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INVESTMENT SERVICES

E-News
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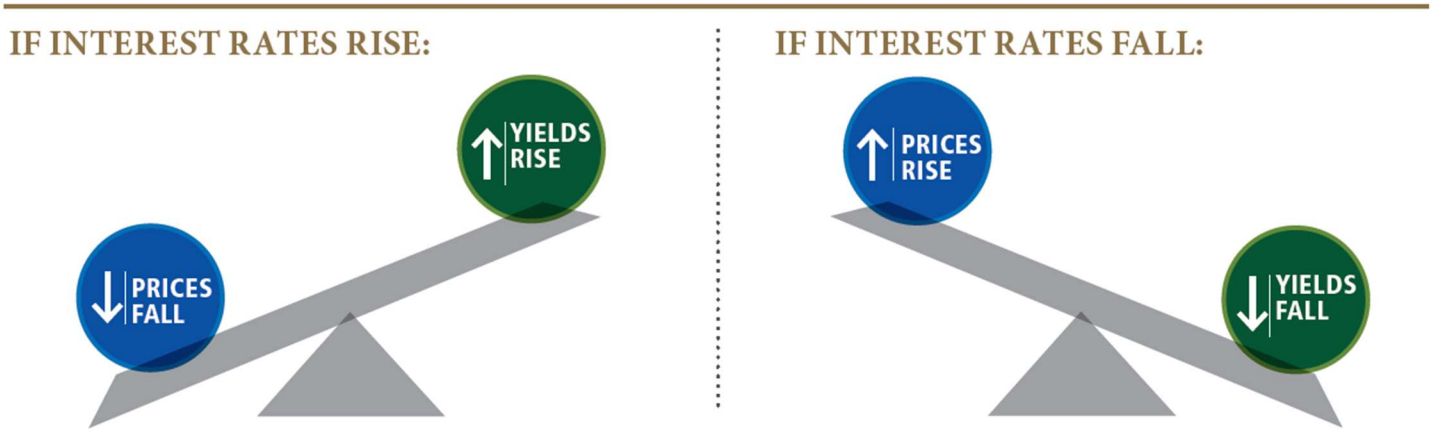
Topics:

What Is A "Discount Rate" and Why Is That Important To Me?



Pension Plan = An employee benefit that commits the employer to fund payments made to eligible employees after they retire. These payments are typically defined as monthly lifetime payments but can often be taken as a lump sum single payment.

Discount Rate = The interest rate used in discounted cash flow analysis to determine the present value of future cash flows. For this discussion, it is the rate used to convert lifetime monthly payments to a lump sum value.

If you happen to work for a company that still offers a pension plan, then I'll first congratulate you. A recent article by Investopedia revealed that roughly 15% of private sector workers are covered by a pension (defined benefit) plan, and that number is declining daily. Over the past few decades, many private sector companies have frozen or eliminated their pension plans and shifted to a profit sharing plan (like a 401(k) for example). This trend is likely to continue due to the fact that it enables an employer to know the cost of operating the plan versus being left with unknown liabilities (like how long their employees will live).

While changing interest rates have no impact on a pension plan's promised monthly payment, the discount rate is of paramount importance to retirees looking to take a lump sum payment for the plan benefit. The discount rate is used to calculate a lump sum option for the pension payout. As the graphic above illustrates, as yields rise (or the discount rate increases), prices fall (pension lump sum values fall).

Let's look at a real life example for someone retiring 1 month apart – 12/1/2022 vs 1/1/2023.

Retiree Details: Age 62, 100% Vested

Pension Plan Options: 1) Monthly Payment or 2) Lump Sum Payment

	12/1/2022 Retirement Date	1/1/2023 Retirement Date
Discount Rate	0.25%	2.50%
Monthly Payment	$3,000.00	$3,045.61
Lump Sum Payment	$632,604.45	$507,163.60

Monthly Payment = Single Life Annuity (Monthly Payment For The Life Of Employee)
Lump Sum Payment = Single Payment

