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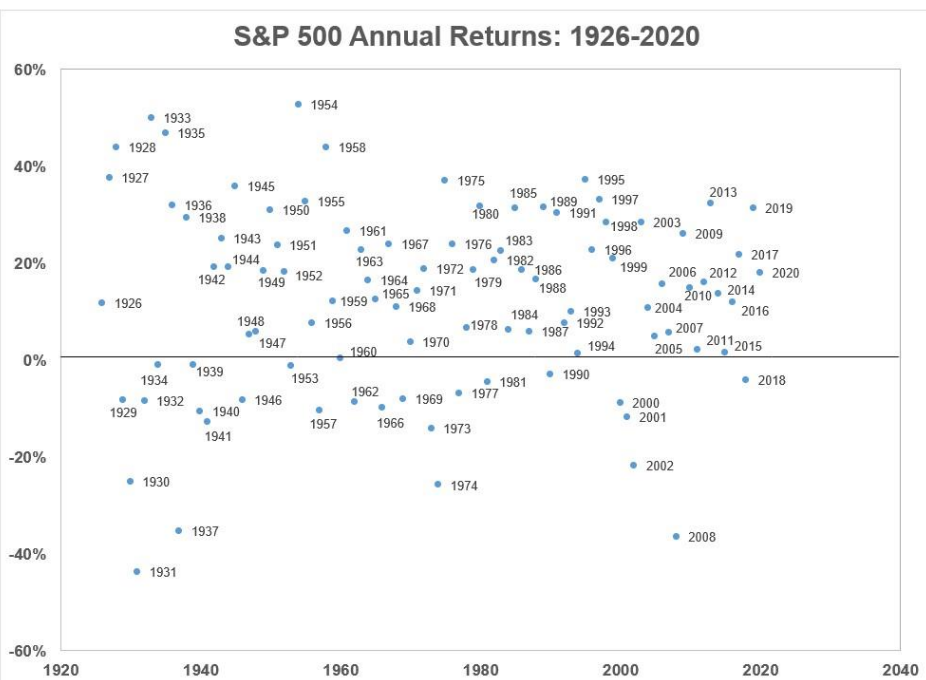
Midyear Musings

The American economy continued its dramatic recovery in the first half of 2021, spurred by the wide adoption of effective COVID-19 vaccines, the abating pandemic, and massive monetary and fiscal accommodation. Rarely mentioned in the media is another important factor in the recovery - the resilience of the American economy. The defining characteristic of American capitalism is how quickly companies adapt to changes in the economic environment and innovate to maintain profitability. Although bets against America might seem wise when things are going badly,they have always failed in the long-run.

Disciplined investors who adhered to a long-term investment plan reaped gains in 2020 and continue to be rewarded in 2021. The S&P 500 was up 14% for the first six-months of this year, including 34 new all-time highs. There were 19 days when the index rose 1% or more and 10 days when the index fell 1% or more – a welcome respite after experiencing 139 + or – 1% days in 2020.

The S&P 500 has doubled since its pandemic low point in March 2020. Anyone who fled the stock market last spring and remained in cash has missed a 15 month 100% return, one of the fastest doubles in stock market history. The small-cap Russell 2000 is up over 17% year to date, and is up 62% over the past 12 months. Had you bought an S&P 500 Index fund on February 19th 2020 - the market peak just before the pandemic bear market - and held it until June 30th of this year, your total return would have been just under 28%.

In every bear market, there will be Pied Pipers ready to lead you astray and profit from your fear and uncertainty. If your favorite news sources scared you out of the stock market last spring, it might be time to seek advice elsewhere. The past 15 months provided us the latest proof of legendary fund manager Peter Lynch's maxim - *"The real key to making money in stocks is not to get scared out of them."* After the outsized returns of the past year, now might be the perfect time to rebalance your portfolio to get it back to its original stock/bond allocation.



As this chart clearly shows, there is no consistency or predictability in stock market returns from one year to the next – a clear picture of why having a long-term focus is so important.

Since 1926, the S&P 500 has yielded, with dividends reinvested, an annualized average return of about 10%.

Yet, in only 5 of those 95 years was the return between 8% and 12%.

The return was positive in 70 years and negative in 25 years.

The best yearly return was 54% in 1933 and the worst return was -43% in 1931.

