The ACM Journal

Tooth Fairy

Our daughter Nyla just lost the last of her baby teeth. That means braces are in our near future. It also means we have seen the last of the Tooth Fairy.

I say good riddance. The Tooth Fairy has been nothing but trouble since our first child was young. She has been unreliable, derelict in her duties, and often shows flagrant favoritism. In this era when everyone should be treated the same and our little darlings need to feel special all the time, the Tooth Fairy has ensured the exact opposite.

The Tooth Fairy is supposed to leave money under your pillow the night you lose your tooth. At our house, it is not unusual for the Tooth Fairy to take several days, and even up to a week to come around. It has become so bad that Nyla hardly remembers to check under her pillow anymore. I have been inclined to chalk this up to supply chain constraints, but the tardiness has been going on well before Covid disrupted global logistics.

Also, the Tooth Fairy has been leaving one dollar per tooth for Nyla. I don't have a problem with that, but we have it on good authority that the Tooth Fairy has been leaving Ariana up to ten dollars per tooth. What can explain such blatant inequality? At first, I thought it might be that Ariana lives in some fancy, rich kid neighborhood where the cost of living is higher. But no. She lives in our town. I thought maybe she was

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Portfolio Review

The first half of 2022 has been challenging for both stock and bond investors as persistently high inflation, anticipation of further Fed interest rate hikes, and negative GDP growth weighed on returns. The S&P 500 experienced its worst first half of the year since 1970, while bonds have experienced a loss of more than 10%.

Inflation Continues to Rise

Concerns over inflation that hampered first quarter returns escalated in the second quarter as CPI continued to increase to a high of 8.6%. With inflation appearing to be less transitory than previously anticipated, the Fed took more aggressive actions in its latest meeting by raising the Federal Funds rate by 75-basis points, the first time it has done so since 1994. Additional restrictive monetary policy measures, such as further rate hikes and reducing the Fed's balance sheet are likely needed to tame inflation, especially when considering that the Federal Funds rate is still notably below the current inflation rate and the Fed's balance sheet has continued to grow since the beginning of the year.

Energy stocks remain the winning sector so far this year thanks to elevated oil and gas prices. Energy has been the only sector delivering positive returns this year and is up more than 30%. Despite its strong performance recently, the energy sector still has the second lowest price-to-earnings ratio, with only financial services being lower. Non-cyclical sectors such as utilities and consumer staples are also holding up much better than the rest of the market as they are down only -0.6% and -5.3% this year, respectively.

Low volatility and value have been the strongest performing factors for both US and international stocks. Low volatility has a high allocation to non-cyclical industries that tend to hold up better during challenging environments. Value has done well with its tilt towards energy stocks as well as its avoidance of many overvalued technology stocks that have suffered tremendous losses recently. Inflation and interest rate hikes initially weighted heaviest on unprofitable tech stocks, but we have since seen more established, profitable companies experience major declines. Netflix and Meta Platforms (Facebook), for example, have lost -71% and -52% so far this year.

US Dollar Strengthening

The US dollar has been unusually strong against foreign currencies, driven by a flight to safety in the face of global uncertainty and rising US Treasury yields that offer better returns to foreign investors. However, a strengthening dollar is a headwind for US investors owning international stocks. Despite this headwind, international stocks have slightly outperformed US stocks this year, despite significant economic troubles abroad. With the US dollar near historically high levels and valuations for international stocks far lower than US stocks, it would not be surprising to see international stocks outperform in the years to come. Thus, it remains