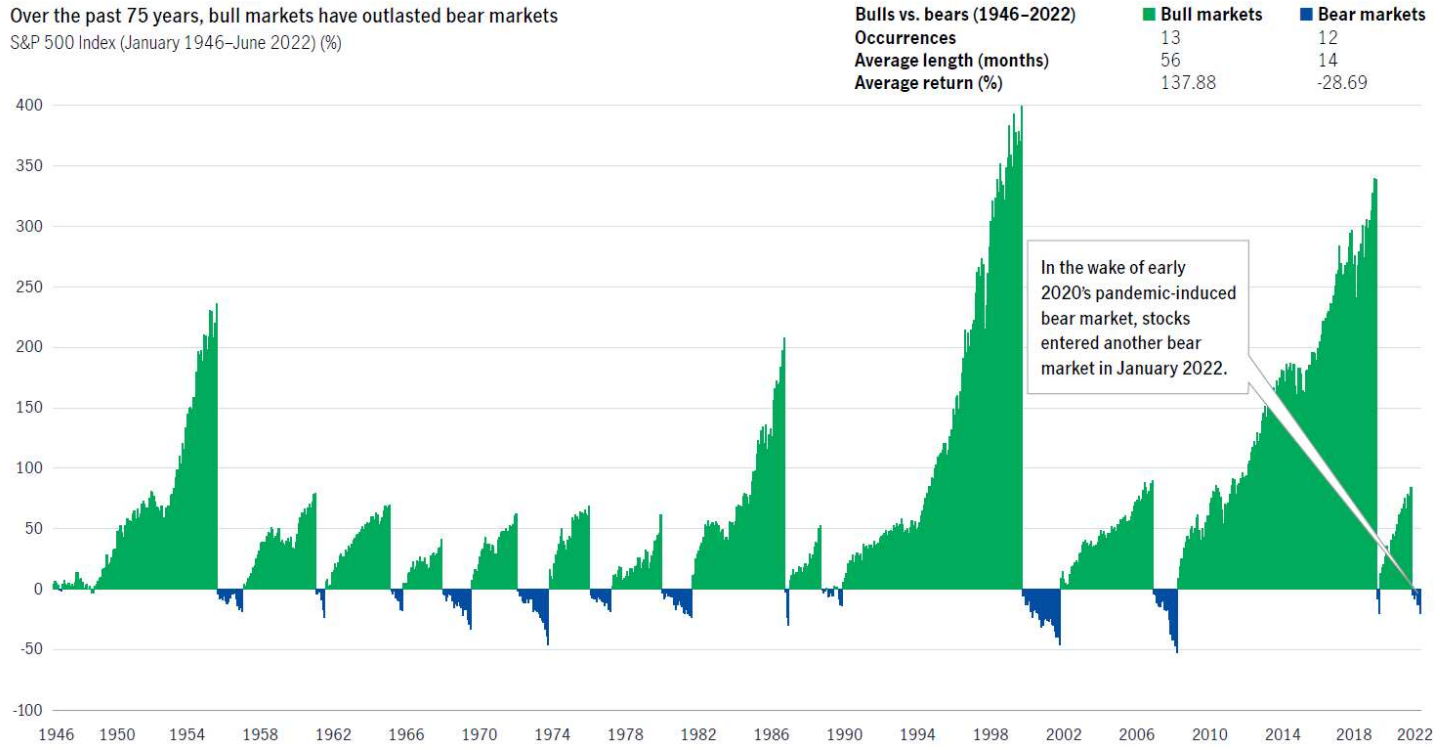
Estimated Net Lump Sum Payment Difference for Retiring 1 Month Later = $125,440.86

It is important to note that each employer sets the rules and parameters (within allowable Federal guidelines) for the specific aspects of the pension plan. It is also important to note that the employee in this example can choose either benefit (monthly payout or lump sum) and can also choose the date of their retirement. In this example, working an extra month would have benefited the employee with future pension credits, with an extra month's pay, and potentially a year-end bonus, but it came at the cost of more than $125k lost in the pension lump sum.

This is just one of many topics that illustrate the critical importance of proper financial planning.

US Equities Have Always Recovered

If you are new to investing, you may be for the first time experiencing an unpleasant event – a bear market. If you've been investing for some time, you know that bear markets are nothing new but still just as unpleasant!



As the chart of the S&P 500 above shows, over the past 75 years US Equities have experienced 12 bear markets with 4 of those occurring in the last 22 years. You may find the 14 month average length or the -28.69% average return of bear markets surprising.

The good news is that **US equities have ALWAYS recovered**. Bull markets have created far more wealth that bear markets have temporarily subtracted. A long-term investor that invested $100 in the S&P 500, reinvested all dividends, and most importantly held that investment during both the good and the tough times would have seen that $100 compound to $254,491.11 by June 30, 2022!

