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The ACM Journal

The Hard Way

The Armbruster family always seems to do things the hard way. We eventually hit our goals, but there is no overnight success in our endeavors, and felicitousness is rare. So it was with the event that came to dominate our lives over the past two and half years.

Our son Omar was a sophomore in high school when we realized that college was around the corner, and we were clueless about the application process. Our direct knowledge was thirty years stale, and Omar's plan to attend a small school where he could ski on the cross-country team was quite different from what ours had been. Nipa and I decided we needed to get educated, especially when we realized that the rigors of high school and extracurricular activities left Omar little time to do his own research.

The life of a high schooler, particularly those engaged in sports, music, or other activities is especially hectic these days. Coaches are strict about attending practices, and event schedules are often shared just days in advance. So, one May weekend when Omar had a rare respite from sports, we packed up the family and made our way through New England. We did six college tours in three days, often missing the last few minutes of one tour to race to the

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Portfolio Review

Stock market returns were effectively flat for the third quarter. July and August experienced fairly strong returns, but losses in September weighed on full quarter results. Mid-cap and small-cap stocks were slightly negative this quarter, but strong performance in the first half of the year has still provided attractive year-to-date returns.

While small-cap stocks faltered in the third quarter, their returns have been quite strong over the past eighteen months. Valuation metrics, such as the price/earnings ratio, have been much more attractive for smaller company stocks recently. Despite their strong relative performance of late, small-cap valuations still remain far below those of the overall stock market, which may bode well for their long-term relative performance going forward.

Internationally, developed markets fared better than emerging markets, but both have generally continued to lag behind U.S. stock market returns. Much of the poor performance in emerging markets occurred in July as China imposed restrictions on private companies in the education sector. Returns continued to fall in September as Evergrande, one of China's largest real estate developers, faced increasing possibility of defaulting on its interest payments. Fear of the impact this event could have on the Chinese economy and global financial markets contributed to lower returns throughout international and domestic markets.

Along with weak stock market returns in September came an increase in stock market volatility. There were a number of factors contributing to the higher volatility. Economists reduced U.S. GDP growth estimates for the remainder of the year, citing a surge in the Delta variant as a primary headwind to demand. On the supply-side, shortages in labor and various raw materials, as well as supply chain disruptions, pushed inflation above 5%. The Fed reacted by revising their expectations for future interest rate hikes to a date sooner than previously expected and indicated a taper on asset purchases beginning as early as this year.

Stock returns reacted negatively to rising yields, most notably growth stocks. Growth stocks tend to underperform value stocks during periods of rising interest rates as it makes future profits appear less attractive to investors. Currently, growth stocks also face regulatory headwinds as companies like Facebook, Apple, and Google face lawsuits and Congressional investigations. Given how expensive growth stocks are, and how reasonable value stocks currently trade, it would not be

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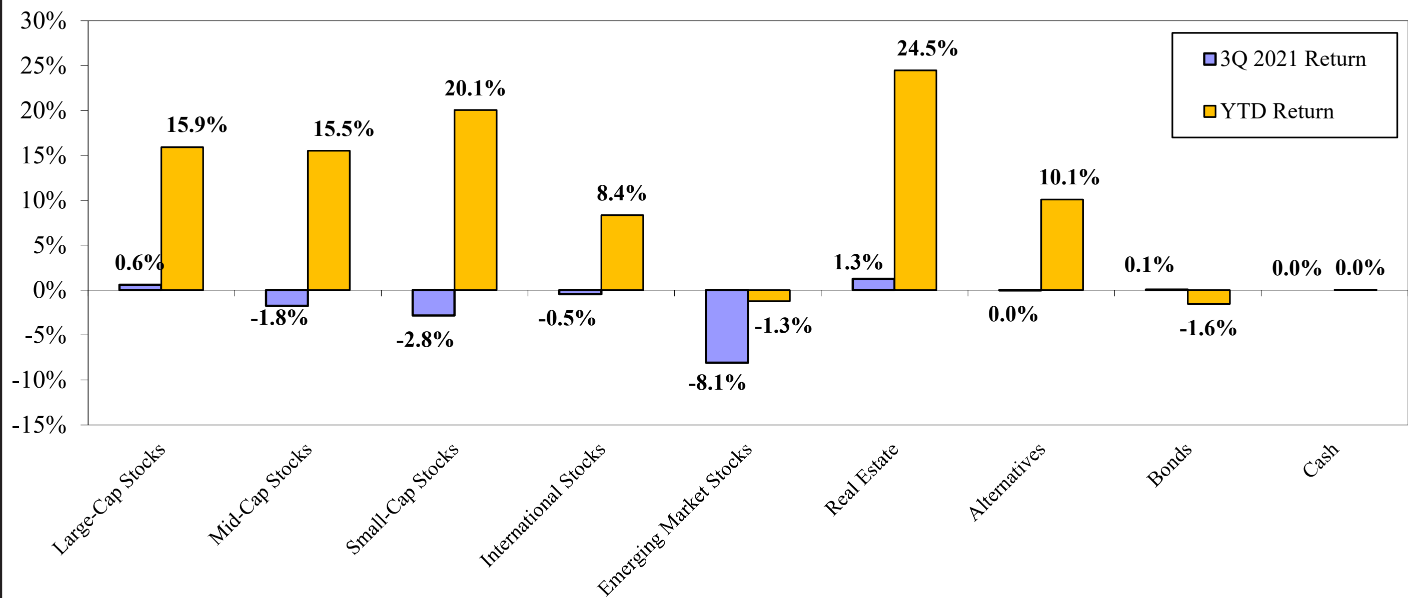
Third Quarter 2021 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indicies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Bloomberg US Aggregate Index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Cash is the yield on the 3-month T-Bill.

