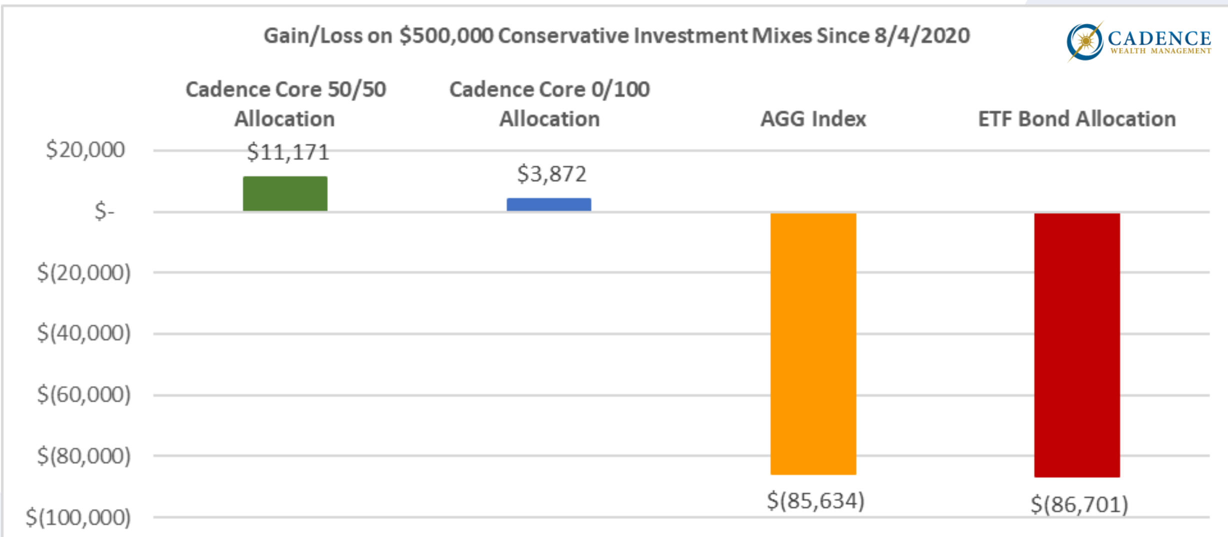
There are a variety of ways for investors to gain exposure to bonds and other forms of fixed income. They can buy individual bonds, either from government or corporate entities, they can buy exchange-traded funds that track any of the various bond indexes, and they can own fixed income mutual funds, to name a few. Over the past 12 years, Cadence portfolios have contained all of these options, as well as others, but as fixed income asset valuations crept ever higher, we have settled on mutual funds to handle the majority of our fixed income exposure. We have rounded out the conservative side of our portfolios with a tactical allocation toward alternative investments, which own assets other than stocks or bonds, or they do own stocks and bonds but are not managed as typical buy-and-hold assets. Using well-chosen mutual funds and alternative investments has spared our clients the vast majority of the historical pain experienced in the fixed income markets since August of 2020.

To illustrate just how successful this approach has been, consider the returns on conservative assets since the bond market peaked on August 4, 2020. Two of the returns being illustrated are the bond portions only of the Cadence 50/50 and the Cadence 0/100 stock-bond portfolios. Those are the green and dark blue lines in the middle of chart that are hugging each other quite closely. Included as well are the returns of the alternative assets sleeve we use in lieu of some of our bond exposure, which is the light blue line at the top. Lastly, we compare those results to a portfolio of bond exchange-traded funds, as well as to the iShares Core US Aggregate Bond Index, otherwise known as the AGG, which are the orange and red lines marching in near lockstep at the bottom of the chart:



From August 4, 2020 through October 31, 2023, $500,000 allocated in the fixed income portion of our Cadence core portfolios would have lost between $8,000 and $13,000. That's around a -1.5% to -2.5% loss. Compare that to the nearly $86,000 lost by the index itself, and the nearly $87,000 lost by a bundle of bond exchange-traded funds.

