Quarterly Newsletter

Q3

Oct. 2023

A Challenging Environment

By: Eric Johnson
Financial Advisor

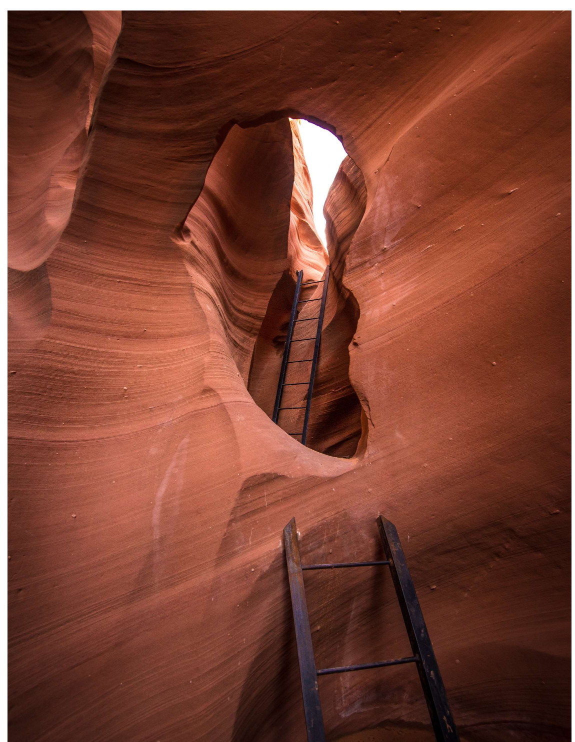
One thing I recently learned as a parent is that when you must repeat yourself multiple times in a (relatively) brief period, a tense situation may be incoming. My three-year-old son Abe is in a season of discovery and learning, which brings about both a joyful curiosity but also an increased tendency to challenge my wife and my requests. My first attempt to ask him to do something is usually pleasant in tone, and I always remember to include the "magic word" of "please." With each attempt, my tone tends to darken, and the question/request turns into a statement/demand. Thankfully, each of these situations has eventually been resolved, but looking back, we always wonder how we got into such an intense emotional state over something that started so innocently.

The fact that I have had to write about and discuss fixed income/bonds, an asset class that has been a ballast for diversified portfolios for the past couple of decades, so frequently over the past two years can only mean that, just like this recent season with Abe, we have been in a challenging environment (to say the least!) Using the Bloomberg US Aggregate Bond Index as the standard-bearer for the universe of US bonds, we are currently in the longest (at 37 months, as of the end of Q3 2023) and deepest drawdown (down 15.7% from its high in August 2020) in the index's history (incepted in 1976.) Before this recent drawdown, the previous deepest occurred between August 1979 and April 1980 at 12.7%.

What do these episodes (as well as all bond drawdowns) have in common? A brisk increase in interest rates. In August 2020, the 10-year Treasury yield bottomed at 0.52% at a time of continued anxiety during the COVID-19 pandemic. As of the end of last month (September 2023), the 10-year had spiked over four hundred basis points (one one-hundredths of a percent, the common fixed income parlance) to 4.59%. When yields go up quickly in a short period of time, you can expect prices to be negatively impacted. Though I am certain it would be difficult to find someone who believed that rates would stay as low as they were in August 2020 for long, the pace of the increase in interest rates over the past three years has been staggering and unprecedented.

Much ink has been spilled (or whatever the digital version of that phrase would be) over the reasons for why longer-term interest rates have continued to climb year-to-date in 2023. Examples include a stronger-than-anticipated economy (see our previous newsletter for a discussion of how many pundits/soothsayers have been expecting a recession that has yet to materialize), the supply/demand dynamics of Treasuries based on fiscal spending, and a higher risk premium. Whatever the reasons are, the fact of the matter is that the long-term future of investing in fixed income should be much better than these past couple of years (how couldn't it?!)

In the short run (which we would still consider three years to be, especially in comparison to the expected lifetime duration of the accounts that we manage), the direction of interest rates is the most crucial factor, especially starting from such a low yield. In the long run, though, your expected return (for the period of the investment) is much more connected to your beginning yield. Expected returns for 10-year Treasuries are almost nine times higher (not considering the compound effect of reinvestment) than they were three years ago. Getting to this point required a drawdown from which we are still working our way back, but the recent weakness does not signal that "fixed income is broken" or that you should sell bonds. Quite the opposite, in fact! To use common "investment speak," though investors should turn more "bullish" when prices fall (or for bonds, yields increase), the opposite usually happens, and emotions attempt to sabotage an investment plan by panic selling (usually right before the nadir.)



I would also like to follow up on my italicized comment above regarding "the period of the investment." For this phrase, I will use the term "duration," which in the realm of bonds is considered the length of time in which you would be paid back your initial investment (it can also represent how volatile your investment would be due to changes in interest rates). When looking at expected returns based on yields, your expectation should only be based on the duration of the investment. If you are wanting to estimate returns for the next ten years for fixed income, you would not use the yield you are currently getting in your money market fund or a Treasury bill, which have very short durations and have reinvestment risk (as the Fed could cut the short-term interest rate rapidly in times of fears of declining economic growth.) You would use an investment with a similar duration to provide the best estimate (such as a 10-year Treasury, though with interest rates at their current level, the duration for a 10-year Treasury is closer to 8 due to the amount of interest you receive through the investment's lifespan.)

