On Course Financial Planning

Facing the Future with Optimism and Courage

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geo@oncoursefp.com 425-861-9997

Irrational Exuberance

December 5th marked the 25th anniversary of the night in 1996, when then-Federal Reserve Chairman Alan Greenspan introduced the phrase "irrational exuberance" into the popular investing lexicon. In a speech at a dinner of the American Enterprise Institute in Washington, he worried that the stock market might have risen too far, too fast –

"How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy?"

For the remainder of his speech Greenspan essentially admitted that neither he nor anyone else knew the answer to these questions. His comments were widely reported in the financial media and were taken to mean that Greenspan believed that the stock market was already, or would soon be, in a mania that would lead to a market crash. The day after Mr. Greenspan's speech, the Dow Jones Industrial Average fell 1% on no other significant news.

The S&P 500 Index closed the afternoon of Greenspan's speech at 744. It ignored Greenspan's worries for the next 39 months, eventually topping out at 1,528 on March 24, 2000, just before the dot.com crash. Anyone who fled stocks in response to Greenspan's comments missed, over the next three years and three months, a doubling in the S&P 500. This is just another example of the truism that the economy cannot be accurately forecast, nor the market consistently timed by anyone. With 20/20 hindsight, it's easy to spot a market bubble. But lacking 20/20 foresight, everybody, and I do mean everybody, is just guessing.

On December 5, 2021, the S&P 500 stood at 4,538 – up more than six times since Greenspan's speech. $10,000 invested in an S&P 500 Index fund on December 5, 1996, would be worth, with dividends reinvested, almost $100,000 today, despite the three intervening market crashes. The combined annual earnings per share for all companies in the S&P 500 in 1996 was just over $40. This year it will be close to $200 - almost five times greater. The total per share cash dividends paid by S&P 500 companies in 1996 was $14.90. This year it will be about $60 per share - 4 times greater. For comparison, since December 1996, inflation, as measured by the CPI, has increased about 1.8 times.

The day after Greenspan's speech, the headline – "Fed Chairman Pops The Big Question "Is The Market Too High"" appeared in the *Wall Street Journal*. The best thing an investor could have done after reading the headline would have been to put down the paper and go for a walk. Today, investors have many more sources of headlines shouting for their attention. These voices are especially dangerous this time of year because they include economic and stock market forecasts for 2022 made by self-promoting, smart sounding people who have no idea what will happen next year. The holiday season is the perfect time of year to turn off the TV, log off your computer, forgo social media, go for a walk and leave your portfolio alone. Then let the compounding proceed, uninterrupted.

In the News

December 5th was also the 88th anniversary of the day in 1933 that the 21st Amendment to the US Constitution was passed to repeal the 18th Amendment, officially ending 13 years of prohibition. The 21st amendment is unique among the 27 Amendments to the Constitution because it is the only one that repealed a previous Amendment.

The S&P 500 fell 0.8% in November. This meaningless fact led to the pointless observation that since 1950, there have been 22 Novembers in which the S&P 500 fell. The "good news" is that in 19 of these years the S&P 500 rose during December. This is an example of the kind of irrelevant, random, data mining of "facts" that supposedly provide some sort of insight about what stocks will do next. But there's no evidence that the performance of the stock market in one month has any influence on its performance in the next month. Never has been, never will be. Too many investors are fooled into believing that correlation is causation and make decisions that end up causing them financial grief.

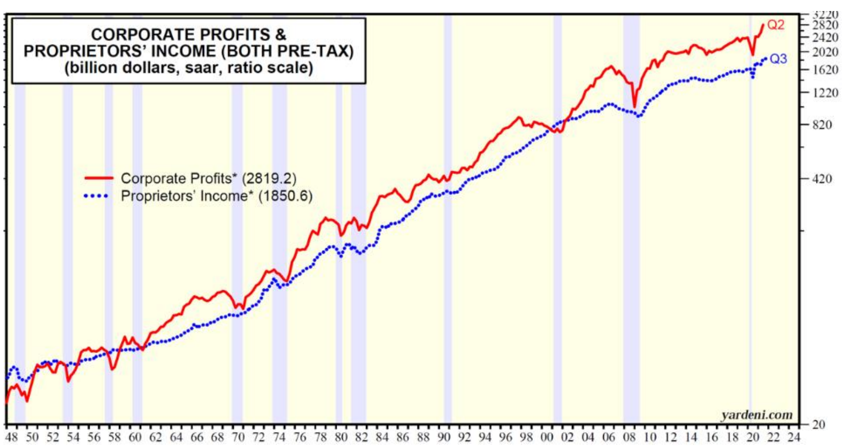
When stocks decline enough to generate headlines, many investors become anxious and sell. When stocks post strong returns, many suffer from FOMO (fear of missing out) and overweight stocks in their portfolio. Having a comprehensive financial plan is the best way to minimize the emotions that can lead to counterproductive buy and sell decisions. Your financial plan acts as the road map to your financial goals, regardless of what's happening in the stock market. Long-term academic data and my own experience convince me that the path between an investor and his or her financial goals is best travelled by adhering to a well-designed, comprehensive financial plan.

