WOODSTOCK

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A quarterly newsletter offering our views on the market and economic topics of interest to investors.

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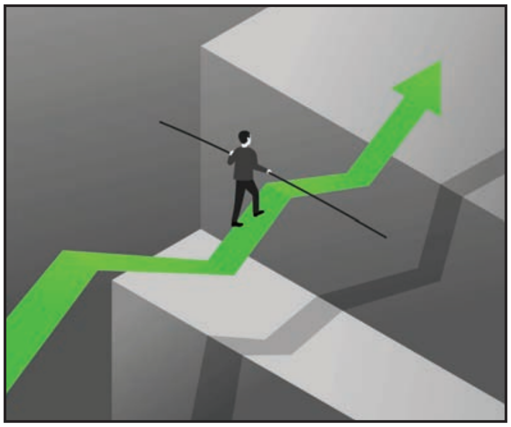
A Middle Ground for Investors

William H. Darling, Chairman & CEO

Choices are about to be made. Central banks and legislatures seem poised to decide what they want to do. For central banks, "plentiful liquidity helped governments, businesses and households survive lockdowns. Cash flows collapsed but bankruptcies barely increased. Asset markets and the real economy exited the crisis on a strong footing."[1] But now there may be "too much debt and too much money in the system."[2] The choice for the Federal Reserve and for the European Central Bank is to take away the "punch bowl" of combined net asset purchases of about $235 billion per month, in coordination, perhaps, over a period as short as 12 months.[3] Their actions risk dramatically affecting the values of financial assets.

For legislatures, a "potential dramatic increase in the scope of government" risks the "unintended consequences" of "chronic higher unemployment (severe among the young), lower gross domestic product and higher taxes that discourage risk-taking."[4] The choice for the US Congress is to endorse the zero-sum economics of "scientific socialism" where "wealth is created only by exploiting the poor, all income comes from labor and the economy needs central direction because markets can't self-correct."[5]

Or, the other choice is to endorse the modern economy. As far back as the 18th century, economists showed that "specialization of labor was valuable, that capital was productive, and that labor and capital could work together to increase income," meaning increasing the size of the pie. Property rights, cooperation through trade, and little or no central direction could create wealth that benefited all of society.



For the individual investor, the headline describing the decision that jurors must make in the Theranos, Inc. investment trial seems relevant. The jurors must decide whether those putting cash into the company were "savvy speculators who made an unwise, but informed bet or whether they were hoodwinked by a lying founder."[6] The choices described above for central banks and legislatures are also dramatically either/or with little middle ground. Investors, however, can choose a middle ground while waiting for the consequences -- and unintended consequences -- of the decisions described above to become evident.

The middle ground, putting good companies into individually managed portfolios, should continue to work over the long term, even with the severe potential problems discussed above.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow. We thank you for your support and want you to know that we are dedicated to serving your best interest.

[1] *Dimitris Valatsas, "As Central Banks Taper, Investors Should Take Cover," WSJ, 10/7/21*

[2] *James Mackintosh, "Something Is Awry in the Treasury Market This Summer," WSJ, 8/16/21*

[3] *Ibid, Valatsas, WSJ 10/7/21*

[4] *WSJ, 8/11/21 Letters*

[5] *Paul Rubin, "The Woke Left's Primitive Economics," WSJ, 10/6/21*

[6] *Heather Somerville, "Theranos Trial Jurors to Weigh Whether Investors Were Dupes or Savvy Speculators," WSJ, 9/28/21*

Peering Down From Way Above Trend, A Look at the TINA Problem, and Portfolio Rebalancing Headwinds

Thomas C. Stakem

Assessing the trends in certain data sets helps portfolio managers grapple with the TINA problem and how to best rebalance portfolios for the long term. Because of the devastating effects of the COVID-19 virus on economic and financial statistics, investors absorbed large negative rates of change early on until those depressed numbers became denominators for more recent data. But investors have been treated to many astonishing rates of change over the last year because of easy base-period comparisons. In most cases, the percentage changes or growth rates have conformed to a classic sine curve pattern. But those puffed-up numbers have now passed, and we are on to discerning what longer term trend growth will be for many of our favorite data series.

Being above trend over some time period implies negative second derivative performance ahead, a negative change in the rate of change. Growth slowing from 17% to 10% or 5% would be a negative second derivative even if still positive absolute growth. For a portfolio manager, this has implications for portfolio construction in terms of asset mix (allocation) and potentially sector diversification because above-trend performance can drive above desired equilibrium exposure to an asset class or to an economic sector of the market.

What does getting back to trend look like? In terms of inflation, the capital markets have concluded that 2.5% is the central tendency, RGDP growth is 1.5%-2.0% based on reasonable population and productivity growth assumptions, corporate earnings growth of 5% or nominal GDP growth because higher corporate tax rates and margin pressure will offset share buyback influence. P/E multiples (now two standard deviations above average 15x) will drift lower as negative real interest rates lessen and/or go positive from their current -1% to -2% levels. Asset class returns (cash, bonds, stocks) and their implication for asset mix and sector allocation decisions will result from these interactions.

