HFG WEALTH MANAGEMENT

INSIGHT

PERSPECTIVES FOR THE GOAL-FOCUSED INVESTOR

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The Worst Investor in the World

The daily market headlines are scary. The "experts" have all sorts of predictions on what markets will do. Will inflation cause a recession? Will the war cause oil prices to skyrocket to $200 and throw the world into panic? The fact of the matter is that markets are constantly consuming known information and giving us the latest prices based on the collective wisdom of all of its participants.

Every investor is faced with the following questions: Is now a good time to invest? Should I take some money off the table? Aren't we due for a huge correction? Aren't the markets being irrational?

No one wants to be “that guy” that invests right at the peak only to watch his money tumble for the next few days, weeks, or even years. We all think we are smarter than that.

Meet “that guy” named Bob, the investor we all try not to be. Bob’s father had told him that the only way to make money in the market is to be a long-term investor. Bob was a good son and when his father died in 1973, he took his $100,000 inheritance and invested it in the market. In 1973-74, the S&P dropped by nearly 50%. Bob had invested his life savings at the peak, just before it fell in half! Bob was discouraged, as anyone might be, but he remembered his father’s words and stayed with his investments. However, he was too scared to put more money in the markets.

After 15 years of saving and slowly regaining his confidence, he invested another $100,000. Unfortunately this was in August 1987, and he watched the markets dive 20% with Black Monday for seemingly no good reason. Bob was devastated by his bad luck. Sworn off investing, he sat out the next 13 years, witnessing one of the great bull runs of our time culminate in the rise of the dot-com era. He finally feels that he is missing out and invests another $100,000 in December 1999. This happened to be the peak of the dotcom bubble, and he saw the markets go down by 46% over the next few years.

Bob later neared retirement. He received a lifetime service award of $100,000 from his company, which he decided to invest in the stock market in September 2007, just before the subprime mortgage crisis sent stock markets down over 50%. Bob could not believe his bad luck. He decided that he has no business trying to time the market and vowed not to try again. However, for Christmas 2019, he thought he should put some money in the market for his children. Things were going well in the economy; maybe they would have better luck. Bob invested another $100,000, then the world discovered something called COVID-19 and he watched his investment tumble over 40% by the end of March 2020.

In May, 2020 he called his family together. "I am done with markets. I have failed my family in providing for you. I never could have imagined that I would be such a bad investor. Every buy decision I have made over the last 50 years has been wrong. I am sorry." His family was stunned. Then his wife spoke up: "Bob, our account is worth $5,729,804. You have done a great job!"

Bob wasn't a bad investor after all. He actually generated a return of 1,332% on his $500,000 investment, an annualized internal rate of return of 7.93%. For reference, if he had instead invested this same money in an account earning a guaranteed 2.50% he would only have $948,402.

Bob never panicked, which allowed the power of compounding to work for him. In fact, Bob did a lot better than many investors. Market timing and trading is the holy grail of money-making - who doesn't want to buy low and sell high? Unfortunately, it is impossible to get it right consistently enough to beat the market over long periods. According to studies, the average investor had a 20-year annualized return of only 1.9% as of end-March 2020, primarily due to market timing, speculation, and poor investment discipline.

During emotional periods of market stress, the best decisions are usually the ones that are not made. At the end of the day, sometimes the best decision is to do nothing. However, even though Bob's results turned out to be fine, you really don't want to be like Bob. Staying invested over the long-term is important, but because risk is constantly changing, both from a market and personal perspective, the "set it and forget it" mentality is not the best option. Regular re-evaluation and planning will help to offset the inevitable pitfalls of investing over the long-term.

How Inflation & Interest Rates Affect You

As much as COVID-19 has been the topic of public conversation over the past two years, "inflation" has become the most googled search term this year and moved to the top of investor concerns moving forward. Inflation refers to a general increase in the price of goods and services and the consequent decrease in buying power of a given unit of currency. Higher prices mean you get less for your dollar. The most concise definition of the cause of inflation is too many dollars chasing too few goods. A lot of what we are seeing today is the direct result of events of 2020 and the pandemic policies that were created to combat the issue. The "goods" in the equation were reduced as a result of essentially closing the global economy, and the "dollars" side of the equation was increased as a result of increased government spending and pandemic benefit programs, which increased the money supply. Regardless of how we got here, this is the situation that most investors face today and it is important to understand what the effects of inflation are on a personal level as well as how it affects your finances. The effect inflation will have on your personal finances will depend on your individual circumstances but there are some areas where almost everyone will feel the effects.

