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2021 Second Quarter Newsletter & Outlook

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The Shortest Recession on record received the Most Stimulus on record, the result of a dire situation and reflexive response. The consequences of unleashing a flood to extinguish a conflagration will be fodder for many books to come. Interesting times, indeed, as the herky-jerky, pandemic-hobbled global recovery continues and Covid-19 becomes more virulent.

In the first half of 2021 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 1.86%, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) gained 15.25%, and the Barclays Aggregate Bond Index lost 1.60%. The range of MCS individual client returns was from a gain of 6.54% to a loss of 0.10%.[1]

Newer clients, who have little to no equity exposure, had the lowest returns. Clients with the highest returns had higher US equity exposure or exposure to a legacy stock position that outperformed. MCS client returns were protected from the bond market pullback by the focus on short term bonds, which did not decline in price.

The Economy

Investors are in a high-risk environment.

Despite vaccine progress, C-19 Delta variant infections are rapidly growing. This was predicted over a month ago, and the markets are waking up to the fact Covid-19 will continue to disrupt the global economy.

Most people will go on about their business anyway. Recent analysis by Bloomberg indicates the US economy may be minimally impacted by the Delta variant because the states and counties where vaccination rates are lowest contribute less to the overall economy. That said, the Wall Street Journal reported on 7/26, "Florida is recording more Covid-19 cases than any other U.S. state, as hospitalizations in some areas increase at the fastest rate since the start of the pandemic." The global impact of the Delta variant is significant, especially in SE Asia, threatening continued supply chain and travel disruption.

At the same time, people are itching to spend money. Too much money chasing a constrained supply of goods, services, and labor, is the classic recipe for higher inflation (or worse, stagflation[2]).

How Inflation Works is a Bit of a Mystery

Among the most significant of recent events is the Federal Reserve Bank's change in tune about inflation. The Fed has moved from confidently declaring that inflation is transitory, to now saying inflation is most probably transitory, but it's a very complicated situation, and they could be wrong, but they don't think so. Probably…

In July 2017, the Fed Chair Janet Yellen admitted concerns about the direction of inflation after inflation data came in too low. In June 2021, Fed Chair Powell used the same reasoning that Yellen used four years ago – 'temporary or transitory factors' – to account for why inflation is too high.

Compare Yellen's 2017 quotes:

> *"Temporary factors appear to be at work. It's premature to reach the judgment that we're not on the path to 2 percent inflation over the next couple of years. As we indicate in our statement, it's something we're watching very closely, considering risks around the inflation outlook,"*[3]
>
> *"The shortfall of inflation from 2 percent … is more of a mystery."*[4]

To Powell's 2021 comments:

> *"Inflation has increased notably in recent months. This reflects, in part, the very low readings from early in the pandemic falling out of the calculation; the pass-through of past increases in oil prices to consumer energy prices; the rebound in spending as the economy continues to reopen; and the exacerbating factor of supply bottlenecks, which have limited how quickly production in some sectors can respond in the near term. As these transitory supply effects abate, inflation is expected to drop back toward our longer-run goal.*[5]
>
> *… these [inflationary] effects have been larger than we expected, and they may turn out to be more persistent than we expected.*[6]

From a recent Wall Street Journal article on Powell's July testimony before Congress:

> *The recent surge has created an unexpected problem for the Fed because inflation has strongly exceeded that objective. "Inflation is not moderately above 2%. It's well above 2%. It's nothing like 'moderately,'" Mr. Powell said.*
>
> *The question facing the Fed is "where does this leave us in six months or so when inflation, as we expect, does move down?"*[7]

My conclusion, after reading scores of articles, is this: absolutely no one knows where our current situation is headed.

The pandemic offers great lessons that, even though the probable course of the disease was well understood, simply knowing was not enough to avoid bad outcomes. So, forget about Wall Street and Fed forecasts or assurances. Strong desire, some supporting data, and positive affirmation aren't enough to justify paying such high prices for stock exposure.