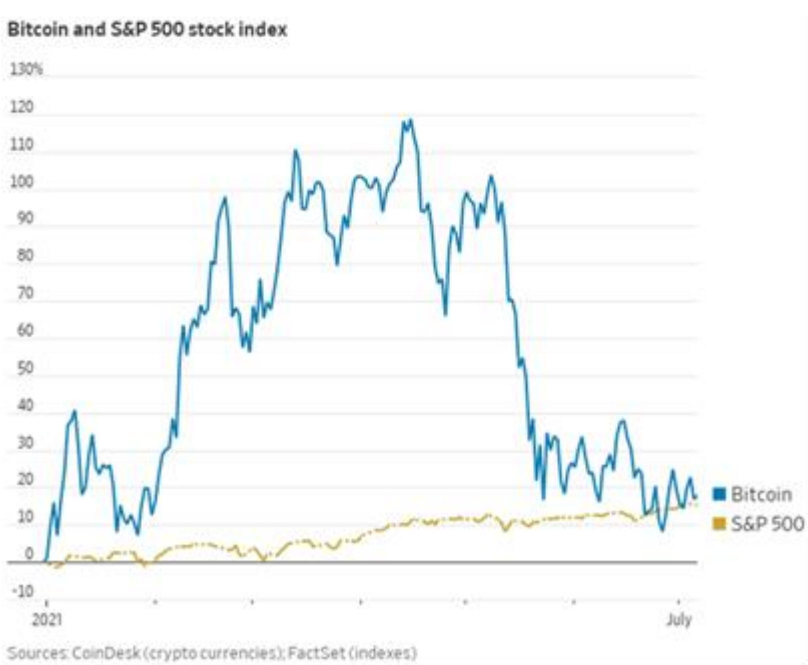
There were 34 years with a gain of 20% or more and 7 years with a loss of 20% or more.

Every year there are reasons to shun stocks—and those who get frightened often end up missing out on the market's long-term gains. In the short run, speculation drives the market as investors fixate on the problems of the day - interest rates, political upheaval, inflation, potential changes to the tax code, etc. But in the long run, the stock market's performance roughly reflects economic growth and rising corporate profits. My advice - bet on humanity's unquenchable desire for progress. Every day, billions of people wake up, trying to figure out how to make their life better. That restlessness drives economic growth—to the benefit of those who own a globally diversified stock portfolio.

One of the most important lessons for investors to learn is that nobody is giving away free money on Wall Street; there are no free lunches. Yet investors are always on the lookout for "new" and "better" investment options. Recently we have seen investors flock to meme stocks, nonfungible tokens and cryptocurrencies in hopes of hitting the jackpot. But beware. Get-rich-quick schemes are the domain of swindlers, charlatans, and social media liars. A potential rate of return cannot be separated from the risk that underlies an investment strategy. For example, I know of a strategy that can quickly double your money - but there is a 50/50 chance that you will lose everything. Many mathematically challenged people fall for this offer every day, focused more on the possible upside than the equally probable downside. But any clear-thinking adult would reject my strategy of heading to the roulette table of the nearest casino and putting all your money on red. Attempting to maximize return, especially in the short-term, involves taking high risk and is likely to produce disappointing, if not devastating, results. Acting continuously on a rational plan offers the best chance for long term investment success.

Random Length Lumber Continuous Contract

The recent price rise of lumber is the latest example of my Eiffel Tower maxim that "If the left side of the chart looks like the left side of the Eiffel Tower, it won't be long before the right side of the chart looks like the right side of the Eiffel Tower." Lumber prices dropped over 40% in June, the largest monthly drop in history, and fell 59% from recent highs that had pundits wringing their hands and proclaiming that it was a precursor to runaway inflation. Apparently, the supply bottlenecks and frenzied buying that accompanied the economy's reopening and sent prices to all-time highs are winding down. The question remains how much lumber prices will fall. The price is likely to remain relatively high due to the strong housing market. According to an article in the Wall Street Journal, "*During the run-up, wood was hoarded by builders, retailers and others worried about running out of material during a construction season sent into overdrive by low mortgage rates and federal stimulus payments.*" One factor in the price collapse is that the builders and retailers that were hoarding lumber during the price runup are now selling from their stockpiles.



Crypto has been the get rich quick and get poor quick story of the year. This chart compares the price change of bitcoin to the S&P 500 since the first of the year. Bitcoin was once the only crypto asset and today 48% of crypto investments are in bitcoin. Despite claims to the contrary, nobody knows what the future price of bitcoin will be.

To my way of thinking, there are no bitcoin investors. Rather, there are speculators who purchase bitcoins in the hope that someday they will be able to sell them at a higher price - a classic "greater fool" activity.

