On Course Financial Planning

Facing the Future with Optimism and Courage

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2022 in Review

Let me begin 2023 with an understatement - last year was an unpleasant one for investors. Stocks began the year hitting all-time highs, but it was downhill from there. The Federal Reserve's 2021 prediction that the spike in inflation would be "transitory" was a bust, and the Fed proceeded to raise interest rates at the fastest rate since 1980. The Russian invasion of Ukraine exacerbated inflation by temporarily sending oil prices and other commodities much higher. In summary, the favorable economic fundamentals we experienced from 2010 to 2021 - low interest rates, low inflation, and modest economic growth vanished last year. After more than a decade of impressive annual gains, we are now mired in a period of losses and bad news.

The returns on major stock and bond asset classes varied widely but were all disappointing. Including dividends, the Dow lost 6.9%, while the S&P 500 Index lost 18.1%. This is an unusually large disparity between these two large cap indexes. The Dow consists of only 30 stocks and has a large weighting to energy and healthcare stocks, which did relatively well last year, and a smaller weighting to tech stocks which suffered large losses in 2022. It's important to remember that the S&P 500, with an annualized average return of about 10% for the past 95 years, rose 31% in 2019, 18% in 2020 and nearly 29% in 2021. Sometimes stocks go down because they've gone up too much. It's called reversion to the mean. Get used to it. From 2019 through 2022, the S&P 500 had an annualized average return (with dividends reinvested) of 12.9% according to data from www.dqydj.com.

Bond prices fall when interest rates rise. In most bear markets, bonds rise as investors seek safety in fixed income assets and the Fed lowers interest rates to boost the economy. Last year was a notable exception. We had a bear market in stocks, rising interest rates and falling bond prices. In 2022, for the first time, both stocks and bonds declined more than 10%. The Bloomberg US Aggregate Bond Index, which tracks government and investment grade corporate bonds, had its worst year since its inception in 1976, falling 13%. The Fed's anti-inflation weapon of choice—higher interest rates—is a blunt instrument used to bring the demand for goods, services, and labor into alignment with the supply of goods, services, and labor. That's the bad news. The other side of the coin is that higher interest rates have raised the yield of bonds and cash investments. The Vanguard Total Bond Market Index ETF (BND), which tracks the Aggregate Bond Index, has a current yield of 4.1%. The return of reasonable bond yields should reassert the proper non-correlating aspects that bonds provide in a properly diversified portfolio. The lesson from 2022 is not that bonds are bad, it's that any asset can have a terrible year. Most years, stocks go up - but not always. Bonds usually act as portfolio shock absorbers to offset stock volatility - but not always.

Stocks were unusually volatile last year. There were 60 days in which the S&P 500 rose 1% or more and 64 days in which it fell 1% or more, the most "1%" days in more than a decade. The small-cap S&P 600 Index fell 16.1%. This was also unusual. In bear markets, small-cap stocks usually decline more than large cap stocks. But not so in 2022. Developed market international stocks, as represented by the MSCI World ex-USA Index, lost 14%, while the MSCI Emerging Markets Index fell 20%. On the bright side, very few investors realize that in the fourth quarter of 2022, large-cap domestic stocks, small-cap domestic stocks, international stocks, emerging market stocks, REITs and the Aggregate Bond Index all had positive returns.

The years 2020 and 2021 were great for homeowners, the national Case-Shiller home price index rose 40%, eventually topping out in June of 2022. Now comes the downdraft. At year end, the average 30-year mortgage rate stood at 6.6% - twice the 3.3% rate at the beginning of the year. Sales hit a 6.7 million annual rate in January 2021, but by November, 2022, sales were down to a 4.1 million annual rate, a drop of 39%, according to First Trust.

At the beginning of 2022, nearly $3 trillion was invested in cryptocurrencies, supposedly the antidote to the inflationary activities of governments and central banks. By the end of 2022, more than $2 trillion of that money had evaporated, despite the fact that we were experiencing what were supposed to be ideal conditions for crypto.