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surprising to see the rotation out of growth stocks and into value stocks continue and intensify in the future.

Higher inflation expectations influenced a sell-off in bonds towards the end of September. This wiped out the modest return that the high-grade bond market generated in the beginning of the quarter and caused the U.S. 10 Year Treasury yield to rise from 1.28% to above 1.5% in the final weeks of the quarter. Bond returns have been uninspiring, and likely will remain so for several years since the current yield is a strong predictor of future returns, and today's yield is a paltry 1.5%.

So far this year, stocks have generated high returns, especially in the domestic market. Bond returns have not fared as well with interest rates starting the year at historically low levels and facing upward pressure with higher inflation. If inflation remains elevated longer than expected, it may continue to negatively impact both bond and stock returns. In addition to inflation concerns, unresolved government deadlines regarding the debt ceiling and government funding threaten to add to market volatility to close out the year. Additional volatility seems imminent.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, NY, ACM is employee owned, independent, and minimizes conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

A Sober Look Ahead

Despite a weak September, the stock market has generally fared well of late. Returns have been strong year-to-date, and over pretty much any trailing period. There have certainly been bumps in the road, such as the COVID correction in March of 2020, but the last major disruption was thirteen years ago in 2008. While rising stocks are generally good, there can be too much of a good thing. We may be getting to that point, and the same may be true for the bond market.

The problem with stocks rising too much is that they start to become expensive. For example, a stock that trades at 15 times its annual earnings appears attractive relative to the range of where stocks have generally traded in the past. An attractive valuation today means there is still room for that stock to appreciate in the future. On the other hand, a stock that trades at a high valuation today, such as Tesla with a price/earnings ratio of 426 times earnings, may have limited upside in the future.

The bottom line is that low prices today generally lead to higher returns in the future, and high prices today generally lead to low future returns. The relationship is not as clear as we would like and trying to time the cycles of market ups and downs based on this logic is all but impossible. Nevertheless, it has played out on average and over time.

This relationship of current prices to future returns is fairly universally recognized in the investment world, leading many to question future stock market return potential. The table below shows forecasts for various components of the stock market looking forward 7 to 15 years. We assembled these forecasts from investment firms that we deem to be superior research shops and/or highly credible sources. There is a range of possibilities, but the main point is that all of the forecasts are well below long-term averages for every part of the capital markets. Returns in the future are expected to be much lower than what we have enjoyed in the past.

That said, overvaluation in the stock market is rarely the trigger for bear markets. Usually there is some other issue that suddenly changes the economic landscape or market sentiment. Today there are a host of such issues, including the threat of rising interest rates, higher inflation, likely lower corporate earnings,

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Long-Term Forecasted Returns

Data Source	US Total Stocks	US Large-Cap	US Small-Cap	Intl Total Stocks	Emerging Markets	US Bonds
AQR	5.9%			6.5%	7.0%	1.6%
BlackRock		6.4%	7.6%	7.4%	7.1%	1.4%
GMO		-5.8%	-6.3%	-0.1%	0.9%	-0.9%
JP Morgan		4.1%	4.6%	6.5%	7.2%	2.1%
Morningstar	-0.5%			1.1%	1.5%	1.5%
Research Affiliates		1.5%	3.1%	6.2%	8.0%	1.7%
State Street		5.6%	6.1%	5.8%	5.8%	0.8%
Vanguard		3.2%	3.1%	6.1%		1.8%
Long-Term Average	**10.2%**	**10.0%**	**11.7%**	**9.4%**	**10.8%**	**5.1%**