However, to get the true measure of how the conservative portions of Cadence core portfolios have performed over this stretch, you have to combine some of the returns of the alternative sleeve with the fixed income mutual fund returns, because as stated previously, we have diversified some of our risk reduction away from fixed income into alternative investments. When you add those together in the proportions we have them in our portfolios, the conservative portions of our portfolios have actually increased in value since August 4, 2020. Investing $500,000 in the two conservative portions of the Cadence core portfolios illustrated here versus investing in the AGG index itself or the ETF bond allocation would have resulted in the following gains and losses:



Those are some BIG differences. Of course, this is over the entire August 2020 – October 2023 timeframe, and the conservative portions of the Cadence core portfolios did have negative returns in 2022. However, those returns averaged around -4.5% versus the AGG index's -13% and the ETF bond allocation's -15%, so even in their one bad year, those Cadence allocations held up very well.

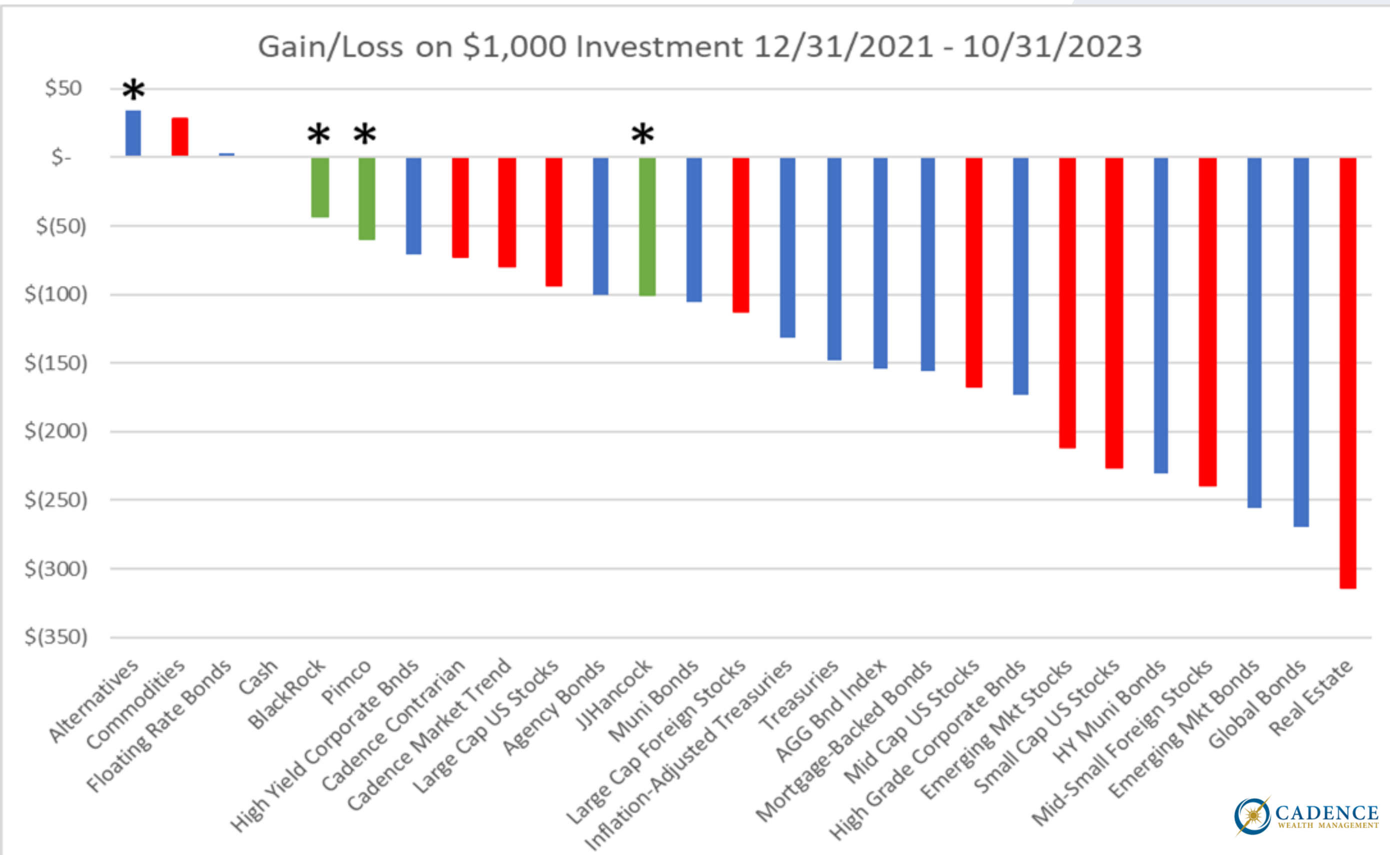
The comparison to the exchange-traded fund portfolio is especially noteworthy since those particular investments tend to be cheaper to own than mutual funds. While many investors have been shifting their conservative assets to ETFs, we have resisted the urge to do so because we believed that the navigation of an over-valued fixed income market was best left to those who have traded in and out of bonds for decades, those being the managers of our fixed income mutual funds. The benefits of that decision should be evident by now. Remember, it's not always what you pay, it's what you net that counts.