Due to the fact that INFLATION has dominated the recent news, I wanted to mention that this investment return has bested inflation over this period cumulatively by 16,649.84% or by 6.92% per year. US equities have proven to be one of the most effective wealth building mechanisms ever conceived!

Why is it that we all know that we should buy low and sell high, but when it comes time to buy low, we fail to do it? **I recommend that you buy stocks now!** When you "feel" like it's time, you will have already missed the boat!

Source: Standard & Poor's as of 6/30/2022
The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance is no guarantee of future results. Income tax consequences of investment returns have not been factored.

Stats of the Month

Kids Are Expensive – Raising a kid born in 2015 until the age of 17 would cost a middle-class couple a total of $310,605.

Daily Up/Down Split – From 1950 through 2021, the US stock market up/down split was 53% / 47%. In other words, the US stock market has been positive on average 133 of the annual 252 trading days per year.

Want A Job? – The number of job openings in the United States was 10.698 million as of June 2022, off from an all-time peak of 11.855 million in March 2022. A decade ago (June 2012), the number of job openings in the United States was 3.911 million.

Covered – The percentage of Americans lacking health insurance coverage fell to just 8.0% (26.4 million people) in the 1st quarter of 2022, the lowest percentage ever for the United States.

Housing Peak? – After reaching an all-time US high of $457,000 in April 2022, the median sales price of new homes sold in the USA has fallen during the last 2 months to $402,400 in June 2022, its lowest level since June 2021.

Housing Market Cycle – The average home price in the United States increased +8.1% per year for the 10-years ending 5/31/2022 but that included an increase of +18.3% in price for the 1-year ending 5/31/2022. In the previous decade, American home prices increased just +1.4% per year for the 10-years ending 5/31/2012.

Ready $ – The size of the money market fund industry in the USA (both taxable and tax-free) on Wednesday 8/17/2022 stood at $4.6 trillion, up ~ $1 trillion from pre-pandemic levels.

Student Loans – As of 6/30/2003, credit card debt in the US was almost 3 times the size of student loan debt, i.e., $690 billion to $240 billion. By 6/30/2010, credit card debt ($740 billion) was smaller than student loan debt ($760 billion). As of 6/30/2022, credit card debt ($890 billion) has been overwhelmed by student loan debt ($1.59 trillion).

Sources: Bureau of Labor Statistics, Census Bureau, Investment Company Institute, S&P, TDPel Media, World Bank

The Markets

In August, tough speak from the Fed willing to risk a recession to tame inflation led to an equity market selloff.

US Market Highlights		Global Market Highlights	
Consumer Confidence	↑ ↓	MSCI EAFE-International Stocks	↓
Jobs	↑	Emerging Markets	↓
Consumer Spending	↑	Oil Prices	↓
GDP	↓	Inflation	↑
Interest Rates	↑	Australia, France, Germany Kong	↑ ↓ ↓
US Stock Market	↓	Inflation	↑

Here are the selected updated market stats:

Index	8/31/2022	12/31/2021	12/31/2020	12/31/2010	12/31/2000
DJIA	31,510	36,338	30,606	11,578	10,788
NASDAQ	11,816	15,645	12,888	2,653	2,292
S&P 500	3,955	4,766	3,756	1,258	1,320
MSCI EAFE	1,841	2,336	2,148	1,658	1,405
10 Yr UST Yield	3.13%	1.51%	0.91%	3.31%	5.11%

** Source: Yahoo Finance, MSCI.com

Summary

August started off well enough, building on the summer rally over the course of the month's first two weeks. Investor sentiment was lifted by a surprisingly strong employment report that saw the economy add 528,000 jobs in July and later by a better-than-expected Consumer Price Index (CPI) report that saw inflation decelerate slightly. A fresh batch of positive earnings surprises provided an additional boost for stocks. Overall, the

earnings season turned out to be better than what many investors had expected. With 97% of the companies comprising the S&P 500 reporting, 78% reported earnings that exceeded Wall Street analysts' estimates.

While equity markets rallied in July and into early August, the summer rally ended on August 26th with Federal Reserve Chairman Powell's hawkish speech at the Jackson Hole Economic Symposium. Chair Powell noted the Fed will continue to use restrictive policy "for some time" to tame inflation, returning it to their preferred 2% level. He also warned that pivoting from this strategy too early might lead to similar inflation levels that we saw four decades ago when inflation peaked above 14% in 1980. The Chair said, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain." Powell also talked about recent economic data being mixed, but in his view, the "economy continues to show strong underlying momentum."