A Roth IRA allows you to earn tax-free growth and take federal tax-free withdrawals if certain requirements are met. (You must be at least 59½ years old, and it has been at least five years since you first contributed to any Roth IRA (the five-year rule)). For taxpayers in the 10% or 12% federal income tax brackets, any long-term capital gain in a non-qualified account is untaxed - thus equivalent to a Roth IRA with none of the requirements needed for tax-free Roth IRA withdrawals. So, single filers with a capital gain and taxable income less than $40,525 ($81,050 for married couples filing a joint return) will pay no federal capital gains tax in 2021.

Most Americans (59%) prefer a donation in their name to a favorite charity rather than a traditional holiday gift for themselves, according to a new poll from Fidelity Charitable. In its survey of 1,500 people, Fidelity Charitable found that 64% of those surveyed said that they plan to do charitable giving before the end of the year. Perhaps the best way to avoid the frustrations of supply chain shortages this holiday season is to make a charitable gift on behalf of someone else. Most of those surveyed by Fidelity are not donating in the most tax-efficient way, such as using securities and other appreciated assets instead of cash to avoid capital gains taxes. If you are age 70½ or older, you can donate directly from your IRA to a charity using a Qualified Charitable Distribution (QCD). A QCD is an otherwise taxable distribution from an IRA or inherited IRA that is paid directly from the IRA to a qualified charity. A QCD counts toward your RMD up to $100,000. If you file jointly, you and your spouse can each make a $100,000 QCD from your own IRAs. This is a valuable benefit for charitably inclined seniors who cannot deduct their charitable contributions because they take the standard deduction. Since QCDs do not appear as income on your tax return, they are tax free IRA withdrawals. 54% of those surveyed by Fidelity Charitable use QCDs and more than 90% of those surveyed noted that their charitable gifting in 2021 will be equal to or greater than the gifts they made last year.

Perhaps low interest rates are here to stay. Why should investors be compensated for holding US Treasury securities that have no default risk and are guaranteed to pay back principal at maturity? The annual interest on the national debt is about $560 billion. Five years ago, it was $455 billion - when the national debt was about half of what it is now. The national debt is ten times higher than it was 20 years ago, but the cost of annual debt service is only about 50% higher. Because rates are so low, the annual cost to add trillions of new debt has been relatively low, making the political decisions to add the new debt quite painless. Some see this as a disaster in the making while others see it as the reason why the Fed cannot change interest rate policy and why rates will continue to stay low. Time will tell.

Leverage is your friend when you can borrow money at a rate that is less than the rate of inflation. Short-term interest rates are below the current level of inflation and will likely remain so for at least the next year. Even 30-yr fixed rate mortgages are lower than the current rate of inflation. So, how can a smart consumer arbitrage these variables? If you buy an asset that you assume will increase in value at a rate greater than the loan rate, (such as a home) you don't pay cash, you put the minimum amount down and finance the asset at a fixed rate for as long as possible.



Here's a chart from Ed Yardeni showing corporate profits and proprietors' income (small business income) going back to the late-1940s, with recessions indicated by the gray columns. Corporate profitability reflects the growth of the U.S. economy, and it has been on an upward trend since the end of WW II - regardless of who held power in Washington DC. Hot wars, cold wars, recessions, high inflation, low inflation, high tax rates, low tax rates, high interest rates, low interest rates, financial frauds, bursting financial bubbles and everything else. Why has the economy been able to grow despite all the intervening problems? Maybe it's because people get up every day and work hard to make life better for them and their children. Despite the endless babbling of vainglorious politicians who believe things can improve only if we listen to them, we seem to be doing just fine on our own.

