The ACM Journal

Buying the Farm

Sixteen years ago, Nipa and I bought our farm. Although the property once was used as a working farm, under our care it would be very much a hobby farm. We have since raised countless chickens, millions of honeybees, numerous barn cats, lots of vegetables and fruit trees, and three no-longer-small children.

The farm has been the epicenter of our home lives. Regular readers of this column know it has been a money pit and has required endless time and work to keep up. But it has also provided our kids with a wonderful chance to grow up in a supportive community and natural environment.

One of the more fun, but unexpected aspects of owning a farm is the social interactions it affords. While we thought we were moving out to the quiet life, the farm is always abuzz with activity, and not just from the honeybees. It is not unusual to have my neighbor John stop over to borrow something or to help me fix some broken piece of equipment. Others stop by to grab some rhubarb from the garden, or to pick up some eggs. We've had deliveries of manure and wood chips from real farmers

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Portfolio Review

Stock market returns for the second quarter bear a striking resemblance to what occurred in the first quarter: US, international, and emerging market stocks were all positive, large-cap stocks outperformed their small-cap counterparts, developed international markets outpaced emerging markets, and most factor funds lagged behind the overall stock market. Technology, communications, and consumer discretionary sectors continued to lead the way by returning over 10% for the quarter and over 30% for the year-to-date period.

The stock market has been quite narrow, meaning just a handful of stocks are driving the lion's share of returns. This has occurred before, notably in the early 1970s and the late 1990s, during prior technology booms. It may be that hopes for a similar boom, this time driven by artificial intelligence, are driving stocks to what seem to us to be unreasonable valuations.

Avoiding a Recession…For Now

It may also be that the economy has held up better than expected. Heading into this quarter, concerns over an imminent recession continued to build, particularly as the reverberations of bank failures were starting to be felt. There was also a potential default on Treasury debt in June if the debt ceiling was not raised.

First Republic Bank joined the list of bank failures on May 1st when it was taken over by the FDIC and sold to JPMorgan Chase, making it the second largest bank failure in US history. This contributed to the poor performance of regional banks in aggregate for the second quarter, failing to rebound from their dismal March during the outbreak of the crisis. Because several factor strategies, particularly value strategies, held a high percentage of financial services stocks, performance was well below the overall market.

As consumer credit remained strong and no other sizable institution failed following First Republic, widespread fears of these events materializing into a broader economic collapse largely dissipated. However, a new fear soon emerged over the potential of a US debt default. While there have been similar concerns in the past during debt ceiling negotiations, this time it seemed more serious. Indeed, yields briefly rose to over 7% for Treasury securities maturing in early June, the period when the Treasury would likely deplete its reserves to pay bills if a new debt ceiling deal was not passed. The potential crisis was averted with the passing of the Fiscal Responsibility Act (you may find this name to be ironic).