As of the end of Q3, we still have an "inverted yield curve," meaning that short-term rates are higher than longer-term rates (though that inversion decreased in Q3, with longer-term rates increasing). A question that comes up from clients is, "why do we own something that pays/yields less than cash alternatives (like a money market fund) right now?" After we confirm the understanding that we are not market timers (we do not jump back and forth between short and long duration instruments), we note that we are attempting to match duration of when funds will be needed from the client's investment portfolio. If we know you will need funds within the next year, we will want those funds invested in a cash alternative (especially with current interest rates providing a short-term positive real [after-inflation] return). Since we try to have several years of anticipated cash flows invested in fixed income (particularly outside of the stock market), we will invest a percentage of the portfolio in fixed income holdings that have a "duration" greater than cash alternatives. With the recent interest rate spike, that has meant a certain level of drawdown – however, we are now able to reinvest interest at higher rates for longer periods as well as have the potential for principal gains if economic growth slows down (a risk for cash alternatives, as discussed above, when economic slowdown leads to lower short-term interest rates).

We continue to stand ready to discuss with you the ins and outs of fixed income (as well as its usually more tantalizing cousin, stocks!) as it relates to your financial plan. The past couple of years have been challenging both personally for our team (due to illness, home renovations, and this past summer's heatwave) as well as in markets, but we have only grown more confident in the efficiency and effectiveness of investing in fixed income and equities, and we are thankful that you allow us to share those lessons with you.

3 Quick Ideas

Oftentimes, we get so busy taking care of our day-to-day responsibilities that we can easily overlook other planning areas in our lives. We get it – that's life! But sometimes, there are planning areas that truly deserve specific attention because the cost of not taking care of them can be higher than one might think.

One popular question we pose to clients is - *Do you and your spouse, or trusted family member(s), have a centralized location for passwords and login information?* Most people do not, and this makes sense because few people enjoy having discussions that involve planning for worst-case scenarios. Additionally, cataloging one's login info/ passwords is time-consuming, and who has the time for that?! However, as mentioned above, the consequences of improper (or a lack of) planning and having a centralized place for logins and passwords can cause serious strife in an already stressful situation.
Here are three quick tips to help you and your family.

1. Confirm that your spouse can access your phone and email account.

In the event one of you is incapacitated (or worse, unexpectedly passes away), it's important that the other spouse can access your phone for several reasons. It allows you to receive two-factor PIN numbers for logins, access, and reset passwords if needed. It also gives you the ability to access contacts and get in touch with people or services that are important and/or helpful. As for emails, having the ability access and receive important emails can help with obtaining copies of statements or other information that might be necessary for your situation.

2. Use a password management tool that you and your spouse can both access and use with relative ease.

It can be as simple as using a spreadsheet or small notebook; however, in today's day and age, they are dedicated secure apps that you can use on your phone! This is not an endorsement of any kind, but my wife and I use an app called "Nord Pass." It costs a few dollars per month, but the app is encrypted, secure, and allows us a place to store all of our login information and passwords. If one of us ever updates or changes a password, the app will update it for both of us – that way, we are always up to date! There are plenty of other great alternatives out there, such as "Total Password," "1Password," "Bitwarden," and many others that can be found with a quick Google search.

3. Know where your legal documents are stored and how to access them.

If you have physical copies of your legal documents printed out, then a fireproof safe might be a great spot to store them (so long as you can remember the access code!). Maybe you have PDF copies saved on your computer or cloud storage - whatever the case may be, be sure that each of you knows where the documents are and how to access them.

Aside from being prepared during worst-case scenarios, one added benefit is that having all this information organized and ready sure helps make life a bit easier right now. For example, forgot your Netflix password? Check the password manager app, and you've got it! Small things like this tend to help. More importantly, you can have peace of mind knowing that your family has access to all necessary information in your absence.

Around The Office Updates

Looking Into Q4

Copies of Tax Returns

If we have not already received a copy of your 2022 tax return, we would like to get a copy from you at your convenience. This allows us to maintain updated information as it relates to your financial plan.

How The West Was Fun!

Recently, Jimmy and Sandi brought the whole family out to California to visit Sandi's side of the family and have a little fun. Upon their return, they brought some wonderfully cooler weather with them (you're welcome!). Kaylee is now 6, Maggie is 3½, and their son, Casey, just turned 8 months! It's very quiet and peaceful in their household…

Ranch Season!

As the long and hot summer draws to a close, and we say goodbye to the oppressive heat and humidity, it can only mean one thing… Ranch Season! Recently, Eric took both of his boys, Abe (3½) and Jonah (1½) out to the family ranch for some good old fashion guy time. It's worth noting that Abe lasted a whole 10 minutes sitting in the deer blind! As a whole, they had a ton of fun and are happy to be able to enjoy the outdoors again.