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Black Friday and Crypto

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Greetings and welcome to December. This edition of our monthly communication is a bit longer than normal. We present general announcements, a brief discussion on market volatility and close with a longer discussion about cryptocurrency.

General Announcements

Staffing

Please join us in congratulating our colleague John Voigt on his retirement at the end of this year. John joined PIM in March of 1999. Over the course of his nearly 23-year career, John has been behind the scenes taking care of PIM and its clients in a variety of ways. Functionally, John has been the head of finance and accounting for most of his career with PIM. At times this included being the head trader for client accounts in custody at Charles Schwab & Co as well as many other senior administrative functions. For those of you who have actually interacted with John, you know what we have always known. John is a top-notch professional and among the nicest guys any of us have ever known. We extend to him our most sincere best wishes for a happy retirement.

Please join us in welcoming the newest member of the of PIM team, Ms. Faezeh Rafiee. Faezeh joined PIM in September of this year as Client Service Administrator, reporting to Chief Operating Officer Jennifer LaDuca. There is a substantial learning curve associated with the client service role, and Faezeh is doing a fabulous job so far. As training progresses, PIM clients will have the opportunity to work with Faezeh directly, which we trust you will thoroughly enjoy.

Charitable Contributions and QCD

PIM recently made its second annual charitable contribution to the Frank Bosone Memorial Scholarship at Bellevue College. This second contribution completes the minimum required capitalization for the fund, which will soon begin making scholarships to students.

If you wish to make a qualified charitable distribution for 2021, there is still time. Please reach out to PIM for any help you need. If you are interested in making a qualified charitable distribution but do not have a particular charity in mind, the Frank Bosone Memorial Scholarship is accepting contributions.

Mass Communication Method

Beginning with our last monthly written communication in November, PIM is using a new electronic distribution method for emails that we intend for all PIM clients concurrently. When you receive this type of message from us, the sender will be Personal Investment Management, Inc <contact@pim4you.com>. The reason for the change is that in an attempt to reduce unwanted spam/ junk, Microsoft recently implemented more stringent rules that prohibit mass emails at the scale we require and have traditionally relied upon.

Black Friday Indeed

Christopher J. Reedy, MBA, CFP®, CIMA®

Concerns about the Omicron variant of COVID-19 caused a major sell-off in global equities on Friday, November 26th. The Dow Jones Industrial Average was down 2.53%. The S&P 500 was down 2.27%. The NASDAQ was down 2.23%, and the Global Dow was down 2.71%.

None of what follows presumes that PIM's valued clients are unaware of market dynamics. We have the utmost respect for your general level of sophistication. Still, severe market volatility can be an emotional roller coaster. Professional investors distinguish themselves from retail investors in many ways; the ability to maintain dispassionate objectivity is among the most important. Maintaining dispassionate objectivity is supported by periodic reminders of the fundamentals of investing.

These fundamentals include the following: 1) Nobody knows what equity or fixed income markets will do from one day to the next. Nobody. Trends are identifiable. Valuations relative to historical averages are easy math. Economic data points and analysts' opinions are readily available. Still, consistently accurate predictions of short-term market movements are impossible. 2) Market timing does not work over the long run. A win here and there risks lulling active traders into a false sense of security and the mistaken notion that skill, rather than luck, is the reason for occasional positive outcomes. One big mistake, and it's over. 3) The best defense against market volatility is diversification. In the PIM context, this is our clients' Investment Objectives (model allocation – conservative, moderate, growth, aggressive, etc.).

It is with this last point in mind that I spent a few moments in the office over the weekend looking at my own accounts. In doing so, I was not concerned about the number of points lost by the major indices listed above. Nor was I interested in how much money I "lost" on Friday, in dollar terms. My interest was in the percent my accounts were down for the day, particularly relative to the market.

My investment account in custody at Charles Schwab & Co. owns exactly the same investments, in exactly the same proportions, as PIM's 60/40 moderate model. In our industry this is often referred to as "eating your own cooking". My retirement account is the same, with the exception of one fund that I've owned for a long time (and that has been a meaningful detractor to overall performance this year). My wife's retirement account is at TIAA, associated with her current employer. Overall, I experience approximately the same investment return and volatility that PIM clients do. So, how did my investment account do on Black Friday? I was down 1.25%. This is about 55% of the percent loss in the S&P 500 on that day. My experience may not match yours exactly. There are factors that cause modest differences in the performance of accounts with the same investment objective. Still, for a straight 60/40 Schwab portfolio, my experience should be similar to yours. This is the value of diversification.