The economy continues to hum along, and the crises du jour in the

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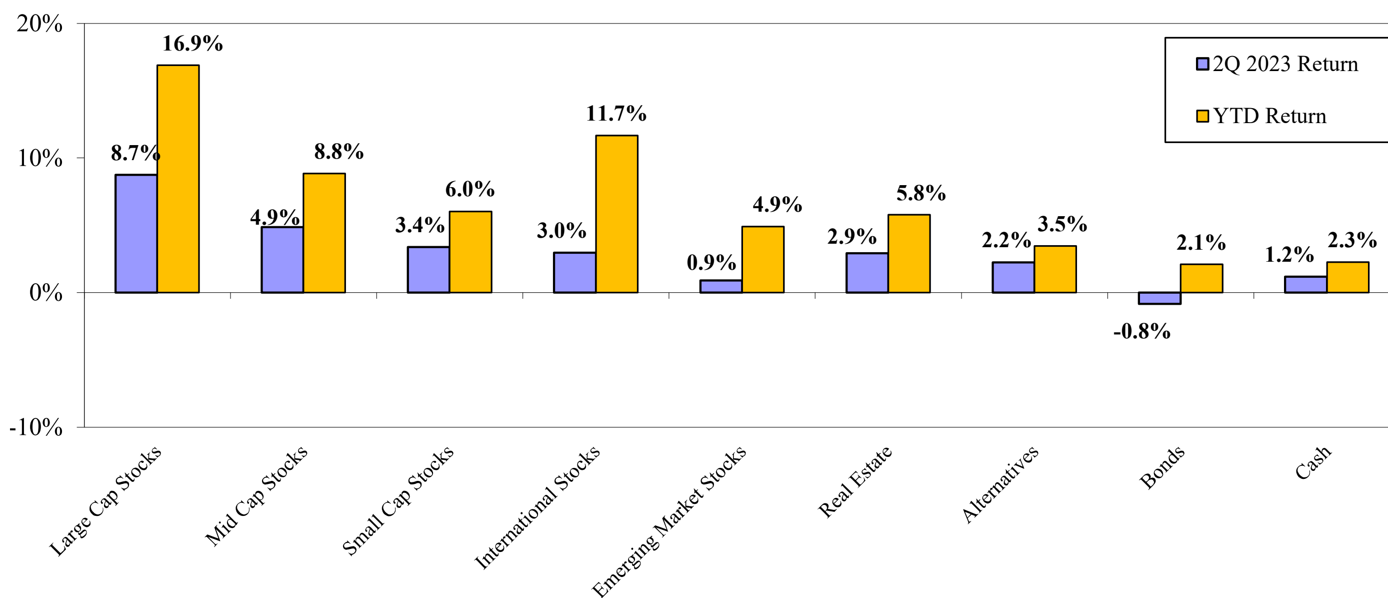
Second Quarter 2023 Asset Class Returns



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 US Select 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.

Portfolio Review

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second quarter did not derail that. However, there are still significant longer-term problems in the global economy that bear watching. The largest and most obvious is the huge overhang of debt. The global economy has grown on the back of debt issuance that is at unprecedented levels. Just as an overindebted person can't continue to spend indefinitely, there are limits to government borrowing. At a minimum, economic growth must slow since it can't continue in the absence of the debt-fueled orgy of the past few years.

Interest Rates on the Rise

The bond market lost ground in the second quarter as interest rates continued their march higher. Short-term rates have been driven higher by the Federal Reserve, but now even market-driven longer-term rates are starting to react.

Despite moderating some, inflation is still running hotter than the Fed would like. There are signs that it could continue for some time, which likely means we should get used to higher interest rates. The ten-year Treasury bond was yielding 3.28% early in the second quarter and is now over 4% as I write. Rising interest rates mean falling bond prices, thus the negative return for the quarter.

More troubling for bonds is that we may be in a new interest rate cycle that will continue for some time. Historically these cycles have lasted between 25 and 40 years. If we do see rates rising on a long-term basis, that could be a real change in the way we live and invest. No more 3% mortgage rates. No more cheap money for corporations to boost their earnings. No more low-rate student loans. No more high valuation levels for stocks. We will need to make decisions differently.

This may be corrected, at least temporarily, with a good recession. Generally interest rates fall during economic downturns. That may be on the horizon, but these are interesting times and anything could happen.

The Reemergence of Reinsurance

Reinsurance funds, those that invest in relatively obscure catastrophe bonds and quota shares, have provided uninspiring returns over much of the past decade. From 2014 to 2022, the Swiss Re Cat Bond Index, which measures the returns of the catastrophe bond market, returned an annualized 3.7%, far below its long-term average of 6.8%. However, the cat bond market got off to a hot start in 2023. It returned 10.5% in the first half of the year, which is the index's strongest start to the year in over 20 years.