When It Comes to Your Money

Making sound financial decisions is critical to managing risk effectively, but it's neither easy nor intuitive - *especially now*. The National Safety Council (2003) defines risk as "a measure of the probability and severity of adverse effects." Today, both the probability **and** severity of adverse economic events are much higher than normal – a very precarious situation.

Two theories about risk can help us understand why most investors are not being more cautious despite warning signs (like historically overvalued asset prices) that are readily available.

- **Social Action Theory** states that people take risks because of peer pressure or a general community perception that an activity is low risk.
- **Habituated Action Theory** says that engaging in high-risk behavior many times without a negative outcome decreases the perceived risk associated with the behavior.

I refer to the latter as 'Cursed with Early Success'. Remember the folks that pyramided their real estate equity to buy multiple houses during the 2008 Real Estate mania? It *did work* for a while. A similar psychological dynamic is at work in today's financial markets.

As your fiduciary, I'm obligated to *act in your best interests*. Abundant evidence of historically high valuations (documented in previous newsletters), coupled with conditions that are unique in modern economic history, implies a significantly *increased probability* (not certainty) of disturbing capital losses. Just over a year ago, the stock market lost over 35% in 6 weeks. Its quick recovery, backed by 10-plus years of 'Buy the Dips and Stay the Course' mentality, demonstrates the behaviors that Social Action and Habituated Action Theories predict.

Nevertheless, many market pundits have a response that downplays the risk of buying stocks and bonds now. In their view the Fed simply won't let a major economic catastrophe happen. They believe the Fed will print money, be the stock and bond buyer of last resort, and bail investors out just like it did last year.

Furthermore, pundits claim, the Fed is committed to maintaining this low interest rate environment to support historically high government debt and asset prices.

Pundits beliefs were contradicted in the same Wall Street Journal article referenced above[8]. Referring to a situation in which inflation does become a concern:

> *There could come a point when "the risks may flip," he (Powell) said.*
>
> *If inflation stayed too high or began to seep into consumers' and businesses' expectations of future inflation, which can be self-fulfilling, then the Fed would raise rates. "People need to have faith in the central bank that we will do that," Mr. Powell added.*

In my view, the market's current narrative of "The Fed will bail out investors, no matter what" relies too heavily on the dozen years to date following The Great Recession, during which the Fed had to continually respond to a slower than desired rebound in employment and lower than expected inflation.

The Fed, in trying to fix those problems, pursued very market 'friendly' policies of lower interest rates.

Powell is saying he will raise rates if inflation becomes a problem, which is expected Fed policy. Yet, at the same time the Fed has adopted a new policy of letting inflation 'run hot' to make up for years of inflation deemed too low aka 'inflation averaging'. Powell's statement about raising rates when 'risks may flip' coupled with inflation averaging policy strikes me as incoherent and high risk. It appears to guarantee the Fed will act late in trying to bring down inflation should inflation be higher than desired.

To summarize, markets are trading at historically high levels based on assumptions about the future. One key assumption is that inflation will not be a long-term problem. Although pundits recognize that inflation is a now short-term problem, they believe that the recovery will soon normalize, resolving shortages of labor and materials, thus relieving inflationary pressure.

I'm skeptical that the extreme economic distortions attributable to the pandemic will be quickly resolved. A better model of what lies ahead is likely the mess of positive and negative developments that defines our Pandemic management experience to date.

Remember, it was the Fed that famously missed the implications of the real estate mania before The Great Recession, and it struggled to get the post-crisis economy and employment back on track. The real estate mania was much easier to understand than our current situation.

Your Investment Risk

Each client has given me written instruction about how much downside risk they are willing to tolerate. You may not remember doing this. It was a "Statement of Investment Objectives" form completed at the time we set up your account, or when we last updated our agreement with you.