Source: GMO, Morningstar, AQR, Research Affiliates, Vanguard, JP Morgan, BlackRock, State Street, Dimensional Fund Advisors, Ken French, Armbruster Capital Management, Inc. Long-Term average returns are for the period Jan 1926 – Aug 2021 for US Total Stocks, US Large-Cap, US Small-Cap, and US Bonds, Jan 1970 – Aug 2021 for International Total Stocks, and Jan 1988 – Aug 2021 for Emerging Markets. The following indices represent the following categories: CRSP 1-10 represents US Total Stocks, CRSP 1-2 represents US Large-Cap, CRSP 6-10 represent US Small-Cap, MSCI EAFE represents International Total Stocks, MSCI Emerging Markets represent Emerging Markets, and the Five-Year US Treasury Note represents US Bonds. Morningstar, Research Affiliates, Vanguard. BlackRock and State Street are 10 Year forecasts; GMO is a 7 Year forecast; AQR is a 5-10-Year forecast; JPMorgan is a 10-15 Year forecast. Forecasted Returns are presented as nominal returns.

A Sober Look Ahead *continued from page 3*

and exogenous events such as geopolitical tensions.

Rising Interest Rates

Interest rates directly impact the returns of the bond market. As rates rise, bond prices fall. We've been in a 40-year period of falling interest rates, making bond investments quite profitable. However, with rates now at uber low levels, we may be entering a long-term cycle of rising rates.

Rising interest rates are not only bad for bonds, but also for stock investors. Many stock valuation models include interest rates as the discount rate for corporate earnings. So, as interest rates rise, valuations decline. More practically, higher rates mean higher borrowing costs for corporations, making it more expensive for them to invest and grow. So, rising interest rates could present a problem across the capital markets.

The Fed has kept short-term interest rates low for some time but may be ready to hike rates as early as next year. Market forces set longer-term rates, and they have been rising lately, albeit from very low levels. An increase in inflation could also result in interest rates that continue to rise.

Inflation

Inflation has been tame for decades. It really has not been a problem for investors since the 1980s. However, prices have been rising lately, and not just in a few areas. Energy prices are up, which impacts transportation costs, which results in a general rise in the price of finished goods. Because prices are up, employees need to earn more, so wages rise, and the cycle feeds on itself. The Fed has assured us that inflation will be transitory, but so far it has been higher and lasted longer than anticipated, and it appears to be a global phenomenon. Until supply and demand come into balance, inflation is a risk, and unprecedented global liquidity combined with labor and material shortages don't bode well for that balance.

Corporate Earnings

Corporate earnings have remained surprisingly resilient during COVID, and profit margins remain at high levels, thus supporting relatively high valuations within the stock market. However, proposals for higher corporate tax rates and increased regulation, as well as inflated input costs, could weigh on earnings and margins in the future. So far these proposals have not become law, and it is not clear they will be enacted, but there does seem to be a movement toward reigning in corporate behavior through both legislation and the courts.

Exogenous Threats

Other issues that could derail the stock market include a slowdown in China, a government shutdown in the U.S. as we once again face the debt ceiling in December, renewed terrorism, a global energy shortage, a slowdown in global growth as we work off unprecedented government debt, and countless others. Reading the news these days is almost sure to cause extreme depression. There are so many issues in so many parts of the world, that any one of them could become a significant threat to our safety, economy, and markets. This of course has been true many times throughout history, so we caution about becoming overly concerned, but certainly these issues bear watching.

A Silver Lining

On a more upbeat note, there are actions we can take to address economic uncertainty. Diversification, which has been a liability the past ten years as large-cap tech stocks dominated the market, should offer higher returns and a smoother ride in the years ahead. Valuations for small-cap stocks, international stocks, and particularly "value" oriented stocks are much lower than those of the overall U.S. stock market and could provide stronger future returns. Similarly, alternative investments seem poised for better days ahead. Many of these strategies have lower correlation to the stock and bond markets, which should help them generate returns regardless of how traditional investments perform.

While the outlook for stocks and bonds is not rosy, it doesn't imply that investors should sell out and hunker down. First off, the erosion of purchasing power from inflation can be just as damaging as actual market losses, so cash is a poor choice these days. Second, it can be expensive to sell out of investments if there will be capital gains taxes to pay. Finally, it is possible that the stock market continues to rally for far longer than seems possible or rational. Markets certainly move in mysterious ways, and interest rates could conceivably drop further. Rather, the better approach is to stick with a diversified, long-term asset allocation plan but reset expectations since past is unlikely to be prologue as we look out over the coming 5-10 years.

Chris's Corner: Will I Be Able to Collect Social Security?

Social Security is a topic that is sure to arouse emotions. The "entitlement" nature of it bothers some folks. Some just don't like the thought of not working and surrendering their retirement security to the government. Others don't believe it will be around since the Social Security Trust Fund is basically broke. Also, deciding when to take Social Security involves some uncomfortable topics, such as life expectancy. However, Social Security is really a good thing that should be part of a deliberate retirement income strategy. Spoiler alert: it will be there for you when you need it.