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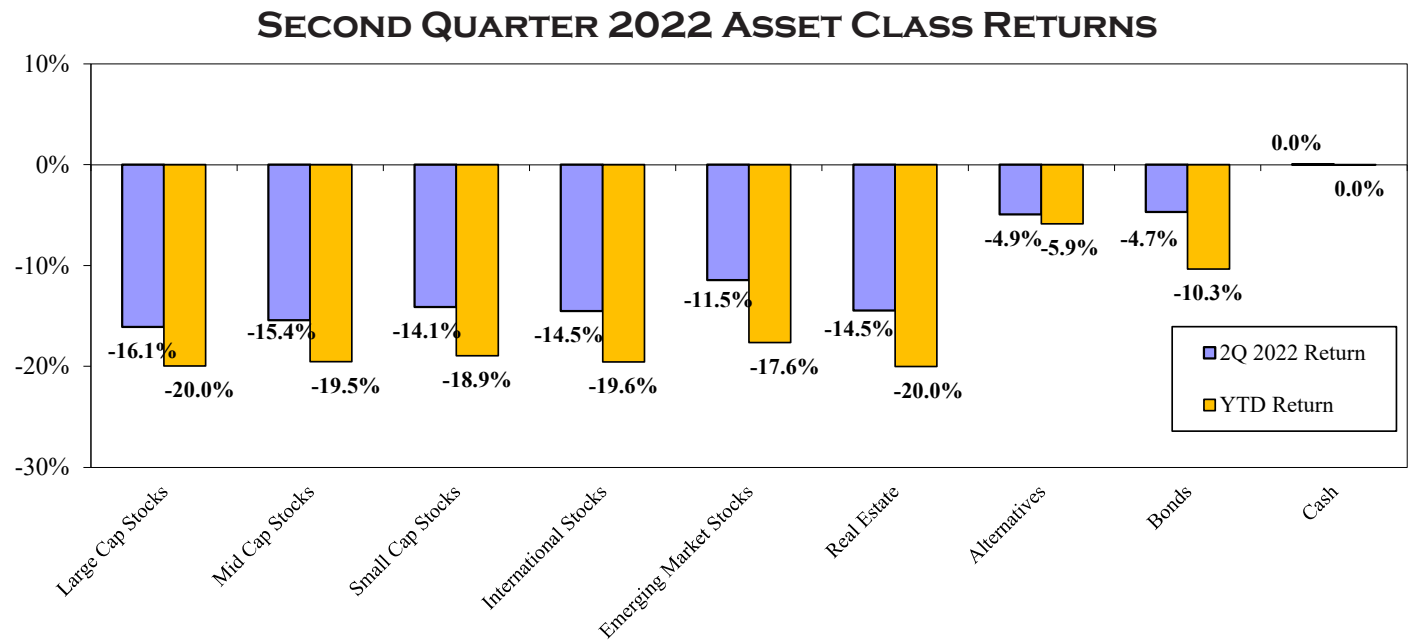

Large cap, mid cap, and small cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Bloomberg U.S. Aggregate Bond Index. Alternatives are represented by the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

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important to maintain a proper allocation to international stocks for diversification and the likelihood of stronger returns.

Recession on the Horizon?

Many analysts had previously forecasted a recession by the end of 2023, but recent economic developments suggest that one may come sooner. Real GDP in the US decreased by -1.6% in the first quarter. The definition of a recession is loosely defined as two consecutive quarters of negative GDP growth. Consensus estimates for the second quarter are mixed, with most analysts estimating real GDP growth ranging from either slow growth to further decline. Notably, the Federal Reserve Bank of Atlanta has projected a decline of -2.1% as of July 1st. Other data points also point towards troubling times. The yield curve between 10-year and 2-year Treasury bonds has inverted several times in recent months. An "inverted" yield curve where longer-dated bonds yield less than shorter-dated bonds has often been a predictor of coming recessions. Consumer sentiment is also at an all-time low.

With the probability of a recession increasing, 10-year Treasury yields have dipped from a high of 3.5% in mid-June to just below 3% at the end of the quarter. Nonetheless, rates still ended much higher than the 2.3% yield as of the beginning of the quarter, resulting in another tough quarter for bond returns since yields and prices move inversely to one another.

