"Bad Recipes and Acronym Soup"

About

This newsletter is designed for advisory clients and friends of **ADK | Wealthcare Partners**.

Independent global sourcing from distinguished and reputable sources drive the underlying perspectives.

Al Kaufman takes full responsibility for the content and hopes you find the topics to be timely, instructive and helpful. Recipients are welcome to share these insights.

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Market Shaping Developments

"Let's make America great again" was first used in Ronald Reagan's 1980 presidential campaign.[1] It came at a time when the United States was contending with inflation, energy shortages, and the prospect of a weakening economy — along with American hostages in Tehran who were swept up in the Islamic Revolution of 1979 and the evolution of the contemporary Iranian state.[2]

Roughly a generation later, the US remains a world leader and exceptional in many ways with a mission beyond ourselves and our borders. Meanwhile, Iran has became a regional agitator and purveyor of terror.

While Ronald Reagan was providing his uplifting message to the US electorate, Iran was being shaped by Mohammad Ruhollah Musavi Khomeini (aka Ayatollah Khomeini) —who was driven to expand the influence of [Shiite] Islam in the region. Khomeini sat atop the Islamic Republic's power structure once the revolutionary dust settled.[3] Since 1989, Ayatollah Ali Khamenei, his successor as supreme leader, remains the most powerful individual in the Islamic Republic. In that capacity he oversees the military; supervises the constitution; sets general state policy; and appoints commanders of the Revolutionary Guards.[4] His hatred of Israel and the US are well documented as is his disinterest in negotiating with the United States.

The Islamic Revolutionary Guard Corp (IRGC) was established to protect the Shiite clerical regime in 1979, but their role and resources quickly expanded to include ground, naval and air forces, overseeing Iran's ballistic missile program, and conducting overseas operations through its Quds force—including military support for Hezbollah and Hamas.[5] Their overall body of work prompted the Secretary of State to add the IRGC to the list of foreign terrorist organizations (FTO) on April 15, 2019—the first time the US has designated part of another government as an FTO.[6, 7]

A remarkable political and economic reset within China in the late 1970s has also served to shape current headlines and influence market narrative. After Chairman Mao Zedong's death in 1976, China was left with no central authority figure at a time when the country was reeling politically and economically. Mao's designated successor did not pan out and was soon supplanted by Deng Xiaoping—who had recently been living in seclusion because of "political mistakes."[8] With support from Communist Party reformists, Deng and his successors oversaw a Chinese economic boom through the use of various free-market principles and selective divestitures of state enterprises.[9] Since the early days of economic reform in 1979 through 2017, China has been among the world's fastest growing economies. **According to the World Bank, their growth represents the fastest sustained expansion by a major economy in history.**

However as China's economy has grown and matured, its rate of growth has naturally slowed. Policymakers, perceiving that fixed investment and exports are no longer sufficient growth engines, now seek to stimulate future growth with private consumption, services, and innovation.[10] With a population of 1.4 billion, there is a need in Chinese planning circles to 'Go big or go home!' And the Chinese have chosen to GO BIG. Innovation has become a top priority through a number of high-profile initiatives to upgrade and modernize China's manufacturing through extensive government assistance in order to make China a global player in target sectors. US Trade

Market Shaping Developments — Continued

Representative Robert Lighthizer describes the *Made in China 2025* initiative as "a very, very serious challenge, not just to us, but to Europe, Japan and the global trading system." [11]

Apart from improving domestic capabilities , China is expanding its influence globally through partnerships such as the *Belt and Road initiative*—which helps to finance and build infrastructure projects in Asia, Africa, Europe and elsewhere.[12]

Xi Jinping—President of China and general secretary of the Chinese Communist party—is a powerful leader. He comes from a family dedicated to the advancement of the communist cause, but with some interesting twists. His father, Xi Zhongxun, joined the Communist Party of China in 1928 while imprisoned by the ruling nationalist for taking part in a student demonstration. Following the post-war transition from the Chinese Civil War, he climbed party ranks but also experienced setbacks such as the purging of his leadership positions. During the Cultural Revolution he spent long periods of confinement in Beijing. Following the Revolution, Xi Z was *deemed* fully rehabilitated and held leadership roles in Guangdong where he helped stabilize the provincial government and began to liberalize the economy.[13]