Holding Up Through Bad Times

The two main reasons why the conservative portion of our portfolios have outperformed the major indexes, a portfolio made up of ETFs, and, well, history, are because we used alternative investments for part of our conservative exposure, and because the mutual fund managers we are using did their jobs exceptionally well. For a number of years now, we have used a few flexible bond funds as the core of our fixed income exposure, trusting those professional managers to invest in the sectors of their world that would avoid as much pain as possible during bad times.

We do use additional funds that target more focused areas of the fixed income market, and those funds have performed in line with their indexes, but the core of our conservative holdings shifted toward more favorable areas in time for us to avoid those historic losses.

The following chart shows the gains and losses of individual asset classes since the end of 2021 through October 31st of this year. More volatile investments like stocks are red lines, and less volatile ones like bonds are blue lines. You'll notice that a lot of the blue lines did just as poorly as the red lines, which is a very rare occurrence. The core bond funds we use are the green lines, which you will see outperformed the majority of the bond classes. Those three investments, plus the alternative category, have the asterisks to show just how well our conservative assets held up relative to pretty much everything else. 7 of the 24 asset classes were still down over 20% as of the end of October, and 16 of them were still down 10% or more.



*Components of Conservative Portions of Cadence Core Portfolios

Of the volatile asset classes, only commodities have a positive return over the time period. Of the remaining growth-oriented investments, the Cadence Separately Managed Accounts are the two best performing after commodities, which is another reason why most clients' losses were minimized to be just medium to small single digit losses, while the average asset class was down -14%.

You Can Win on the Downside Too

Still, most client portfolios are down since 2021, and even though it's understandable with almost every single asset class in the red since then, it is difficult to feel like losing less on the downside is a win compared to how making more on the upside would feel. Just know that the math on the upside and the downside is the same: being down -5% on $1,000,000 as opposed to being down -15% leaves you with $100,000 more, just like being up 15% as opposed to just 5% would. Whether you win by 10% on the upside or the downside, you are still ahead by the same amount of money.

You will never see a less complicated chart, especially out of me. 10% is 10%, and the conservative parts of our portfolios, as well as the Cadence Separately Managed Accounts, have helped keep clients from losing more over a particularly difficult period.

Conservative Investment Outlook in the Near Term

We are in relatively uncharted territory with many, many asset classes today, both the historically volatile as well as the historically "safe". Valuations and economic indicators, among other things, indicate we are probably not yet out of the woods when it comes to investment returns. These past few years showed us all that bonds are not always the safe investments we want them to be. Knowing this could be the case given just how extreme bond valuations had become, we at Cadence opted to look outside of the fixed income world to diversify away from the stock market risk carried in our portfolios by incorporating alternative investments. Additionally, for the fixed income exposure we did leave in the portfolios, we opted to use professional managers to choose which bonds to own and which to avoid, as opposed to using index-hugging options like exchange-traded funds. Since the earliest days of our country, our economy and our financial markets have survived many shocks, as we will continue to do. While not as dramatic as George Washington leading boats over the Delaware on Christmas night 1776 to attack a garrison of Hessian soldiers, our conservative investments have secured what should be considered a victory in relatively poor conditions, preventing losses from equaling the majority of the stock and bond investment categories over three very bumpy years.

Ask Cadence: Your Latest Questions Answered

Q

What's Cadence's quick take on markets right now?