As a reminder, reinsurance funds make money in relatively placid times, but lose money when large natural disasters occur. An investor's return includes the insurance premiums paid by cat bond issuers less the claims that are paid out to cover the damages caused by adverse events. These funds fit in nicely with a broader alternative investment strategy since returns are uncorrelated with stock market returns and economic activity (a bear market or recession doesn't cause category 5 hurricanes to form).

There have been a couple factors that have contributed to this year's favorable returns. Premiums for catastrophe bonds recently issued are up by roughly 50% versus just a couple years ago. This means that investors are being paid significantly more for taking on similar levels of risk. This so called "hard market" environment often results when the reinsurance industry suffers losses for several years. Big losses from hurricanes, earthquakes, and other events cause reinsurance companies to raise their rates for future policies. Today's rate increases are as strong as they have been in over twenty years.

Another factor that has benefited reinsurance returns is rising interest rates. Catastrophe bonds earn a yield of a fixed spread plus a short-term Treasury-bill rate. With short-term T-bills yielding over five percent, the extra return is up significantly from the close to zero percent yields of a few years ago.

With these factors in place, should we expect to see a repeat in double digit returns in the second half of the year? Even though yields remain attractive, similar returns are certainly not a guarantee. The good news is that, on average, historical annualized returns for the Swiss Re Cat Bond Index has been 1.2% higher during the months of July through December compared to January through June. This return comes with additional risk, however, as the standard deviation of returns is also more than twice as high compared to first half returns. The Atlantic hurricane season obviously contributes a large portion of the volatility. The Stoneridge catastrophe bond and quota share funds each lost over 13% in a period of about a week due to the damage caused by Hurricane Irma in September of 2017 and by Hurricane Ian in September of 2022, so steep losses over a very short period are not unusual. Weather patterns are inherently unpredictable, but with this year being an El Nino year, the outlook is for a relatively quiet hurricane season, at least for major storms.

We often hear that investors don't want to invest in reinsurance funds because climate change increases the risk of loss from primary perils such as earthquakes and hurricanes. However, the data doesn't show this. While there is some evidence of increased hurricane activity from warmer air and ocean temperatures, there has been no statistical uptick in larger hurricanes or landfall hurricanes (the kind that result in losses for reinsurance funds).

Reinsurance, like all the strategies we invest in, will go through strong and weak return periods. After years of subpar returns, expected future returns of the strategy appear much more attractive because of a hard market for insurance rates and higher Treasury yields. But just as no one can definitively time the stock market, no one knows for sure when the next natural disaster will occur or how much damage it will cause. The way to earn sizeable uncorrelated returns is to be able to literally ride out the storm and commit to the strategy over a long-term horizon.

Chris's Corner: Planning for Estate Taxes

Is it possible to have too much money? The answer is yes if the subject is estate taxes. Currently few of us have to worry about Federal estate taxes since the exemption is so high, but that is set to revert back to its former limit at the end of 2025. This means a reduction of approximately 50% from today's generous level.

The current Federal gift and estate tax exemption is $12,920,000 per individual, or $25,840,000 per couple. If the exemption is allowed to expire, it will drop back to $5 million, and when adjusted for inflation it will be around $6.2 million. In 2021, the current Presidential administration proposed limiting the estate exemption to $3.5 million as part of its annual budget plan. The proposal did not make it into the final budget, but it does give a sense of how the administration thinks about this issue.

It is an important topic though, because the estate tax can be costly. Amounts over the exemption are taxed, and rates quickly rise to 40%. Although currently only a small portion of the population have taxable estates—per the Tax Policy Center it is less than 0.1% of the 2.8 million people who are expected to die this year—it did provide $27.1 billion in revenue for the federal government in 2021, per Datalab. The Congressional Budget Office expects that amount to double if the current exemption expires.

They may not be ideal, but there are things you can do to prepare for a reduced estate tax exemption:

Gifting – Make lifetime gifts now. You can make gifts up to the $12,920,000 exemption limit without having to pay taxes, though you will have to file gift tax returns for any amounts over $17,000. Gifts made now would count against current exemption amounts, regardless of what happens with future exemption levels.