And diversification goes beyond portfolio asset allocation, down to the level of individual mutual funds and exchange traded funds. I found it noteworthy that the investment in PIM clients' Schwab accounts that may have the highest Standard Deviation (highest volatility), the Morgan Stanley Insight Fund (multi-cap, concentrated growth), which one might expect to be down by more than the market, was actually positive .01%, call it break-even. Again, diversification at work.

One risk of writing this type of commentary is that the markets may recover from a day like last Friday before we can even get this published. That may happen this time. But the core message is durable regardless. Diversification is the best defense against volatility.

What is Cryptocurrency?

Brian C. Fahey, MS, CFA & Christopher J. Reedy, MBA, CFP®, CIMA®

Although inflation and COVID continue to dominate the headlines, we assume that PIM clients are growing weary of these topics and would welcome a break. When the Omicron variant is better understood, and to the extent it will impact capital markets, we will certainly report. In the meantime, we have decided to address an area of general interest and general confusion, cryptocurrencies.

The market capitalization of all 6,000 cryptocurrencies surpassed three trillion dollars in November, one trillion larger than sub-prime mortgages at their peak. Even crypto skeptics may benefit from understanding the basics about this market. The following is our take on this new "asset" class.

At the heart of all cryptocurrencies is a software that creates a decentralized immutable accounting ledger using complex cryptography. The ledger allows anyone to view the history of transactions in the currency (using the term "currency" loosely) while maintaining account owner anonymity and preventing an individual from overspending their assets. This technology is generally referred to as blockchain, and there are many different versions of the idea that vary in speed of transactions, complexity, and application. For all the hype around cryptocurrency, learning what this is, fundamentally, seems a little anti-climactic.

Blockchain could be used to replace most financial intermediaries. In the extreme case, there is no need for banks, credit cards or even central bankers to watch over the financial system. The entire financial system becomes decentralized for "crypto true-believers" and exists without the influence of traditional banks to control access to credit or Central Bankers controlling the money supply.

There is a healthy debate about whether crypto's best application is a store of value (digital gold) or a medium of exchange (as with a true currency), or both. A natural requirement of currency is stability and ease of use. Neither of these characteristics are currently present in cryptocurrencies, which frequently rise and fall in value by 10% or more in a day and can be slow and costly to actually transact. Globally, there are roughly 300,000 Bitcoin transactions per day. Credit card company Visa processes 150 million transaction a day.

Real assets that act as a store of value (gold, farmland, or crude oil) respond positively to inflation and have a fixed supply. Of these requirements, crypto only shares one, a fixed supply. Bitcoin, probably the best-known cryptocurrency, has a fixed supply of 21 million coins. It is yet to be seen how bitcoin responds to inflation; its history is too short. So far, cryptocurrencies such as Bitcoin appear to be most impacted by financial market liquidity. Other real assets such as farmland and oil are economic inputs. When the economy is booming and inflation is running high, people demand more food and fossil fuels. Cryptocurrencies are not an economic input for anything. When liquidity is reduced by the actions of central bankers, through higher interest rates and less QE, cryptocurrencies will likely be the most negatively impacted asset.

Central bankers are starting to get involved in the application of blockchain technology, to essentially digitize currency without the anonymous, decentralized nature of crypto. The Federal Reserve Bank of Boston is currently working with MIT to develop a framework for using digital currency in the future. The European Union is working on a digital Euro. The Chinese central bank has developed and is currently using digital currency in several provinces for trial purposes, while also outright banning anything related to cryptocurrency. The announced proposals from Central Banks on their digital currency plans retain all aspects of traditional finance, while adding a digital payment framework.

Why are cryptocurrencies worth so much today?

Three trillion dollars is a pretty big market cap for an asset that didn't exist before 2008 (market cap is the total value in dollar terms for all 6000 cryptocurrencies). It's natural to wonder why a string of computer code with no physical value, no intrinsic value and no cash flow is worth anything at all. The only valuation metrics for cryptocurrencies that we've seen, that make any sense, are based on network effects, the same ideas used to evaluate Facebook (Meta) or Google. Cryptocurrencies are worth what they're worth because people are willing to use them. For individuals with a long-term optimistic view, cryptocurrencies are worth today's price because they will someday be used much more than they are today. If you think this sounds cleverly similar to a pyramid scheme, you're not alone. Facebook and Google generate revenue through the network effect by selling advertisements. The more consumers use those services the more others will be encouraged to use the same services, and the more valuable the network becomes because it can reach more people with revenue generating ads. Cryptocurrencies can be "lent" to others, earning the owner interest in a similar fashion to a dollar in a savings account, which is a form of the network effect. There is a legitimate economic reason to use the network effect as a valuation metric, but one must assume that cryptocurrencies will replace traditional currencies to a greater extent than today. Given how much financial power is involved with controlling a currency, we are hard pressed to see how governments would allow a decentralized anonymous system to partially replace their monetary authority. Any valuation for cryptocurrency is based on future widespread adoption and at least tacit government approval.