Most clients indicated that a 10% to 15% annual loss would be tolerable. Interestingly, when I reframe the risk tolerance question from a percentage to dollars, it's not uncommon for investors to conclude the dollar decline is more disturbing than a percentage decline, even though it's just a different way to express the same amount. To put this in perspective, the percentage loss above equates to a loss of $100,000 to $150,000 *per million* of savings. Many clients find this number more alarming, maybe because a loss expressed in dollars is more easily compared to one's monthly budget or annual spending. I encourage you to try this exercise:

- Please refer to the ENDING VALUE from this quarter's Performance Summary page and contact me if you would find a 10% or 15% loss in value very upsetting.
- Alternatively, please contact us if you would like us to calculate the dollar loss amount for you or check your work.

Our goal is to match your overall portfolio risk exposure to your stated risk tolerance, which explains why you have such large cash and short-term bond allocations. The yields are low on long term bonds so there is minimal income cushion to make up for stock declines. An even bigger risk is that, unlike the past 30 years when high quality (A rated or better) long term bonds typically increased in price and offset stocks' decline, the opposite could happen today: both stocks and long-term bonds could decline at the same time in response to higher than expected inflation.

Exciting Succession Update!

I am very, very pleased to announce that Jay Namyet, who retired June 30 as Chief investment Officer for the University of Oregon (U of O) Foundation ($1.2 billion), will be assisting MCS Family Wealth Advisors in our succession planning.

I have known Jay for many years, and I believe his experience in both planning his own succession and evaluating investment managers for the Foundation will help me and MCS clients considerably. After laying the groundwork for his succession two years ago, Jay assisted the Foundation as it pivoted to an unexpected, yet superior, succession option just months before his official retirement date. I found this quite impressive: the ability to set aside an original plan they worked very hard on and focus on what was in the university's best long-term interests when a new opportunity arose.

During his tenure at the Foundation, Jay was recognized with two national awards from Institutional Investor: 2007 Mid-Size Nonprofit of the Year and 2016 Best Governance Model of the Year. In addition, in 2017 industry publication Trusted Insight named Jay as one of the top 30 CIOs (Chief investment Officers) in the country. He sat on TIAA | Nuveen's Investment Council for not-for-profits as well as advisory boards for many major endowment conferences.

Our goal is to find portfolio manager(s) who have a track record of success in good and bad markets, like the period from 2000 to 2010. To offer some perspective, the worst MCS twelve-month drawdown (not calendar year) over the past 30 years was 9%. To contrast, the worst S&P drawdowns exceeded 50%. In other words, I want your savings and my savings far better protected than most investors when the world is falling apart.

Both Jay and I are quite wary of current sky-high valuations, abundant speculation, and the unshakable belief that the Fed is capable of bailing investors out, no matter what. Although the characters and setting are different, we've read this chapter before and we don't like its ending.

I believe that Jay's, Jeff's, and my combined 100 plus years of industry experience and commitment to delivering multigenerational financial security to MCS client families will give clients access to portfolio managers who would have never been on a client's radar.

Our search is focused on Absolute Return[9] managers. Absolute Return strategies seek to deliver steady positive returns while minimizing downside risk through up and down market and economic cycles. My 30-year track record of only two down years, the worst of which was a 6% calendar year loss, is an example of an absolute return strategy.

Jay estimates that he conducted 300 to 400 portfolio manager evaluations over the past 20 years. His experience and insights powered the excellent investment results for the U of O Foundation. He will be the project manager for our search for experienced portfolio manager(s) to assume my role.

Our search will take time, and we will keep you posted as it progresses. It will include in-depth interviews, examining candidates' pre- and post- crisis newsletters, and by looking at their client accounts' 'maximum drawdown' (how far portfolios fell during high market stress conditions).

Once we have selected the firm(s) or individuals, Jay and I will transition to a newly formed MCS investment oversight committee to ensure your investments stay on course. Our goal is to have a successor identified by year end.

Most importantly, we will maintain our oversight role for many years to come. My family money will be at risk just like yours! I'm very mindful that even the best decision today may need adjustments as the future unfolds.