These experiences were not lost on Xi Jinping, his son—who also endured painful setbacks at the hands of the Chinese Communist Party. When his father was beaten and imprisoned during the Cultural Revolution, young Xi was compelled to participate in Mao Zedong's *Down to the Countryside Movement*. Those were uncomfortable and difficult years, but formative as well. Once the Cultural Revolution ended, he sought to join the Communist Party nine times before finally being accepted. His father's faith in the party and its political ideals — which remained unshaken despite 16 years of political imprisonment — served to greatly influence and motivate his son.[14]

China's ascension and plans for growth have major implications for the United States, particularly in areas deemed harmful to US economic interests, such as industrial policies and theft of US intellectual property.[15] Trade friction has become a harbinger of things to come. Recent tariff escalations and a shift toward a nationalist tone coincides with Beijing's recent hardened trade negotiating posture. If Beijing sees little prospect of a US de-escalation, it could impose restrictions on US businesses and individuals in China and even refuse to sell strategic commodities like rare earth elements.[16] Tensions could easily rise.

Why This Matters

TRUMP
MAKE AMERICA GREAT AGAIN!

President Trump's MAGA may seem like a redundant slogan, but its message has become a catalyst for renewed involvement in regions of the world warranting our support. Iranian influence in the Mideast continues to be problematic. However the economic noose of US sanctions on oil exports may force their hand. Among other near term outcomes Iran could backpedal, fight back, face a counterrevolution, receive other aid, or crater economically. Khamenei is determined, but continued *resistance* is more likely than war.

Chinese trade discussions appear to be losing momentum in their current form. President Xi is resourceful and hardened, and his [Communist] Party accountabilities do not lend themselves to sweeping concessions in short order. Instead, the Chinese appear to be preparing for protracted negotiations without tariff-sensitive time pressures. Given that these discussions are of generational importance, some flexibility is warranted and likely. In the meantime, alternative arrangements for trade and supply logistics are underway. New opportunities abound. **The pressure is on and miscalculations, and misguided headlines, could easily agitate financial markets in the short-term.**