The TINA Problem

The term TINA (“There Is No Alternative”) is alive and well, but so too is the capital preservation instinct. Since year-end 2015 (i.e., 2016 to 2021 YTD), stocks have so out-performed bonds that a 60% exposure at year-end 2015 would be 11% points (~20%) higher, resulting in a 71% equity/29% cash and bond mix. While time horizon, estate tax planning and other considerations enter the discussion for taxable portfolios, the above-trend performance reality presages regressing to or below trend in future periods.

Recent equity returns and corporate earnings growth have been so far above trend that many may have forgotten what trend was. Some representative examples are shown in Table 1 below.

Table 1 -- Current Economic Conditions vs. Long-Term Trend

Variable	Current Level	Trend Level
Nominal GDP	13%	5%
Real GDP	6%	1.5%-2.0%
Inflation	4%	2.5%-3.0%
Money Supply Growth	12%	7%-8%
Earnings Growth	40%	5%-6%
P/E Multiple	21x	15x-16x

“Assessing the trends in certain data sets helps portfolio managers grapple with the TINA problem and how to best rebalance portfolios for the long term. ”

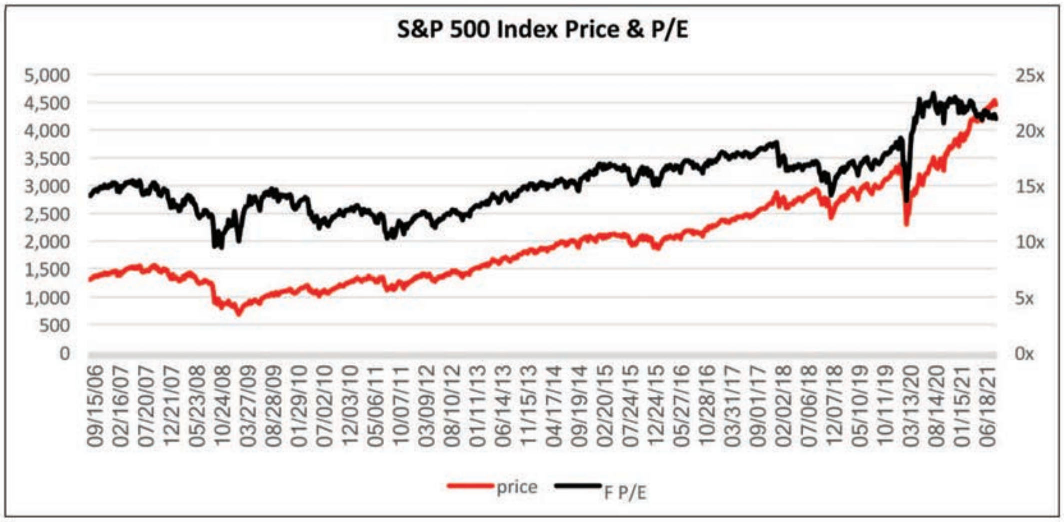
“Growth slowing from 17% to 10% or 5% would be a negative second derivative even if there is still positive absolute growth.”

“The term TINA (‘There Is No Alternative’) refers to there being no alternative to equities with cash a return-less asset as well as a negative-real-returning bond asset class. ”

“In terms of inflation, the capital markets have concluded that 2.5% is the central tendency.”

“Recent equity returns and corporate earnings growth have been so far above trend that many may have forgotten what trend was. ”

Figure 1



Equity Returns Face Headwinds

The current forward P/E (F P/E) of the S&P 500 of 21x is two standard deviations above the fifteen-year average of 15x. This looms as a powerful headwind to equity returns in the event that competing bond yields ever reflect a positive “real” rate of return component in contrast to today’s negative 1-2 percent. The F P/E has been going sideways since March 2020 (see Figure 1 above), which reflects the adjustment underway to reflect growth deceleration and capital market normalization.

> "Recent history (the last two decades) shows that both stocks and bonds are well above trend in nominal and 'real' returns."

> "Pruning the garden, or portfolio rebalancing in an investment context, is an important strategic activity particularly during and/or after well-above-trend asset return periods."

> "Putting good companies into client portfolios is how Woodstock's investment managers are evaluated, not necessarily on short-term client account performance."

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Table 2 -- % Compound Annual Total Return

	60s	70s	80s	90s	00s	10s	20s[1]	1926-2020
Stocks nominal	8%	6%	18%	18%	-1%	13%	24%	10%
Stocks real	5%	-2%	12%	15%	-3%	11%	22%	7%
G Bonds nominal	1%	6%	13%	9%	8%	7%	7%	6%
G Bonds real	-1%	-2%	8%	6%	5%	5%	5%	3%
C Bonds nominal	2%	6%	13%	8%	8%	8%	8%	6%
C Bonds real	-1%	-1%	8%	5%	5%	6%	5%	3%
T-Bills nominal	4%	6%	9%	5%	3%	0%	0%	3%
T-Bills real	1%	-1%	4%	2%	0%	-2%	-2%	0%
Inflation	3%	7%	5%	3%	3%	2%	2%	3%