To better ensure success, we are considering three potential models to implement the succession plan, including:

1. Merge with another firm
2. Hire experienced portfolio manager(s) as successor(s) (recruiters tell us that industry consolidation makes very good talent available)
3. Outsource the investment function to an established firm

Options 2 & 3 have the advantage of post decision oversight to make sure it works as expected.

Many of the best investment managers have high client minimums ($5 to $10 million), which most MCS clients could not meet on their own. We hope to use the buying power of MCS's $165 million in assets, and Jay's and my desire to continue to serve you directly, to negotiate for access to these asset managers at 'wholesale' pricing and terms.

Jay's Note to MCS Clients

Accumulating and retaining significant wealth is no easy task. For those clients with the majority of your accumulation years behind you, your present wealth takes on a much more critical role of funding your desired lifestyle. This is the phase of life when maintaining your wealth outweighs creating additional wealth, for it is only through maintaining your wealth that you get to maintain your lifestyle. And what creates a well-lived life? Being able to do what you want to do, with whom you want to, whenever you want to, for as long as you want to.

It is the emphasis on financial resilience, the ability to avoid serious, negative financial outcomes, that differentiates MCS from other professional investors. Professional investors are competing in many ways that are not necessarily in your best interest: relative to beating the S&P 500 or other investment indexes regardless of current risks, or relative to their peers' performance in the frenzied race to gather assets. But by playing their relative performance games[10], or delegating investment decisions to a computer program, this crowd may ignore your most important goal: maintaining your precious lifestyle.

The investment philosophy Michael and I share is built on deep research, skeptical thought processes, keen underwriting, and a focus on future prospects. When investment opportunities are appropriately priced, MCS will be properly positioned. When risks outweigh future return potential, defensive postures are the order of the day. It is a dynamic process for a dynamic world.

Don't let anyone convince you the business of wealth preservation is easy. The future is unknowable. Past is not prologue. Every investment has its share of risks. Your interests are best served by employing an advisor who understands those risks, acting prudently with the deployment of your wealth, and as a true fiduciary, putting your peace of mind, goals, and dreams above all else.

Endnotes

[1] MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary Income/Growth accounts under management for at least one full month in 2021. These accounts represent 97% of MCS's discretionary assets under management as of 06/30/2021 and were invested primarily in US stocks and bonds (13% of client assets on 06/30/2021 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Barclays Capital US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or particular needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

[2] Stagflation occurs when both inflation and unemployment are higher than desired. It is the worst of all worlds for the Fed because it leaves them conflicted about how to address its dual mandate of price stability (low inflation) and full employment). Combating one problem, like inflation with higher interest rates, slows the economy causing more unemployment. On the other hand, keeping rates low to Increase economic activity and encourage higher employment fuels higher inflation.

[3] Source CNBC 07/12/2017 https://www.cnbc.com/2017/07/12/yellen-heat-inflation-news.html

[4] https://www.dailynews.com/2017/10/25/the-federal-reserve-needs-someone-who-understands-inflation/

[5] June 22, 2021 https://www.federalreserve.gov/newsevents/testimony/files/powell20210622a.pdf

[6] https://apnews.com/article/inflation-health-coronavirus-pandemic-business-6e7c813472a3eb706e0cdafe305c1477

[7] https://www.wsj.com/articles/powell-expects-inflation-to-moderate-but-will-likely-remain-elevated-this-year-11626265800?mod=hp_lead_pos3

[8] ibid

[9] Most investment funds are **Relative Return** focused, meaning large losses are a 'win' if the loss is not as large as the comparative index fund. Of course, losing 22% when the index lost 24% doesn't feel like a win to the investor.

[10] Relative performance means that the manager has done a good job if it lost only 23% when the index lost 25%. This may be a very poor outcome from the retiree's point of view. Assurances that it will come back someday are of little value when the wait to get your money back can be a decade