Unfortunately, recent posturing over the federal debt ceiling has brought out Social Security doomsday talk again. We're frequently asked about the program's solvency, and if we should revise well-thought-out plans to accelerate lower payments to hedge against potential future program changes.

Indeed, this year's Social Security Trustees report wasn't full of positive news. If left alone, the report indicated that the combined trust funds would run out of money by 2034, meaning that current recipients could see benefit cuts, and future recipients would receive lower than expected funds. The report noted that there would only be enough incoming revenue to pay out 78% of scheduled payments.

However, reneging on Social Security for current and future retirees would be political suicide for any politician. It would be almost impossible to keep your political career intact if you weren't part of a solution, regardless of political affiliation and true understanding of how the system works. And, the good news is that there are a wide variety of relatively easy adjustments that can be made to the program that would extend the solvency and retain expected payouts. These include:

- **Raising or eliminating the wage cap.** The current wage cap is $142,800, meaning that workers only pay Social Security taxes on income up to that amount. According to a 2020 Congressional Research Service report prepared for Congress, "phasing in an increase in the taxable maximum to cover 90% of covered earnings over the next decade would eliminate 20% of the long-range shortfall in Social Security". They also noted that if all earnings were subject to the payroll tax, but current benefit calculations were maintained (higher earners don't get a higher benefit), the funds would remain solvent for over 40 years.
- **Redefining what income is subject to Social Security.** Fringe benefits, such as health insurance accounts and flexible spending accounts are not currently subject to Social Security taxes. According to the Center on Budget & Policy Priorities, including employer-sponsored health insurance premiums could close over one-third of Social Security's solvency gap. If other fringe benefits were also included, it could close an additional one-tenth of the gap.
- **Increasing the Social Security payroll tax rates.** Currently, workers pay 12.4% of their wages towards Social Security. For those not self-employed, 6.2% comes from you and 6.2% comes from your employer. Self-employed are responsible for the full 12.4%. According to a September 2021 Congressional Research Service article, increasing the rate from 12.4% to 15.76% would keep the trust solvent for 75 years.

Cutting or eliminating any public welfare programs is a political challenge. Cutting the one that currently covers over 65 million Americans of prime voting age, that people feel passionately about having paid into, and that so many people rely on for a large part of their retirement income, would be nearly impossible. This is one benefit that is not going away.

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next. It was the college equivalent of speed dating.

Since most families start touring colleges during their kids' junior years, we thought we were ahead of the curve. Then COVID hit and the rest of our tours were canceled, as were SAT and ACT exams, often the day before the scheduled date. That left us scrambling again to try to figure out how to navigate the new environment.

The most complicating factor was skiing. Omar is a good cross-country skier and has raced competitively throughout high school. He wanted to ski in college, but most of the teams are very small, usually just six boys and six girls, and are extremely difficult to make.

Balancing all the variables, Omar eventually narrowed his choices down to one finalist for early decision that had the right mix of academics and athletics. The application was rigorous, and while he spent hours writing essays, Nipa and I spent hours editing, critiquing, and strategizing. It dominated our lives for quite some time. We had dreams of him getting accepted and the applications being "one and done." But it was not to be. As usual, we ended up doing everything the hard way.

Omar ultimately applied to ten schools. He did far more essay writing and Nipa and I did far more editing, critiquing, and browbeating. We also took two more trips to New England to narrow down the list of schools and to ultimately select a finalist. We had to sneak across some borders into states we weren't really supposed to be in (sorry Vermont) and had to carefully avoid human interaction during the height of the virus panic. Overall, the process proved rigorous and exhausting for all of us.

It should have been a relief when the acceptances, and a few rejections, came back. However, Omar had a serious case of indecision that continued until the very last day before commitments were due. He finally opted for Middlebury College in snowy Vermont. It had a lot of what he wanted, including small class sizes, a strong academic focus, and a quaint setting in a small town. However, there are some things that he didn't get. One biggie was the fact that he wouldn't be able to make the ski team his freshman year. Still, he is training hard, hoping that good results at non-college races this year will be enough to get him on the team next year.

It seems Nipa and I have passed along the legacy of doing things the hard way. I suspect Omar will eventually make the ski team, but only because of diligence, commitment, and a sheer force of will.

As for us, dropping Omar off at college for the first time should have been a point of pride for what he accomplished and relief that the college process was over. However, it turned out to be one of the hardest things we've ever had to do. While we recognize how good it is for him to be moving on to the next stage and developing his independence, we'd rather have him home. In the end, I'm sure this will be a great experience for our family, but for now it still feels like the hard way.

Armbruster Capital Management, Inc.

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