Effect on Prices

The most obvious indication of inflation is the reduction of your purchasing power. This is an indicator of how much of an item you can purchase with a single unit of currency. We face this every day when shopping for groceries or putting gas in the car. Ultimately, inflation reduces your purchasing power. The same item you purchased for $100 in February 2021 will cost you, on average, $107.20 in February 2022 at an inflation rate of 7.2%. Alternatively, you could find that your money will buy you a smaller quantity of an item. This is commonly known as shrinkflation– businesses will look to reduce the quantity of a product and keep the price the same to mitigate their cost increases. For example, a 16 oz. package may be reduced to 12 oz. while keeping the price the same. In essence, the end user is paying 25% more for the product they are consuming.

Effect on Savings

Inflation tends to diminish the effect of savings, as the future value of the money is less valuable the higher and longer that inflation is elevated. The main reason is the interest rate obtained from banks and credit unions is likely to remain below the rate of inflation. With the inflation rate several percentage points above the base interest rate, money in a bank account will drop in real-terms value over the years as the amount of interest paid is unlikely to keep pace with inflation.

Effect on Interest Rates

The most important result of higher inflation is the effect that it tends to have on interest rates. In general, higher interest rates are a policy response to rising inflation. In the U.S, the Federal Reserve targets an average inflation rate of 2–2.5% over time by setting a range of its benchmark federal funds rate, the interbank rate on overnight deposits. Interest rates tend to move in the same direction as inflation but with lags, because interest rates are the primary tool used by central banks to manage inflation. Conversely, when inflation is falling and economic growth slowing, central banks may lower interest rates to stimulate the economy.

Higher interest rates mean debt financing like mortgages, business and auto loans, and credit cards become more expensive as well. This has the effect of reducing demand for products like housing, autos, and capital goods, which then has the effect to slow the inflationary price increases.

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Effect on Investments

Although many investors are concerned about effects of inflation on investments, the equity markets can be an appropriate investment during periods of increased inflation. Higher than expected base interest rates usually move market values lower initially, as the effects of higher inflation are discounted. However, over a full cycle of economic growth and recession, equities have often been a good investment, relative to inflation over the long term.

However, there is one area that can be significantly affected by rising interest rates that tends to be ignored by most investors. Specifically, this is how of the value of their work-based benefit plans may be affected by higher rates. Many defined benefit plans offer lump sum payouts to their vested participants as a way of managing the overall risk and cost to their plan. These plans reference a uniform interest rate table issued by the IRS known as the IRS 417(e) rates. There are actually three different rates or “segments”, divided up by time periods through retirement based on one’s life expectancy, that encompass the end lump sum calculation. These rates are issued on a monthly basis.

There is an inverse relationship between these interest rates and the pension lump sum amount a participant would receive. When these interest rates increase, the value of the pension lump sum decreases, and vice versa. As the reference interest rates have been so low for a number of years, the lump sum option has been the most attractive choice for retirees. As one nears retirement in the current environment, the process of making the payout selection (lump sum verses monthly payments) has become a much more challenging decision. As a result, it is important to consider the following:

- <u>Know what your plan is offering.</u>
  A plan may incorporate the lump sum option available as part its plan on an ongoing basis or it may offer the option for a limited period of time in a “window." It is critical to know how much time you have to make a decision.
- <u>What are the interest rates that will be used for the lump sum calculation?</u>
  This may be based on the plan year which does not necessarily correspond with a calendar year. Likewise, you must determine which monthly rates the calculation will utilize.
- <u>Are you able to evaluate a comparison with your payments to time your decision?</u>
  In other words, are you able to determine the interest rate month and when it takes effect? Does your plan offer a window of time to aid your decision, showing amounts before and after the rate change?

In the end, an uninformed choice could make a sizable difference to your retirement payout. The effect of rising rates and the expectation of how long they may last can be a key component in timing a decision to retire. As an example, a 1% change in the reference rate can affect a $1 million plan by as much as $100,000. Many people may make this decision by asking advice from others who have retired, not realizing that there may be a very different environment in effect.