Whether or not we are headed for recession is the number one topic of the financial talking heads these days. An article in the *Wall Street Journal* noted that two-thirds of economists at 23 large financial institutions expect the US to slide into recession this year. But a recession is not a foregone conclusion. A 3.5% unemployment rate, the lowest in

50 years, coupled with ongoing job growth, reveals that the economy is still expanding. According to JP Morgan, consumers still have about $1 trillion in estimated extra cash that they have piled up since February 2020, thanks to a combination of government financial support and limited spending options during the pandemic. That's good news for ordinary folk, but bad news for the Fed's attempt to tame inflation.

In no year in memory was the risk of owning individual stocks more evident than in 2022. For the better part of the previous decade, investors bought shares of fast-growing technology companies whose strong gains year after year gave the illusion that their stock prices could only go up. During and after the pandemic, technology stocks became the "can't miss, must have" favorites of both amateur and professional stock pickers. The FAANG stocks – Facebook, Amazon, Apple, Netflix and Google rose dramatically. That euphoric bubble burst in 2022. Google owner Alphabet fell 39%, Facebook parent Meta Platforms fell 64%, Netflix fell 51%, Amazon fell 50%, Apple fell 27%, Peloton fell 78%, Zillow fell 50%, Zoom Video fell 63%, Microsoft fell 29% and Tesla, the most purchased stock by retail investors last year, fell 65%. The lesson to learn from this is that even though some of these companies are the biggest and most profitable companies in America, when it comes to the stock market, it is very hard to stay on top.

Last year's 2022 annual forecast issue of *Kiplinger's Personal Finance* magazine contained this warning – *"Investors will have to pick their spots carefully in 2022…It will be a decent year for stocks if you're a stock picker, a more modest year if you're an S&P 500 investor."* Nothing new here. Every January, there are assertions that the upcoming year is going to be a "stock picker's market" because (insert reasoning here). A portfolio equally divided among the eight stocks *Kiplinger's* recommended for 2022 would have lost 22.4% last year, according to data from Yahoo Finance, trailing the 17.5% decline in the Vanguard Total Stock Market Index ETF (VTI) by an embarrassing amount. I have no interest in *Kiplinger's* top stock picks for 2023 and neither should you.

My Lazy Golfer portfolio consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSMX), 20% to the Total International Stock Index Fund (VGTSX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBMFX) and 10% to the REIT Index Fund (VGSIX). It has an annual expense ratio of 0.17%. Rebalance the fund on your birthday and ignore Wall Street for the remaining 364 days of the year. In 2022, the Lazy Golfer lost 17.2%, according to Morningstar, – ouch. But after annual returns of 16.5% in 2021, 13.6% in 2020 and 21.9% in 2019, one can't complain too loudly. Its annualized average return over the past five years has been 4.7% and 6.7% for the last ten years. You'll save time, money and energy and can ignore all the beat-the-market nonsense by owning a portfolio of low-cost index funds. Admittedly, many investors find this recommendation unsatisfying because, surely, someone must be smart enough to beat the market.

Which brings me to the ongoing saga of Cathy Wood, the once famous, now notorious, ex-media darling, manager of the Ark Innovation ETF (ARKK). The top chart compares the gain in the share price of ARKK to the value of the S&P 500 Index from April 2020 through December 31, 2022. Before 2020, nobody heard of Cathy Wood or ARKK but that all changed when, according to Morningstar, ARKK returned 157% in 2020, ranking in the first percentile of performers, and beating the S&P 500 Index by 141%. The fund attracted $20 billion of new money in 2020 and $16.5 billion in the first quarter of 2021 – just as the fund's share price peaked, along with the number of Ms. Wood's admirers. Let's do some math. With an annual expense ratio of .75%, the $34 billion fund generated fees of $255 million in 2020.