Trusts – You can transfer assets into a Spousal Lifetime Access Trust or Grantor Retained Annuity Trust and permanently remove them from your estate. With a Spousal Lifetime Trust, you can receive indirect interest and access through income distributions. With a Grantor Retained Annuity Trust you are entitled to annuity payments for a specified number of years. After completion, the trust terminates and assets still within the trust are distributed to beneficiaries.

Intrafamily Loans – It is possible to make loans between family members, or to a family trust, which invests the money and then repays the loan. Once the loan is repaid, the assets that remain are protected from the estate by the trust and can be distributed to the beneficiaries. Intrafamily loans carry relatively low interest rates, improving the odds that net returns earned by investing loan amounts will exceed the interest owed.

Super Funding 529 Plan Accounts – You can contribute up to $85,000 ($170,000 for couples) into a 529 account per child or grandchild. This is considered five-year gift tax averaging, frontloading your annual gift-tax allowance in the first year. The growth and withdrawal of the funds are tax-free unless they are not used for qualified educational expenses. Qualified costs include tuition, books, and room and board.

None of these strategies are perfect, or without their drawbacks, but they may be worth considering. One potentially significant drawback is that when you transfer assets into irrevocable trusts, you lose the opportunity to capture stepped up basis. The step-up allows heirs to avoid taxes on gains in the value of assets that occurred prior to death.

Depending on where you live, estate taxes at the state level could add a double whammy to your inheritance goals. This is particularly true in New York where the exemption is only $6,580,000. Even worse, if your estate is over $6,909,000, you pay estate tax on the entire amount, not just the amount over the exemption. That can result in state estate taxes comparable to your federal estate tax even if the tax rate is lower. Again, the strategies listed above may be able to help you reduce your taxable estate to avoid state taxes.

It is still possible that the laws will change ahead of the estate tax sunset, but we wouldn't bet on it. The 2024 election cycle is a full one, and includes potential changes in President, 34 senate seats, and all 435 house seats. In 2025 the newly elected government will need to agree on new laws or at least extend the current ones to avoid expiration. Given the current political environment, and likely narrow majorities, that may be too big an ask.

Tech Rally...Can it Continue?

The stock market has had a stellar first half of the year. But that's only true if you were in the right part of the market. The overall US stock market gained 17% so far this year. International stocks were up a solid, but much lower 12%. US small-cap stocks were up only 6%. And deep value stocks rose a paltry 1%. It was the proverbial tale of two markets. The best of times for some, but not so much for others.

The market has been very narrowly driven lately, with a relative handful of technology stocks contributing most of the growth. For example, while the S&P 500 was up 17% in the first half, seven highfliers (Apple, Amazon, both share classes of Google, Meta, Microsoft, Nvidia, and Tesla) rose 60% while the other 493 stocks in the S&P 500 rose only 6%. Those seven mostly tech stocks are such big companies (Apple's total market value is over $3 trillion), that their price swings drive most of the index return even in a big index like the S&P 500. So, did "the market" have a great first half, or was it just a statistical aberration?

Clearly diversification was a liability in the first half, and really over the past several years. That was also true in the Nifty Fifty era of the early 1970s and again during the Dot Com Boom of the 1990s. But that doesn't mean diversification is dead. In fact, it has often come roaring back just at points when it appeared most useless.

The problem with today's market is that while tech stocks are dominant, there doesn't seem to be a good reason for it. Yes, there is the promise of artificial intelligence changing our world and making our economy more productive. However, I wouldn't count on that in the short run. The internet made similar promises in the 1990s, which have largely come true, but the trend in economic growth hasn't changed meaningfully and we still had a dire bear market in the early 2000s as the Dot Com Bubble burst. On the contrary, the fundamentals seem to be deteriorating for many tech stocks. Revenue has been in a multi-year decline and layoffs in the tech sector have been substantial in the past year. So, valuations are rising just as the economic underpinnings of these stocks are deteriorating. That doesn't make sense.