By Casey Clarke

In doing my best to keep to the spirit of a quick take, our view is we're still in the middle of a broad economic slowdown, the rally in stocks over the last year reflects a bit of a pause in that as well as some amount of denial about it, and we'll probably see the final downward push in activity into early next year. Stocks should move lower along with the broader economy. They're still more than twice as expensive as their 100+ year average on many levels, so the potential for large declines in stocks exists. Longer-term government bond rates have been falling in recent weeks, which could reflect the economic reality of continued slowing ahead. We feel they could fall further in the coming months, but beyond that it truly is anyone's guess. There are too many factors for us to have a confident opinion one way or the other. Precious metals are starting to move higher. With gold surging past $2,000 per ounce this week, that's a potentially major psychological level that's just been taken out. It's very possible that silver and miners follow suit as gold moves more freely upward. The fundamentals for it have really never been better, and as our clients know, the price relative to financial assets has rarely been cheaper. Other commodities, like copper and energy, have come under pressure in recent weeks. Like falling rates, that's likely a reflection of market forces bracing for slower growth ahead. This is a good time to own attractive assets that make fundamental sense. It's not such a good time to own yesterday's winners.

Q

Where can I safely stash some extra cash?

By Casey Clarke

For the first time in a long time, there are actually a handful of options that savers have to get a reasonable return on their money without having to take investment risk. Over the course of the last 21 months or so, the Federal Reserve has raised, in stages, the short-term target on the federal funds rate to ~5.3%. What this means is that savings vehicles that are linked to that rate, and other related rates, can pull in similar interest. Money market funds, CDs, and treasury bonds all pay rates of interest very close to this 5.3% and are great alternatives for money that you want to keep safe, get working harder, and won't need right away for routine bills.

In terms of which might be right for you, probably the most important consideration is how liquid or accessible you want the money to be. Money market mutual funds can be sold off before market close (4:00 EST) and available the next day, whereas CD's and treasury bills, notes, and bonds have specific maturities and holding periods to consider. Although there are secondary markets for both where CDs and treasury securities can be sold prior to maturity, it's best to go in thinking you'll hold them for the duration to avoid any erosion of your return. Combining shorter and longer duration options can be a good way to make sure there's always a chunk of money coming due relatively soon. Another consideration is the safety of the savings instrument. Some money market funds invest in corporate commercial paper and theoretically could decline in value from their $1 per share fixed mark if things got bad out there, whereas money market funds that invest only in U.S. treasury securities are much less likely to waiver. Although it's true that CDs are FDIC insured up to $250,000 per ownership structure, if a small bank holding your CD goes out of business, it could be some time before the government makes good on that insurance.

All in all, risks across all three of these choices are relatively low. For those looking for extra interest on smaller amounts of money, it's probably best not to overcomplicate it and just go with convenience. For larger sums of money, a combination of the three could be a good option. Keep in mind, money market accounts are not the same thing as money market funds. The former is usually a bank option that pays a little more than a traditional savings account, but not as much as a money market fund available publicly and accessed through an investment account.

Q Why can't I invest in hot stocks or markets, then just get out before they crash?