The bottom chart notes the cumulative percentage differential in performance between ARKK and the S&P 500. As can be seen, by mid-February 2021, at the peak of ARKK's renown, it had outperformed the S&P 500 index by more than 200%. But unfortunately for ARKK investors, Wood's genius began to fade in 2021 and it suffered a 23% decline. For 2022, the fund fell another 67%, placing it in the bottom 1% of more than 580 mid-cap growth funds in both years according to Morningstar. As the chart clearly shows, the fund's performance now trails the S&P 500 since April, 2020. ARKK was a performance chasing investor's dream come true – for a while, anyway.

Like most outperforming funds, ARKK has a concentrated, undiversified portfolio – currently it holds only 30 stocks. According to Morningstar, 6 stocks in the portfolio fell between 80% and 90% in 2022. Seven more suffered losses of

between 70% and 80%, and another seven dropped between 60% and 70%. Only one stock in the fund had a loss of less than 36%, and every stock in the fund underperformed the S&P 500 Index last year. There can be no greater example of the rarely mentioned "manager risk" that all active funds contain. Better to have owned the Lazy Golfer portfolio, or shares of SARK, the ETF that sells short all the stocks in AARK's portfolio, in a bet those stocks will fall. SARK rose 47% in 2022. There are no victory laps in investing. Ms. Wood had a lucky streak, she made a fortune, but her investors paid the price.

Despite the surge in inflation, gold was flat in 2022, even with all those gold commercials. The best explanation I've read for the silliness of "investing" in gold is from David Bahnsen's blog –

"My view has been for quite some time that it is a non-productive investment. What I mean by that is that it does not generate any cash flow and does not have any internal earnings stream, so the value becomes a matter of speculation or supply/demand around use. But gold is not really owned much for industrial use, and even its cosmetic use is somewhat limited, so those who own gold or silver for investment purposes must defend the notion of gold being a sort of inflation hedge or currency proxy. And maybe it will be that someday, but that day is not the last 42 years, where gold is down by 50% relative to inflation – a stunning and shocking fact to all who hear it. I will also point out that the most common thing I have been told over the years is that gold gives us a hedge or substitute against crazy unstable monetary policy. Well, trillions of printed QE dollars since 2012 later, gold is lower than it was a decade ago. This should have been the golden age for gold; instead, it has many wondering what exactly the thesis is. At the end of the day, gold can go up a lot, and it can go down a lot, but it rarely does what people seem to want it to do when they want it to do it."

It may be a New Year, but old-fashioned financial fraud is still alive and well. According to an article in the *Wall Street Journal*, – *"Caroline Ellison, a close associate of FTX founder Sam Bankman-Fried, apologized in court this week as she pleaded guilty to fraud and other offenses, telling a judge that she and others conspired to steal billions of dollars from customers of the doomed crypto exchange while misleading investors and lenders. "I am truly sorry for what I did," Ms. Ellison, the former chief executive of Mr. Bankman Fried's crypto-trading firm, Alameda Research, said in a New York federal court…."I knew that it was wrong.""*

Ms. Ellison pleaded guilty to seven criminal counts, including fraud, conspiracy and money laundering. She admitted to conspiring to "loan" billions of dollars of FTX customers' digital assets and fiat currency deposits to Alameda to repay loans Alameda had taken out to finance its investments. Apparently, FTX executives granted Alameda Research access to an unlimited line of credit without having to post collateral, pay interest or be subject to margin calls.

The article continued - *"Ms. Ellison also said she and Mr. Bankman-Fried worked with others to conceal the arrangement from lenders, including by hiding on quarterly balance sheets the extent of Alameda's borrowing and the billions of dollars in loans that the firm had made to FTX executives and associates. Mr. Bankman-Fried was among the executives who received loans from Alameda, she said."*

Once again, in the final days of the year, Congress passed, and the president signed, a host of new tax rules. The SECURE 2.0 measure includes provisions impacting retirement planning. Some highlights –