Going Forward

Unfortunately, there is no certainty of a quick stock market rebound from the downturn experienced in the first half of 2022. Rising inflation is likely to continue to elevate costs and weaken corporate earnings. The potential for higher interest rates will make it more difficult for firms to finance profitable projects. Valuations have declined, but the overall stock market remains richly priced relative to historical levels. While it has been a challenging environment, more defensive strategies have helped reduce downside risk, especially value and low volatility stocks. Short duration bonds have reduced the downside risk of rising interest rates. Alternative investments, most notably the funds used for managed futures and style premia strategies, have performed exceptionally well when diversification was needed the most.

Although expected returns and volatility remain uncertain in the near-term, we'll manage through any further market weakness. These periods are uncomfortable, but they should not change the way you live your life. We would be happy to discuss your portfolio and our strategies for risk control any time if you have questions or start to get nervous.

Chris's Corner: Long-term Care Considerations

We get asked a lot about long-term care insurance. It makes sense that this comes up so often. After all, the prospect of paying for nursing home care for many years and the damage that can do to your finances is scary. A few of the industry stats: the national average cost of a private nursing home room is $108,000 annually. It is likely higher in our area, particularly at the nicer facilities. Long-term care insurance premiums average $5,000 annually for a 55-year-old couple. We think that is probably low. We have seen annual premiums more than that for each spouse. These costs vary depending on a lot of factors, but this insurance is expensive, and premiums tend to go up over time.

Also, there is a high likelihood that you will need long-term care. The Center for Retirement Research at Boston College found 44% of men over age 65 and 58% of women of the same age require some form of long-term care. The odds of one spouse needing care are substantial. Further, these costs are not covered by Medicare.

The average woman requires long-term care for 3.4 years; the average man for 2.5 years, according to a Price Waterhouse study. However, the averages don't capture the wide range of outcomes. A quarter of the time, the expected cost of long-term care is less than $26,000. Only five percent of the time do long-term care costs top $578,000. One percent of the time, costs exceed $949,000, the study found.

Clearly, there is a wide range of possibilities, and the appropriate course of action is dependent on your personal circumstances. Here are some potential approaches.

1. Do nothing. This is of course the easiest and cheapest in the short run. You effectively self-insure and would cover any future long-term care costs out of pocket. If there are no costs, then you come out ahead. This approach is most appropriate for those with at least $2 million in investments.

2. Buy long-term care insurance. We have seen clients use this insurance and it has saved them a lot of money, but premiums are a lot more expensive than they used to be.

3. Buy different insurance. You could buy life insurance that would reimburse your estate for any out-of-pocket long-term care costs. You could also purchase a hybrid policy that pays out upon your death but can be tapped for long-term care expenses during your life.

4. Gifting. You could put your assets into a trust or give them away so that when you need long-term care, you are effectively broke. Medicaid would then cover the cost of your care. There is a five-year lookback period on any gifting before you will be eligible for Medicaid. This approach obviously is fraught with lots of other issues including access to your money, trusting your heirs, giving up a quality long-term care facility, etc.

5. Last minute planning. There are strategies that can be employed to protect assets just before one needs long-term care. These can include prepaying burial expenses, converting assets to Medicaid exempt assets like home equity, and more sophisticated "gift and note planning" that requires the assistance of an elder law attorney.

There are many considerations and nuances to each of these approaches. If you would like to discuss your situation in more detail, give us a call any time.

Alternatives

There was a TV show in the mid-2000s called *Everybody Hates Chris*. It was based on comedian Chris Rock's childhood and how he was always getting into trouble even though he was a generally good kid who was often misunderstood. We see alternative investments the same way: they have some characteristics that make them easy to hate, but they remain a generally good, if often misunderstood idea.

Alternative investments, as we define them, include funds that focus on more esoteric strategies such as investments in catastrophe bonds, small private loans, currencies, commodities, private real estate, and may involve reasonable shorting or leverage. These are all things that sound risky.

Indeed, all of you have heard us mention many times, there are "warts" on these investments. They charge very high management fees, they are tax inefficient (we prefer to hold them in tax-advantaged retirement accounts), they are sometimes less liquid than stocks and bonds, their strategies can be difficult to understand, and they have experienced longish stretches of poor performance.