Seeking Shelter from the Storm

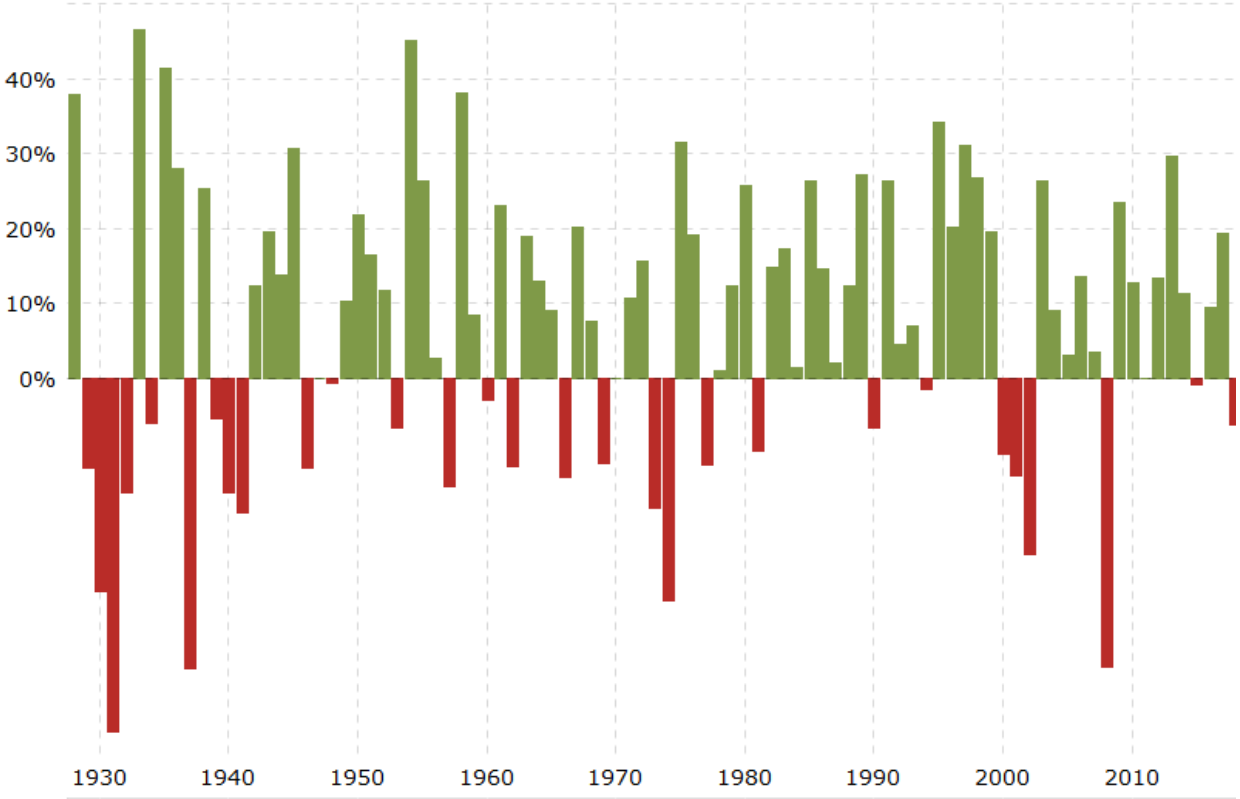
Theory vs Framework

Modern Portfolio Theory (MPT), which was first published by Harry Markowitz in the *Journal of Finance* in 1952, is not necessarily modern anymore, but it remains practical.[17] One of its core tenets has to do with portfolio diversification principles. **Unfortunately the term *diversification* is often misunderstood and overhyped.**

MPT is not designed around a household's unique needs and overall resources. Therefore overzealous and misapplications of this theory—such as cookie cutter portfolios and universal assumptions—can actually decrease the odds of desired lifestyle outcomes. Similarly, market performance data do not serve as adequate resource barometers; they are more akin to flying a plane without instrumentation. Given the ups and downs of markets, coupled with the storms of life, a *dynamic resource guidance system* can be a powerful ally in helping to nurture desired outcomes over a lifetime.

MPT emphasizes one element of resource management that should be practiced within a *dynamic wealth allocation framework*. And in that context, **risk allocation should precede investment allocation**. The next section will expand on this concept.

S&P 500 Historical Annual Returns: 1928 - 2018



Source: https://www.macrotrends.net/2526/sp-500-historical-annual-returns

Modern Portfolio Theory

The theory associated with MPT presumes that investors are risk averse and that there are optimal ways to construct investment portfolios such that expected returns are in line with desired risk—as measured by a portfolio's standard deviation. With this approach, groupings of securities with different behavioral characteristics can reduce some of the unnecessary company or sector -specific risk (aka unsystematic) associated with fewer holdings or groupings that tend to possess similar attributes through different market cycles. Addressing unsystematic risk is a good thing, but not enough.

Seeking Shelter from the Storm — Continued

Determining the number and type of unique holdings in a portfolio, and rebalancing these holdings periodically is a diversification-related practice that is meritorious and expected within institutional domains, however these activities by themselves fail to address other perils, such as the Great Recession of 2008 and 2009—an example of **systematic risk;** something unpredictable and impossible to completely avoid yet common to all securities.[18] These risks can be mitigated through hedging and by certain asset allocation methodologies.[19] However if a resource framework has not been established which has already addressed lifestyle risks, how can an appropriate asset allocation be identified? It can't very well.

As the graph on page 4 demonstrates, financial markets as a whole sometimes fall prey to events which are not considered diversifiable by traditional means. Yet if market realities are ignored in early preparations, lifestyles can become driven solely by the whims of financial markets in retirement. That would be a very difficult road if the first decade of this century is any indication. The S&P 500 is often used as proxy for large companies domiciled in the US and considered as a diversified grouping as far as an asset allocation bucket. However the S&P 500 decreased in value by **10%**, **13%** and **23%** in 2000, 2001 and 2002 respectively and by **38%** in 2008.[20] As per the previous graph, maintaining seed capital while taking distributions this century would be challenging for retirees relying on the perceived adequacy of the S&P 500 as a diversifier. **Traditional diversification and a misguided reliance on MPT can be a recipe for failure.** Equity market returns in the US since 2009 have been impressive, but the next ten years is apt to look much different. Why? Because US markets are especially expensive by historical standards[21] and earnings are unlikely to grow at the same pace as they have since 2008—where we had a relatively inexpensive base to begin with. Moreover, other parts of the world may offer better opportunities going forward relative to certain segments of the US.

How Households Can Improve their Odds of Success

A better construct has to do with determining the least amount of risk that can be undertaken to accomplish that which is being sought, with allowances for aspirational risk if resources allow. A comprehensive framework with corollary processes can support this path. Failing to have a framework in place can jeopardize preferred lifestyles which is why all advisory clients are encouraged to avail themselves to the lifestyle allocation framework available at ADK, beginning with a customized lifestyle plan. Most do. Which is greatly appreciated.