- The beginning age for Required Minimum Distributions (RMD) is now 73 for individuals born between 1951 and 1959, and to 75 for those born in 1960 or later.
- The new law requires the Department of Labor to create a "lost and found" database where you can type in your name and find any retirement plan money from prior employers that you may have forgotten about.
- The $1,000 IRA catch-up for individuals 50 and older will be indexed to inflation starting in 2024.
- Surprisingly, there was no elimination of "backdoor" Roth or "mega-backdoor" Roth contributions.
- For 401(k), 403(b) and 457 plans, the catch-up for individuals aged 50 or older increases to $7,500, making the maximum contribution amount $30,000 for 2023. Starting in 2025, for workers ages 60, 61, 62 and 63, the maximum catch-up contribution is raised to at least $10,000. This "super catch-up" will be set at no less than 50% more than the regular catch-up contribution amount for that year. However, catch-up and super catch-up contributions will not be tax deductible and must be placed in a Roth retirement account if the employee's annual compensation is more than $145,000. Someone has to pay for the revenue loss due to the RMD age increases.
- Starting in 2024, Roth 401(k), Roth 403(b) and Roth 457 plans will not be subject to RMDs, as is the case today.
- For the first time, employees can elect to have employer contributions to retirement plans be treated as Roth contributions. These contributions will be taxable to plan participants, unlike in the past when all company contributions were pre-tax.

- Unused 529 plan balances can be transferred to the plan beneficiary's Roth IRA, although with a variety of limits and restrictions. The 529 must have been in existence for at least 15 years and the maximum amount that can be moved is $35,000. The normal income limits on Roth IRA contributions do not impact this transfer opportunity, however annual IRA contribution limits for the beneficiary still apply. To complicate matters, contributions made in the last 5 years are not eligible for transfer.

It's inevitable that many of the financial media's New Year's investment commentaries and advice will proclaim that the traditional theories about investing are obsolete. They are sure to downplay the value of buy and hold investing and champion whatever their advertisers are promoting. The great mistake many of your friends, relatives and neighbors will be making this year will be to ignore history and latch onto some new tantalizing variation of market timing – the most prolific and unsuccessful investment strategy ever devised by man. If you own a well-diversified portfolio of index funds, it's likely that some of your funds will disappoint in 2023. Remember, diversification is a long-term strategy. In the short-term, anything can happen and some funds in your portfolio are likely to underperform their historical returns and your expectations.

The more you tinker with your portfolio, the worse the likely outcome. Your portfolio should be the servant of a financial plan - which reflects your goals, time horizon and risk tolerance. It should be designed without regard to any market conditions at the time of its creation. It should be planned with the expectation of periodic market declines - even one more rapid and panicked than normal. Even the best plan is no good if you can't stick with it during tough times. Lifetime investment success comes from acting continuously on your financial plan. Likewise, substandard returns come from reacting to current events.

Markets will always be unpredictable. The unpredictability of the next two days, two months, and two years is a given for all investors at all times. That fact should be embraced, not feared. The stock market goes up, then down, then back up. The narrative changes each time (toxic mortgages, Putin, COVID, inflation) and the results are still the same – the world doesn't end and patient, disciplined investors get rewarded. The Vanguard Total Stock Market Index Fund (VTSMX) has yielded a 14.1% annualized average total return, for the 10 years ending 12/31/22, according to Morningstar. The price you had to pay to receive that long-term return was to sit still and do-nothing during times like we are now experiencing. If you can do this, you'll likely be rewarded in the long-term. Having held on so far, it would be folly to bail out now.

History clearly reveals that the economy cannot be consistently forecast, nor the stock market consistently timed. Yet, each New Year brings predictions about which stocks or market segments will do well in the upcoming year. All major investment firms have a high profile "chief investment strategist" whose function is to pretend that he or she can predict the unpredictable. This level of hubris is proof positive of the fall of mankind.

I avoid making stock market predictions and offer my sincere condolences to anyone who invested in 2022 based on the predictions of their financial advisor. I assume that stocks will be volatile in the short-term but will rise more than they fall over the long-term. My only prediction for 2023 is that most predictions you hear and read will prove to be wrong and thus require modification as the year progresses. Let's make it our New Year's resolution to ignore them all.

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