The Centers for Medicare and Medicaid Services announced that the standard Medicare Part B premium, which covers doctor visits and other outpatient services, will increase from $148.50 to $170.10 per month in 2022. This 15% increase in the Part B standard monthly premium is one of the largest annual hikes in the history of the Medicare program. When Medicare began in 1966, the Part B premium was $3 per month. Higher-income Medicare beneficiaries - individuals with modified adjusted gross income (MAGI) of $91,000 or more and married couples with MAGIs of $182,000 or more - will pay additional surcharges known as income-related monthly adjustment amounts (IRMAA), ranging from $68 per month to $408.20 per month in addition to the standard Part B premium. About 7% of Medicare beneficiaries pay IRMAA surcharges.

The recent spike in inflation has been a daily subject in the financial media. The natural inclination for many retirees is to keep their money in "safe" fixed income investments. Fixed income investments are in your portfolio to provide diversification, cash flow and cash reserves, not to make you rich. Rarely, if ever will high quality fixed income investments yield a return greater than inflation. Thus, to maintain purchasing power, it is important for retirees to keep a portion of their assets invested in equities – which have proven to be an excellent inflation hedge.

One of the downsides of gaining wealth from your investments is that in most cases, the gains will be taxed, and we hate paying taxes. Some people act as if they'd rather lose money than pay taxes. Thus, the blessing of earning a profit turns into a perceived liability and they become suckers for "investments" that promise to create gains without taxation. There is an important lesson here - do not cut off your nose to spite your face.

There are too many studies being done today. In a report funded by the TIAA Institute, that must have come from Goofy's desk in Tomorrowland, the Urban Institute projects that 45% of retirees in 2090 will have income less than 75% of their working-years' earnings, up from about 26% in 2020. This guess of what life will be like in the USA 70 years from now applies to millions of people who haven't even been born. Enough already!

To Grandmother’s House We Go

It’s Christmas day and you're on your way to grandmother's house. The kids are in the backseat, the presents are in the trunk and Christmas carols are playing on the radio. After getting on the highway, you soon find yourself in bumper-to-bumper traffic. You’re stuck in the left lane and crawling to grandmother's house just a few feet at a time. Soon, you find yourself watching the cartoon playing on the back seat video screen in the Escalade in front of you.

You notice that traffic in the lane to your right has been moving at a faster pace than your lane. You assume that the right lane would also slow down but the traffic is still moving reasonably well. So, you take a chance and switch lanes. Initially you pass the Escalade and maintain a reasonable pace towards grandmother’s house. But then, inevitably, your lane slows down and, lo and behold, the lane to your left, YOUR OLD LANE, picks up its pace. Soon the Escalade passes you on your left. "I knew it would happen. This always happens to me. The lane I choose is always the slowest one." Is it just me or has this happened to you also?

Rest easy weary traveler, it wasn't your bad luck that doomed the pace of traffic when you switched lanes. You slowed down because all the drivers in the left lane ahead of you saw exactly what you did -- that the right lane was moving more quickly. So, just like you, they switched lanes. Consequently, the number of cars in the left lane decreased and the number of cars in the right lane increased. This caused the right lane to slow down and the left lane to speed up.

The investing lesson that we can learn from our trip to grandmother’s house is that you cannot profit from information that is known by everyone else. In investment-speak we say that the stock market is efficient. In an efficient market, news is transmitted instantly to all participants so the ability to profit from a temporary mispricing vanishes almost as quickly as it appears. It doesn't matter whether you're trading shares of Tesla or stuck in traffic on the way to grandmother's house. Only the first few participants who learn new information can profit by acting on it. Once it’s known by other participants, the information advantage disappears. And believe me, you are nowhere near the front of the line when it comes to hearing news that will impact your investments.

Human nature being what it is, the lane changing game will repeat itself this holiday season as drivers from coast to coast try to outsmart one another and arrive at grandmother’s house just a bit sooner. Only the first few lane changers will profit from their actions. Most likely, that won’t be you. Relax and enjoy the ride.

Another year has come and gone. Just like every year that has preceded it, it was filled with events than no one predicted, many of which were proclaimed to be the precursors to the end of everything we hold dear. But here we are at year end and the world is still spinning around. There’s only one thing left to say in 2021 -- Merry Christmas to all and to all a good night.