The inclusion of Cryptocurrencies in traditional financial markets.

Crypto has experienced a huge increase in attention from traditional financial channels over the past five years. The Chicago Mercantile Exchange has been trading Bitcoin futures, alongside oil and pork bellies, since 2017. There are now crypto-oriented mutual funds, ETFs, hedge funds, banks, broker/dealers and pension fund investments. Crypto-related firms have been increasing their marketing footprint by buying the naming rights to the Staples Center in Los Angeles, sponsoring sports teams such as the European soccer club AC Milan and even a World Tour Cycling Team.

Despite the rising profile and increased valuation of cryptocurrencies, financial market regulators are largely absent. Policy makers have had difficulty agreeing on which agency (or agencies) should regulate the market. On the 23rd of November the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued a joint statement on a policy "sprint" with the goal of "Identifying and assessing key risks, including those related to safety and soundness, consumer protection, and compliance, and considering legal permissibility related to potential crypto-asset activities conducted by banking organizations." This was a statement of intent to investigate whether rules need to be made, as opposed to an intent to actually develop rules.

Meantime, crypto firms continue without regulatory guidance. Some of the larger players in the market, including Seattle firm Coinbase, have issued requests to the SEC for guidance on new crypto lending products without reply. Basic characteristics of a well-functioning and regulated market are absent. Typical investor concerns are related to transparency, clear taxation policies, leverage rules and consumer disclosures.

In our view the interest from institutional investors in crypto is due to the ability to execute the same strategies used in traditional markets with much larger profit margins due to almost zero regulation in a fragmented marketplace. This should not be confused with a deeply held belief that cryptocurrencies will replace traditional currencies in the future. Broker/dealers in the crypto market charge 4-9% total commissions on average. Traditional equity market commissions are close to zero. Hedge fund strategies that earn a fraction of a penny on the dollar, per trade, in traditional markets can earn 10x for the same strategies in the crypto world. ETFs and mutual funds in the same space are charging management fees exceeding 2% for

exposure to Bitcoin futures contracts, which by the sponsor's own admission will lose 0.5% per month (8-10% per year) simply by "rolling" futures contracts forward over time.

Theft and hacking have been a prominent issue in the crypto marketplace since inception. In 2014 Mt Gox, the largest Bitcoin marketplace at the time, lost $450 million of client assets to hackers and was forced into bankruptcy. The issue of theft has not been resolved. According to Elliptic, a crypto research house, $10.5 billion of crypto assets have been lost to theft this year alone. It has been estimated that 4% of Bitcoins are lost per year because users forgot or lost the password to their digital wallet, rendering the coins useless.

Bottom line

Blockchain, as an idea, holds promise. The technology can be used to streamline everything from bond trading and business contracts to tracking shipping containers more efficiently. Digital currencies could bring financial services to millions of people in developing countries at a lower cost than traditional banking. With all the excitement around cryptocurrency historically and still today, the underlying blockchain technology is what may very be most relevant years from now.

Current cryptocurrency valuations reflect hope exceeding reality. Hope is not a strategy. The situation reminds many of the technology bubble years of the late 1990s. At that point the internet held more promise than profits, and a precious few firms would be able to evolve with the very technologies they helped to create. The rally in tech stocks during the bubble years went much further than anyone expected, yet only a lucky few got out before the bubble burst in spectacular fashion. Until regulation catches up with the market, it is impossible to see how the fiduciary standard, our guiding principle, could be applied to cryptocurrency investments.

Closing Comments

It has been an interesting couple of years. We are not out of the COVID woods yet, or the supply-chain and inflation woods, or the political chaos woods. But we are optimistic. Our optimism lies in the fundamental goodness of people, something we are reminded of daily in our interactions with you.

As this is the last formal communication of the year, we wish to again let you know how honored we feel that we have the opportunity to be of service to you. From professional investment management, to retirement planning, to general counsel on topics such as tax and estate planning, we exist to serve your interests, exclusively and confidentially.

From our families to yours, sincere best wishes for a joyous and peaceful holiday season and new year.