The market's month-to-date gains disappeared following the speech as Powell appeared to end any investor hope of a pivot by the Fed. Stocks added to their losses in the month's final days as investors confronted a monetary policy landscape that potentially offered little relief from further Fed interest rate hikes. The Dow Jones Industrial Average, the Standard & Poor's 500 Index, and the Nasdaq Composite each fell by more than 4% for the month.

Sector Scorecard

Only 2 sectors posted gains for the month (Energy 2.8% and Utilities 0.5%), while the remaining sectors finished lower. REITs, Healthcare and Technology sectors were hit hardest with returns lower than -5%.

GICS Sectors	August
Energy	2.8%
Utilities	0.5%
Staples	-1.8%
Financials	-2.0%
Industrials	-2.8%
Basic Materials	-3.5%
Communications	-4.2%
Consumer Disc.	-4.6%
REITs	-5.6%
Healthcare	-5.8%
Technology	-6.1%

Indicators

Gross Domestic Product: The economy shrank at an annualized rate of 0.6% in the second quarter, an improvement from the initial estimate of a 0.9% contraction.

Employment: Nonfarm payrolls increased by 528,000 in July, which was double the consensus estimate. The unemployment rate dipped to 3.5%, while average worker wages rose 5.2% from a year ago.

Retail Sales: Retail sales were flat month-over-month, but when excluding gasoline and auto sales, consumer spending rose 0.7%.

Industrial Production: Industrial output increased 0.6%—double Wall Street estimates—as oil and gas drilling reached a seven-year high.

Housing: Housing starts declined 9.6% in July, as higher costs and mortgage rates pinched new construction activity. Existing home sales fell 5.9% from the sales in June, as higher interest rates weighed on buyer affordability. It was the sixth consecutive month that existing home sales have declined. Despite the softness, the median sales price rose 10.8% from 12 months ago. New home sales dropped to their lowest level since 2016, falling 12.6% in July. Compared with those a year ago, sales are down by 29.6%.

Consumer Price Index: Consumer prices eased in July but remained near record highs as the CPI rose 8.5% year-over-year.

Durable Goods Orders: Durable goods orders were unchanged from the previous month, though were higher by 1.2% when excluding defense orders.

The Fed

Minutes from July's Federal Open Market Committee (FOMC) meeting reflected a broad consensus among Fed officials that additional rate hikes were still required to combat elevated inflation, though acknowledging economic weakness may temper the size and pacing of such hikes.

"Regarding developments abroad, central banks in advanced foreign economies had quickened the pace of policy tightening in order to address above-target inflation," according to the July meeting minutes. "Eight advanced-economy central banks raised their policy rates over the period."

World Markets

Weakening economies in Western Europe and China rippled through overseas markets, with the MSCI-EAFE Index falling 4.61% last month. Losses were posted across European markets, including France (-5.02%), Germany (-4.81%), and the U.K. (-1.88%). Pacific Rim markets fared better, but still ended the month mixed. Hong Kong lost 1.0% while Australia picked up 0.60%.

What Investors May Be Talking About in September 2022

In the month ahead, all eyes will be on the Fed again when it meets in late September. After two consecutive 75 basis point hikes in June and July, the Federal Open Market Committee (FOMC) will once again be meeting to consider what's next for short-term rates. The outcome of this meeting, scheduled for September 20–21, appears more certain following Fed Chair Powell's Jackson Hole speech. But the Fed has indicated that any potential rate hike will depend upon the economic data leading up to the meeting. Some see the second consecutive quarter of GDP contraction and declining energy, metals, and food input costs influencing the Fed's decision. Others believe that comments in August by Powell and other Fed officials that the inflation fight is not over. A rate hike of 0.50% - 0.75% is the expectation.

There may also be at least a hint of politics in the news as well. Yes, we have an election looming on November 8th, and the rhetoric is sure to intensify. Topics that are polling to be the most likely to drive voter decisions include the economy, immigration, education, virus management, Russia/Ukraine, abortion, and gun policy. All I can say is to educate yourself as much as possible and go vote for the candidates that you deem best!

Lastly, an interest development has occurred during 2022. Short-term interest rates have risen rather dramatically. If you are trying to get a home mortgage, then you know! If you are looking and short-term, high quality fixed income rates, then you know as well. For the first time in almost 15 years, we are seeing short-term, quality corporate bonds paying rates that actually get our attention (4-6%). Even CDs have stepped up to

> 3%. With another rate hike in September, those rates will be more compelling. I included in the Stats of the month that there was $4.6 trillion in cash savings presently. If some of that is yours, we need to talk. Putting that to work in short-term fixed income will at least keep the inflation monster at bay to a degree. Buying stocks now at depressed prices today may be one the biggest gift you can give yourself later!