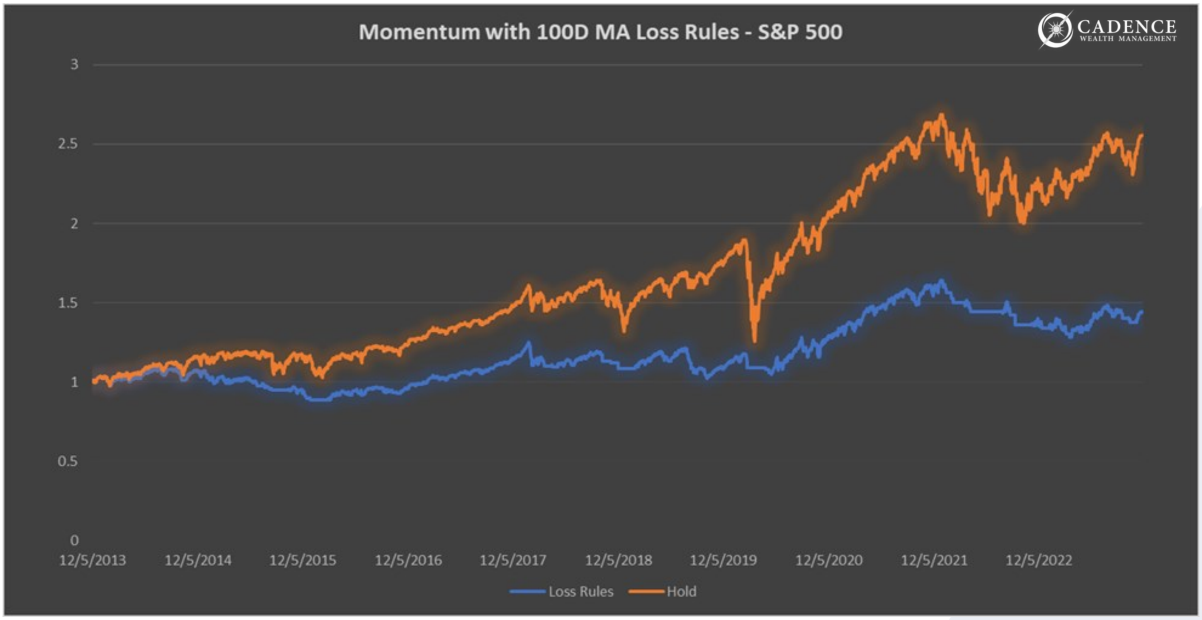
By Casey Clarke

A question that every investor has probably pondered at some point, and one we get occasionally from clients, is why can't we just invest in things that are going up a lot, then get out before they go down a lot? It seems like a pretty simple formula for success. The difficult part about implementing it though, is that we can do either one of those things very easily, just not both of them together and consistently over time. Buying something that's gone up? No problem. Selling something before it goes down? We could sell all of our winners today without a problem. But, holding a hot investment long enough to reap fast money can be a little like picking up a stick of dynamite with an invisible fuse. The issue is that we have no idea how much of it is left to burn before we have a problem. What's really important to remember is that for every investor we hear about who got rich with a stock or hot market, there are countless others who overstayed their welcome. Crypto investors are a recent example of this. When it goes, it tends to go fast.

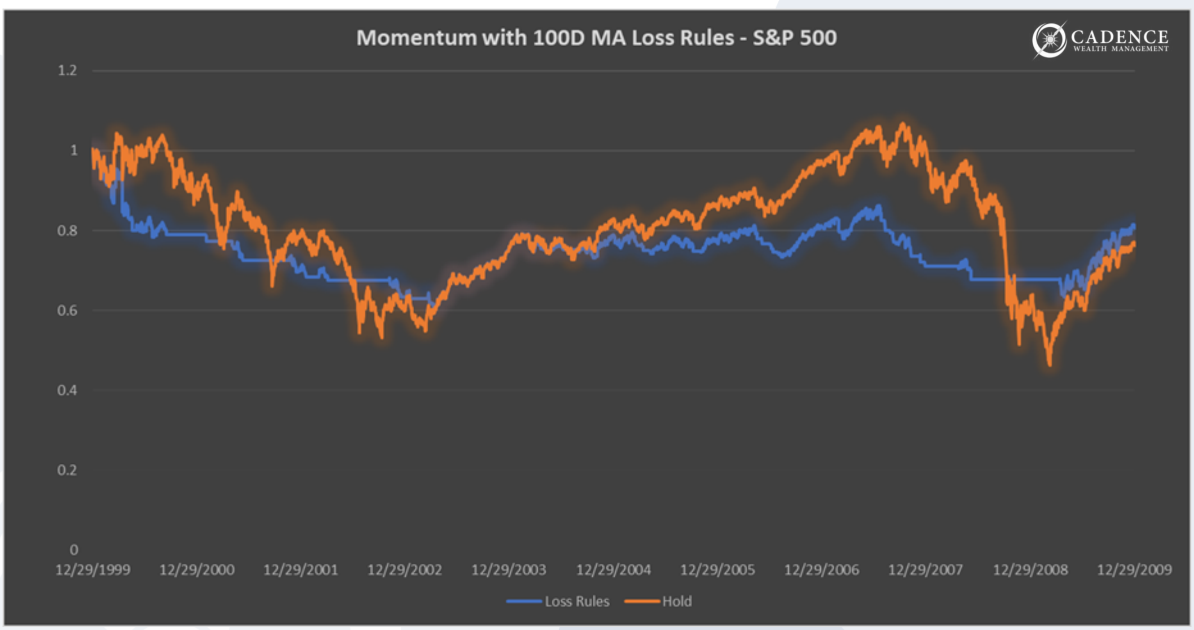
And so, the only responsible way to buy something that is going up a lot and getting more dangerous by the day, is to have a disciplined strategy to help us get out before small losses turn into big ones. One option is to sell after a certain gain, and buy back in after the price of the asset falls by a certain amount. This strategy would work well for an asset that trades sideways in an up and down fashion, but would work much less well for something that is trending either up or down. The asset that trends strongly up will run away from us after selling and may not fall in price adequately to meet our buy-in rules. For the asset that is falling, we may end up buying after a small initial decline, only to be left holding the bag for all the remaining losses.