Interestingly, however, the problems with these investments do not include undue risk. Rather, we hold these funds to reduce the risk of the overall portfolio. As a group, these alternative funds are certainly riskier than bonds, but not by much according to the historical data. They are also far less risky than stocks. And, as we've seen lately, they can offer significant downside risk control in a bear market. That likely won't happen in every bear market environment, but so far this year, an equally weighted mix of the alternative funds we use is up 11.3% compared with a 20% decline for the S&P 500 and a 10% drop for the

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Alternatives

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bond market. So, despite their many problems, an allocation to alternative investments still makes sense for many investors.

It is easy to crow about strong performance now, but admittedly there have been long stretches of five years or so, when alternative investments have not performed well. As a group, they haven't suffered large declines, but their returns were lackluster in the face of a strong bull market in stocks the past several years. Taken in the proper perspective, however, that doesn't seem so bad. Stocks have experienced falls of greater than 50% during their worst moments (see 1972, 2000-2002, and 2007-2009). They also have experienced "lost decades" such as the 2000s when their compound annualized return for ten years was 1.4%.

By comparison, alternatives seem downright tame. Their maximum drawdown over the past 20 years has been a modest 5.3%. Their annualized return has only been two percentage points behind stocks during what has been a strong period for stocks. Could it be that alternatives perform better than the stock market looking forward? That seemed a laughable notion only a year ago, but not so much anymore. More importantly than their absolute returns however is their low correlation to stocks, bonds, and of each alternative fund to the others. That is what accounts for the lower risk profile.

So, while these funds are still viewed skeptically, at best, by many of our clients, we believe they have earned their stripes as strong diversifiers. Even more importantly, that diversification tends to "work" when we need it most. For example, a basket of commodities has a low correlation of returns to stocks over a period of many years. However, because commodity prices are sensitive to economic growth, just like stocks, they tend to fall in price when stocks fall in price. That means the downside correlation of stocks and commodities is quite high, even if overall correlation is low over time. Our alternative funds seem to not suffer from this, at least not as much.

In addition to strong performance in the current stock market downturn, alternative investments have held up well in past stock market dips. The S&P 500 dropped 19% in the fourth quarter of 2018 and alternatives fell only 3%. The COVID downturn in early 2020 resulted in a 33% drop for stocks but only a 3% decline for alternatives.

A big part of the downside protection is because of catastrophe bonds and managed futures. Catastrophe bonds lose money when there are big natural disasters such as hurricanes or earthquakes, but those are not precipitated by economic recessions. Thus, the returns on catastrophe bonds are independent of the forces that drive most other investments. Managed futures funds are trend followers, which means they can make money in up markets buy buying stocks, bonds, currencies, or commodities, or they can profit by shorting these securities in down markets. Historically they have performed quite well in stock market downturns.

We never would have started using alternative investments if things looked "normal" in the stock and bond markets. However, a few years ago the first signs of trouble were appearing with ultra-low bond yields and high valuations for stocks. That is a bad combination, and while the party lasted for many years, it may be time for the hangover. Alternatives, at least so far, have been strong aspirin to relieve the worst of the symptoms.

So, while some will continue to hate alternatives, we have found a number of redeeming qualities, not just in historical research but in real-time empirical data. We continue to believe they are mostly good and simply misunderstood.

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part of some marginalized group. But no. She has two cisgendered parents. So, it is hard to understand the inequity.

Santa Claus has been reliable over many years. He always arrives late in the evening on Christmas Eve; delivers his packages in a timely, efficient manner; and never disappoints. If he can do it, I expect better from the Tooth Fairy. Afterall, she doesn't even need to get to all the children in the world in one night. However, we have learned over some eighteen years now that the situation is not going to improve, so I bid the Tooth Fairy a fond adieu and hope to never have to think of her negligence again.

To those of you still dealing with the irresponsible, unprofessional, laxness of the Tooth Fairy, I wish you good luck. I feel your pain and disappointment, and I don't know how you will be able to explain it to your children. Maybe try blaming it on Putin.

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