We are committed to helping make your assets work well for you in all ways, but in the grand scheme of things **Comfort zone** scores are probably the most significant indicator of our contribution to your endeavors over the years. We remain committed to helping you live the best life you can.

Funny Money

The **guns versus butter** model offers a simplistic production-possibility frontier involving a nation. Buying more guns means buying less butter and vice versa. Acquisitions outside of the prescribed frontier are deemed unfeasible. Pretty simple concept, except when borrowing enters the picture and gums up the works.

According to the Congressional Budget Office, the US federal deficit is projected at $900 billion in 2019 and will exceed $1 trillion each year beginning in 2022. The outstanding debt of the federal government currently exceeds $22 trillion. State, local, and agency debt and unfunded liabilities for programs like Social Security and Medicare are excluded in those figures.[22] Spending restraints are not on the table in Washington DC these days, so we seem to have adopted a policy of spending our way into a guns and butter wonderland.

Plenty of debt sloshing around in the corporate world as well, which has borrowed profusely in this low interest rate environment. More than half of corporate debt is rated BBB — which almost falls into junk bond category. David Rosenberg points to an interesting symmetry between the $4 trillion expansion of the Fed's balance sheet, $4 trillion surge in corporate debt, and $4 trillion in share buybacks. He does not believe that fundamentals have been driving the market for most of this cycle.[23] Irrespective of that position, it is clear that financial markets are not receptive to the idea of higher interest rates.

Dangers of Debt

> **"We use debt sparingly. Many managers, it should be noted, will disagree with this policy, arguing that significant debt juices the returns for equity owners. And these venturesome CEOs will be right most of the time.**
>
> **At rare and unpredictable intervals, however, credit vanishes and debt becomes financially fatal. A Russian roulette equation—usually win, occasionally die—may make financial sense for someone who gets a piece of a company's upside but does not share in its downside. But that strategy would be madness for Berkshire. Rational people don't risk what they have and need for what they don't have and don't need."**
>
> **— Warren Buffet [24]**

While there is a low likelihood of interest rates rising in the short-term through central bank action, contingency plans are being discussed by policymakers for the next recession. Decreasing interest rates to zero may not be sufficient and money needs to come from somewhere. How might this occur?

From 2008 through 2013, the Fed launched three Quantitative Easing (QE) programs whereby treasury and agency securities were purchased with digital money from the Fed.[25] They could revert back to those practices with a QE4 if needed, but that would likely create a bitter political response. Rather than go the QE route, a new path is being considered by some: MMT.

Modern Monetary Theory (MMT)

MMT is a controversial theory that is growing in prominence. Essentially, it involves government directing money to third parties with little expected in return—akin to helicopter money. Whereas QE programs were often viewed as Wall Street bailouts and contributors to wealth inequality, MMT funds could be sent directly to people. Outright debt monetization could actually become a reality.[25] Influential hedge fund manager Ray Dalio is among those supporting the basic philosophy believing it inevitable.[26] Per his analysis, MP3 (an MMT offshoot) could become 3rd generation monetary policy.[27] **A Magic Money Tree or something like the Green New Deal may be closer to reality than we think.**

Annuities

Gladiator spectacles were one of the most watched forms of popular entertainment in the Roman World. These professional fighters generally fought to the death in large arenas. The losing gladiator, if not killed outright, often appealed for mercy. The crowd would try to influence the emperor's judgment in deciding the fate of the combatant by either positioning their thumbs up or down. Raised thumbs meant 'let him go,' thumbs down meant execute him. . . Or was it the other way around? Historians disagree. Perhaps many in the crowd didn't know the difference or had not taken the time to understand the protocols in that arena. Almost sounds like a modern day discussion on annuities. As Rodney Dangerfield would say, "They don't get no respect." **They should.**

At a base level annuities are insurance contracts guaranteed by an issuing company. They can be purchased and designed to supplement 'safe money' objectives, generate predicable income, grow capital, and serve as a pension proxy. Rather than view them as investment alternatives, they are better positioned as *enabling risk management vehicles* in my view. Fees, expenses, company strength, fit, objective, liquidity characteristics, and payment options are among the things to consider in selection.