Another somewhat popular strategy is to buy something when it crosses above a certain average price, say a 100-day moving average, and sell it when it crosses below. The idea is to own the asset when it's going up and acting well, and to be out of it before small losses turn into big ones. It's almost the exact opposite approach of the first one where we take our gains and buy back in cheaper. The issue here is that random price movements around that moving average can cause lots of little losses where we buy higher and sell lower as price moves back and forth around the trigger point. A few months of gains in something that was trending higher can be chewed up in short time with a little bit of sideways trade.

On the following page, we can see the impact that buying and selling around a moving average can have even in a mostly-rising market over time. We're looking at the growth of $1 in the S&P 500 from 2013 to present (orange) versus our 100-day moving average rule outlined above in blue. Our annual return drops from ~9% to ~3.5% over the nearly 11-year span.



The chart below shows the same strategy over a much more hostile period of time for the S&P 500, 1999 through 2009. In this case, we came out slightly ahead of a buy and hold approach, but ultimately ended up with steep losses over the same 11-year period of time. What's notable is that the only time the strategy really excelled was when the market was falling most aggressively throughout the tech bubble, then again through the financial crisis in 2008. In the end, this popular momentum strategy doesn't hold up. It doesn't do anything to protect us from long-term losses in adverse market conditions.



In the end, there is no single strategy that can be executed repeatedly to beat hot markets. In our opinion, it takes a more holistic approach to do that. If we have reason to believe that hot markets can run for a bit longer based on multifaceted analysis, then we could justify owning them to some degree. The question is, are there better assets without all the risk, that have much more room to run? Those are the assets that can be held through the ups and downs because we're not so concerned about avoiding a giant 60%-80% blowup, as is the case with popular, "hot" investments. And if we're not forced to sell every time we think that blowup might be coming, then we don't have to take repeated losses over time that are almost guaranteed to destroy our returns. So, again, chasing returns is like holding that stick of dynamite with the invisible fuse. The probability of repeated success is much lower than we're led to believe. And, holding the dynamite with rules around when to drop it and pick it back up doesn't leave us much better off.

The moral of the story? Don't be fooled by simple sounding ways to beat the market. At the end of the day, we want to own mostly the right assets at approximately the right times. If one gets that generally right, and avoids the big pitfalls associated with doing all that in reverse, they'll do just fine.

Q How much can I save into my retirement plan and IRAs in 2024?

By Tom Shiffer

The contribution limit for employees who participate in 401(k), 403(b), and most 457 plans as well as the federal government's Thrift Savings plan have changes as follows:

	2023	2024
Maximum Employee Contribution	$22,500	$23,000
Catch-Up Contributions for those 50 and Older	$7,500	$7,500

The limit on annual contributions to an IRA have changed as follows:

	2023	2024
Maximum Contribution	$6,500	$7,000
Catch-Up Contributions for those 50 and Older	$1,000	$1,000

The income phase-out range for taxpayers making contributions to a Roth IRA:

	2023	2024
Singles and Head of Household	$138,000-$153,000	$146,000-$161,000
Married couples filing jointly	$218,000-$228,000	$230,000-$240,000

There are many other tax changes for 2024 (income bracket changes, Social Security maximum taxable earnings, gift tax exclusions, etc.) See your tax advisor or visit www.IRS.gov for more information.

CADENCE WEALTH MANAGEMENT