As more cryptocurrencies are created, the percentage of crypto assets invested in bitcoin will likely continue to decline – along with its price. To me, buying cryptocurrencies seems like a high-risk speculation based on libertarian technobabble. Calling it a coin does not make it a legitimate currency. Until cryptocurrencies display price stability and utility, and do not have their price whipsawed by tweets, count me unconvinced.

Speculation is one of the few activities where you can get rich quick if Lady Luck shines on you and the market, for the moment, fails to punish your folly. The financial media's failure to differentiate between investing and speculating has done grave harm to novice investors who often cannot distinguish between real value and illusion. We can't know when over-priced assets will have their day of reckoning, but eventually, the gap between hope and reality will disappear. Novice investors rarely realize when they have been lucky and will attribute their success to skill, which often leads to taking even greater risks. Greed, fear of missing out, naïveté, a lack of common sense, and social media have all played a role in the recent revival of foolish speculating in stocks. Speculation pits one investor against another and the only winners will be the intermediaries who siphon a little bit off the top of every trade. To show that there is nothing new under the sun, I note this quote from Scottish poet, journalist an author Charles Mackay, from his 1841 book, Extraordinary Popular Delusions and the Madness of Crowds:

"Men, it has been well said, think in herds. It will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."

The more complex an investment, the more difficult it becomes to accurately determine its risk. The idiotic belief that outsized returns can be achieved without assuming outsized risk ignores the clear lesson of history. Financial innovations almost always create value for those who devise, construct, promote and market them. But far too many of these innovations have subtracted value from the investors who have been talked into buying them.

My favorite part of the July issue *of Kiplinger's Personal Finance* magazine is the “Five Stocks to Buy Now” article. I have no interest in owning any of the recommended stocks, but each July issue supplies ongoing evidence of the folly of stock picking. Had a subscriber invested an equal amount of money into each of the five stocks recommended in the July 2020 issue, the return over the past 12 months would have been 27% - all five having yielded positive returns. Certainly, an exceptional outcome, one that would encourage many readers to renew their subscription. But few, if any, of these subscribers would realize that the Vanguard Total Stock Market Index ETF (VTI) rose 46% over the same time.

Many retirees seem to favor, or have been advised that they should own, dividend paying stocks during times of low interest rates. Many people prefer to spend a dollar from dividends or interest rather than a dollar generated from the sale of stock or capital gains. This preference is known as the "free dividend fallacy" because it considers dividends and interest as equivalent sources of income. The price of a bond does not change after an interest payment but the price of a stock, or stock fund, is immediately reduced by the amount of the dividend when it is paid. When a $10,000 bond pays out $300 in interest, the bond's price does not change, and the holder will be paid $10,000 on the bond's maturity date. When $10,000 of stock pays out $300 in dividends, the value of the stock immediately drops to $9,700. There is no guarantee that the price will return to $10,000 at some future date. Using dividend paying stocks as a replacement for low interest yielding bonds is a strategy that ignores the additional risk of dividend paying stocks.

Social Security will let you withdraw your original application for retirement benefits only once and it must be done within 12 months of the date you first claimed benefits. You must fill out Social Security Form SSA-521 and send it to your local Social Security office. Social Security will treat it as if you never applied for benefits in the first place. The catch - you must repay every dollar you have received. That includes your monthly retirement benefit, any family benefits and any money withheld from your payments, such as for Medicare premiums. If you have been receiving retirement benefits for more than a year, this option does not exist. But after you reach your full retirement age (66 or 67, depending on your year of birth) you can request a “suspension of benefits.” Until age 70 you will accrue delayed retirement credits which will increase your monthly retirement payment when you reinstate your benefits. If you suspend benefits, any family members who receive benefits based on your earnings record will also be suspended, except for divorced spouses.

In the 18th century, milkmaids were considered “fair of face, the prettiest girls in all the land” because they did not have the common, smallpox face scars. Due to their close contact with cows, they were exposed to, and infected by, cowpox, a mild disease that generates immunity to smallpox. In 1774, a Dorset farmer named Benjamin Jesty purposely inoculated his wife and two sons with cowpox, and vaccines were born (the Latin vaccinus - “from cows”).

The primary statistic that will be debated for years to come - 80% of Covid-19 mortalities came from 16% of the population (those aged 65+). Why didn't we do a better job protecting the vulnerable while allowing the less vulnerable to have fewer restrictions?

Congratulations to defending champion Joey Chestnut who broke his own record on July 4th, devouring 76 hot dogs in 10 minutes, 26 more than the second-place finisher in the Nathan’s Famous International Hot Dog Eating Contest.