Too often, annuities are dismissed as being overly complicated, expensive, poor investments, and not worth consideration. They have also been oversold and abused at times—which has created a generation of antagonists. While there will always be those with ulterior motives or bad intentions (aka sin nature), I believe the bigger problem revolves around ignorance of their proper use and potential. In the right hands, and in the proper situation, annuities can increase the odds of successful outcomes while helping to protect client lifestyles. Scenario analysis with a sophisticated planning system can help to determine whether there is an appropriate fit from within a contemplated mix of assets and desired outcomes.

Consider the advantage that retired individuals and couples possess in retirement if their pension addresses foundational cash gaps otherwise unmet. When markets disappoint they can adjust discretionary spending, but their core baseline income is not in harms way. And their investment capital is free to foster lifestyle and legacy priorities as the decades unfold. Sounds pretty good doesn't it? Unfortunately, pensions offered through public and private employers are becoming less common.

Americans without a pension must often rely on financial markets and other asset-based investments — such as real estate or mineral interests — to supplement their foundational needs beyond social security. Their seed capital will need to navigate market downturns and living expenses for the duration. Given that these are unknown variables, it is not prudent to dismiss tools and techniques which can mitigate some of the longevity risk that pure investment vehicles cannot.

Liquidity and access to capital are among the potential drawbacks to consider when contemplating the potential benefits of a specific annuity and benefit combination. Proceed with caution, but with an open mind as well. **A properly positioned annuity can, among other things, serve as an excellent pension-proxy and improve the odds of favorable lifestyle outcomes in other areas as well.**

Voices

"Liberty cannot be established without morality, nor morality without faith."

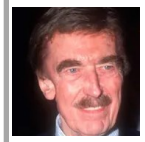
— **Alexis de Tocqueville, Democracy in America**

"Only a virtuous people are capable of freedom. As nations become corrupt and vicious, they have more need for masters."

— **Benjamin Franklin**

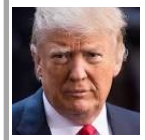
"If we lose freedom here, there is no place to escape to. This is the last stand on earth."

— **Ronald Reagan**



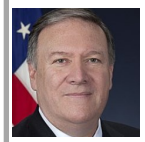
"Get in, get it done, get it done right, and get out."

— **Fred Trump**



"I think Ronald Reagan was one of the great presidents, period, not just recently. He had the demeanor. I thought he had the bearing. I thought he had the thought process."

— **Donald Trump**



"Over the 5, 10 and 25 year time horizon, . . China presents the greatest challenge that the US will face in the medium to long-term."

— **Mike Pompeo**

"When it is obvious that goals cannot be reached, don't adjust the goals, adjust the action steps."

— **Confucius**

"If your opponent is of choleric temper, seek to irritate him. Pretend to be weak, that he may grow arrogant."

"Build your opponent a golden bridge to retreat across."

— **Sun Tzu**

"I have never done anything to let down ordinary people, and when others have bullied the people, I did not obey."

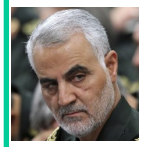
— **Xi Zhongxun** [From plaque memorial; Xi Jinping's father]

"It is for the people of Asia to run the affairs of Asia, solve the problems of Asia and uphold the security of Asia."

— **Xi Jinping**

"It is the mission of the Islamic Republic of Iran to erase Israel from the map of the region."

— **Ali Khamenei** [2001]

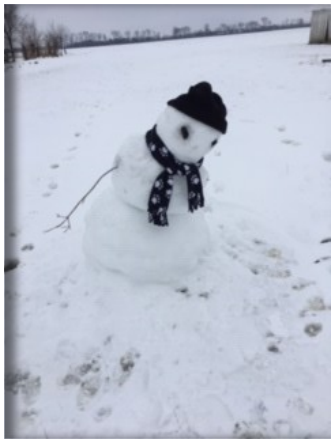


"We are near you, [USA] where you can't even imagine … We are ready. If you begin the war, we will end the war."

— **Qassem Soleimani** {Major-General of al Quds Force]

<u>Advisory clients will receive a discussion outline and comments with this newsletter as part of the ADK accountability process</u>. These submissions are designed to help you better understand the perspectives, strategy and rationale associated with managing your financial resources.

Thank you for your business. Please let us know how we can better serve you, your family, and perhaps others as well.



Anxiety in the heart of man causes depression, But a good word makes it glad.

— Proverbs 12:25

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Investing involves risk including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price. Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Quantitative easing is a government monetary policy occasionally used to increase the money by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Asset allocation does not ensure a profit nor protect against a loss.

Endnotes

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