The Hidden Price of No Fee Trading

Disruption Change Revolution Creative Destruction

These are terms we've all heard when it comes to what the Internet and new technologies have brought to our lives. Much of that change has been a net positive, but some has come with a cost…and often times a "hidden" cost. Sure, it's "free" to have a Facebook account, but make no mistake that to Facebook you are the product…a product that they are happy to sell to their advertisers and one that created revenue of $117,929,000,000 in 2021.

During the early days of the explosion of the Internet, online securities trading firms were all the rage. This guy

was raking in the dough…not from trading on E-Trade but by starring in their commercials. And let's be honest, they were hilarious!!!

More recently, online trading platforms, maybe none more popular than Robinhood have gained popularity advertising "No-Fee" or "$0 Commission" trading. Most of us have been around the block and understand well that nothing of value in life is truly free. So the question arises, "What is the cost?"

It's funny that you should ask! Five US professors asked the same question and used their own funds to test an algorithm that they developed. In the study, they executed ~ 85,000 trades in 128 different stocks and found significant discrepancies in the prices to buy and sell the same securities. With their study complete, they extrapolated the data to estimate that small-time US Investors pay as much as $34,000,000,000 annually in what we might call "hidden" fees.

To be sure, some degree of pricing variation is normal in any market. Differences can arise because of changes in liquidity, volatility and market conditions, as well as the kind of order sent to the exchange. The study found however, a "very large variation" in prices achieved from buying and selling stocks at different brokers, with the execution of some trades costing 10 times more — as measured by the basis-point spread that was charged — when made through one intermediary than with another. Out of the six market makers that handled the orders in the experiment, more than 60% of all orders eventually went to Citadel Securities and Virtu. Unsurprisingly, spokespeople from both declined to comment.

The contracts negotiated between brokers and market makers are private. But Robinhood Markets Inc.'s December 2020 settlement with the Securities and Exchange Commission shed some light on the conflicts of interest between brokerages and their clients. According to the SEC's settlement order, unidentified market makers told Robinhood that they would have to provide worse prices if the broker wanted to get a larger share of overall profits from the trades it routed through the firms.

Investor Lessons

- Trading is not investing – it is speculation
- Trading comes at a cost – some are easy to spot and others are harder to ascertain
- Limiting trading eliminates expenses – eliminating expenses keeps $ in your pocket

Our newer investors are often interested in the number of transactions that occur (or do not occur) inside of the portfolios that we manage during given periods of time. We are mindful of the three points above when managing your money and take all decisions to execute trades in your portfolio very seriously. We also know well that the hidden costs (bid/ask spreads, routing, and execution) can increase substantially during periods of crisis, which is why we almost never choose to execute sell trades during the heat of crisis moments. Typically those days are dominated on the sell side by those that are panicked and hysterical, and we strive to be exactly the opposite!

Study Link: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4189239

Quotes of the Month

"When a defining moment comes along, you can do one of two things. Define the moment, or let the moment define you."
-- Roy McAvoy (In the movie, "Tin Cup")

"I try to invest in businesses that are so wonderful that an idiot can run them. Because sooner or later one will."
-- Warren Buffett

"Working hard and working smart sometimes can be two different things."
-- Byron Dorgan

History has demonstrated time and again the inherent resilience and recuperative powers of the American economy.
-- Ben Bernanke (Fed Chairman 2006-2014)

The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubts.
-- Bertrand Russell

Riddle of the Month

A sudden noise startles a gopher, an owl, and a raccoon at the edge of the forest. The owl flies off and the gopher retreats into his burrow, but the raccoon runs for the trees. How far can the raccoon run into the forest?

Last Month's Riddle

I can't be seen, but I'm all around. I have no mouth, yet can make a sound. I can be harnessed, but never bound. No hands have it, yet I move the ground. What am I?

Answer:

The wind.

Do You Know Someone Who Could Use Information Like This?

Please feel free to send us contact information for anyone that you recommend we add to our E-News. Don't worry, we'll request their permission before adding them. We promise to protect their information and to provide quality content in thoughtful and hopefully entertaining ways.

Best regards,

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P.S. If you are new to our E-News, we welcome you and hope that you enjoy it.