[1] Decade to date 11/5/21

- *G Bond = government bonds*
- *C Bond = corporate bonds*
- *Two-digit historical return precision is highly overrated in forward return forecasting and our focus on the last sixty years (not Ibbotson back to 1926) is intended to highlight where returns are above/below trend and what reversion to trend may look like.*

Rebalancing portfolios can be exacerbated by the investment mantra "TINA," which refers to there being no alternative to equities with a cash return-less asset class as well as negative real returning bond asset class. As Table 2 above shows, this expression really gained currency in the last two decades as nominal yields fell to zero, creating negative real returns of 2 percent. This stands in stark contrast to history. which shows that cash (T-Bills) has returned the rate of inflation or no "real" rate of return compared to stocks and bonds which have both provided positive "real" investment returns. But recent history (the last two decades) shows that both stocks and bonds are well above trend in nominal and "real" returns. Bonds of both stripes and T-Bills, however, remain mired in low nominal, negative "real" return territory.

Pruning the garden, or portfolio rebalancing in an investment context, is an important strategic activity particularly during and/or after well-above-trend asset return periods. The tug-of-war between overexposure to equities resulting from the last several years' performance may have resulted in above-equilibrium exposures in both an asset mix and economic sector sense. But addressing them runs into the TINA problem as the reinvestment return seems so inferior. High, above-trend valuations can be associated with low prospective returns which often follow. Just mean regression at work.

What's a Client to Do?

Tom's Stakem's article, "Peering Down," is a graduate course in finance and investment in three pages with charts focused on what's happening now and likely to happen over the next two to three years. Good companies either held or bought now have a good chance to perform well compared to an index or an alternative asset class. Quality companies bought now have a good chance to hold their value or recapture it when negative financial events or extraordinary international events happen.

Portfolio managers at Woodstock research the companies on our Monitor List not only to know when to purchase them in client accounts, but also to know the appropriate time to sell them. Individual stock selection can be an advantage for individually managed portfolios. In the recent past, it has been a great advantage at Woodstock. Putting good companies into client portfolios is how Woodstock's investment managers are evaluated, not necessarily on short-term client account performance. As clients ourselves, we intend to keep trusting that system over the long term.

William H. Darling, client

Henry P. Phippen, client

Tax Roundup: Tax Guide, Social Security, and Tax Gaps

William H. Darling, CPA – Chairman & President

Jeanne M. FitzGerald, CPA – Tax Manager

This issue includes a seasonal cornucopia of tax-related news: a new tax guide, good news from Social Security, and thoughts on tax revenues and the "tax gap."

Our sister company Woodstock Services Company is providing an electronic version of a 2021-2022 Tax Planning Guide on our website. There are good tax rule explanations and good tax planning tips throughout its 26 pages, particularly on executive compensation (pages 6-7) and on estate planning (pages 22-23). If you have any specific questions about the annual guide's contents, don't hesitate to contact us.

There is a piece of good news for "the nation's 60 million Social Security recipients."[1] The Cost-of-Living Adjustment (COLA) for next year's social security payments is 5.9%, as announced in October. This would be the largest COLA since 1982. The average COLA for the last 14 years has been 1.4 percent.

Any discussion of tax rules changes should keep in mind the sources of tax revenue that the federal government relies on. From 2015 to 2019, estate and trust income taxes, estate and gift taxes, and excise taxes together provided approximately 4% of total US tax collections. Business income taxes provided between 12% and 8%, declining over the period. All other tax collection came from individual income taxes and employment taxes, 84% to 88%, increasing over the period.[2] The grand total collected was a little over $3 trillion per year.

The best explanation of what the proposed federal government push to "close the tax gap" would actually look like came in a recent letter to the editor in The Wall Street Journal: "Let me tell you how enhanced audits would go down. Returns of rich folks are complex and they hire accountants and lawyers to defend them. So the local director will insist his agents lean on grandpa and grandma and extract a little from each audit through intimidation."[3] On top of that, the Congressional Budget Office estimates that the tax gap is not $700 billion, but closer to $200 billion because of the law of diminishing returns.[4] Informed tax collection tries to move from forced extraction to an art. As the Frenchman Jean-Baptiste Colbert once said: "The art of taxation consists of plucking the goose so as to obtain the most feathers with the least hissing."

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

"Our sister company Woodstock Services Company is providing an electronic version of a 2021-2022 Tax Planning Guide on our website. "

"The Cost-of-Living Adjustment (COLA) for next year's social security payments is 5.9%, as announced in October."

[1] *"Big COLA Hike Coming?" Dina Hampton, Financial Planning, September 2021, p. 44*

[2] *"Tax Shares Over Time," Journal of Accountancy, August 2021, p. 51*

[3] *"What 'Closing the Tax Gap' Will Look Like," WSJ, 9/24/21*

[4] *"Biden's Dream of an IRS Strike Team," WSJ, 9/4-5/21*

Wishing you all the happiest of holiday seasons!

Your ideas and questions are important to us. What would you like to see in our Quarterly Market Perspectives? Please contact your portfolio manager, or anyone from Woodstock's team of professionals, and let us know.

We want to hear from you!

If you're new to Woodstock, you can reach us at **info@woodstockcorp.com.**