By the numbers, the price/earnings ratio for the overall stock market is 23. That's pretty high when compared to historical norms. It is even worse for growth stocks, which are dominated by the tech sector. Their P/E ratio is 34. That makes the stock market expensive and likely overvalued. However, there are a number of bargains in today's market. Large-cap value stocks have a P/E of 11, small-cap value stocks trade at a 9 P/E, and international value stocks are similarly cheap. These value stocks are generally real companies with real earnings. Their growth may be anemic, or they may be in less sexy industries, but when a downturn comes, as it did in the wake of the Nifty Fifty and Dot Com eras, I'd rather be holding real companies that trade at reasonable levels. Indeed, as the Dot Com Boom turned to bust from March of 2000 through September of 2002, value stocks actually rose by 14% while the S&P 500 fell 38% and the tech-heavy NASDAQ lost an astounding 74%.

When looking at relative performance, the tech sector is at almost exactly the same point versus the overall stock market that it was at during the peak of the Nifty Fifty and Dot Com Boom eras. Those prior periods ended badly for tech stocks. Could this time be different? Don't bet on it.

That doesn't mean we're due for a huge correction or economic crisis, though I wouldn't rule that out. However, it very likely means that we're in a period of very slow growth. We're expecting that could last for the better part of a decade, and we're likely in the early stages. The way to address that from an investment perspective is to rely on diversification. Just as value stocks held up in the downturn of the early 2000s, it seems likely that they are again well positioned to weather the storm. Lower volatility stocks should also do well. In fact, the historical data indicate that a diversified factor strategy fares quite well during periods when the overall stock market struggles.

It may be some time until the tide turns, but it seems certain that it will. Our portfolios will leave some money on the table if the mania continues, but we feel confident in how we're positioned if the economy and stock market falter.

Buying the Farm

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in our area and have had a chance to get to know folks across many different social strata.

So, it is with enthusiasm that I announce the purchase of another farm that will provide yet another social avenue. This one will be owned by my partner Chris Cebula and his family. It is right around the corner from our farm. Chris and Deanna have been looking for a new home for several years. The crazy market lately hasn't helped, but they finally took the plunge on a farmhouse and twenty-seven acres. We've been partners in business for roughly ten years, and now we'll have another way to work together.

Like our house when we first moved in, Chris's new place will require a lot of work. It is quirky, like most old farmhouses, and needs to be brought up to date. Then there is the matter of taking care of the three barns and all the land. It also comes with an orchard with forty-five fruit trees. That will make it easier, and hopefully cheaper, for us to make cider in the fall, but it will also require a lot of winter/spring tree trimming.

Much of Chris's land is field, some of which is still farmed. That means less lawnmowing. I spend hours each week mowing roughly six acres. He'll only have to do two or three acres. That still requires a big lawnmower, and of course you can't have twenty-seven acres without having a tractor. Those "toys" make fast work of farm chores, but they also create new ones. Mower blades need to be sharpened and all machines need regular oil changes and other maintenance. I find that the likelihood of a machine working is inversely related to how much time you have to do the job. Anytime I'm really rushed to get something done, it's almost a guarantee that the tractor won't start.

There will be many headaches on Chris's farm; many fights with Deanna about priorities; many dollars spent on maintenance, equipment, and upkeep; and many hours of hard labor. However, there will also be countless memories of his kids growing up outdoors, eating food grown right there, learning lessons about life and nature, and building a life filled with family and friends.

There will also be plenty of opportunities for Chris and me to lend each other a hand with some oddball project or other. We'll likely raise chickens together and help each other fix whatever broke that week on our farms. We'll share ideas and probably a few beers. We'll talk seriously about things that aren't that serious and find deeper opportunities to chat about whatever actually is important. I can't wait.

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