Quarterly Market Perspectives

Summer 2023

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

IN THIS ISSUE

Eyes on Money Market Funds and Private Equity

William H. Darling, Chairman & CEO

Adrian G. Davies, President

What are we watching and thinking about? Woodstock uses pooled investment vehicles for client cash, so we're watching money market funds. We're interested to see that of all the categories of investments in the endowment model, private equity seems to be taking an outsized share. And we like to tell Woodstock's story.

New Rules for Money Market Funds

Investors expect to take risks when investing in equities. They have a different view of risk when their cash allocation is the subject. The US Securities and Exchange Commission (SEC) recently rewrote the rules governing money funds for the third time in 15 years, in hopes of preventing bailouts of money market funds in times of turmoil. The current surge of dollars into money market funds from investors and companies is because money market funds are offering returns of 4% to 5%, while insured bank savings accounts are offering about 0.5 percent. The gap is too big and cash has moved dramatically since several banks failed.

The main focus of the new SEC rules, set to take effect near the end of 2024, is liquidity guidelines. The daily liquidity guideline is moving from 10% to 25% of total assets and the weekly guideline is moving from 30% to 50 percent. This would seem beneficial and follows the financial saying that more money has been lost chasing yields than in bank robberies. However, there is a second focus that involves fees. In a 2014 change, the SEC "allowed funds to charge investors a fee, or suspend redemptions altogether, when a fund's liquid assets slipped below certain levels."[1] The SEC agrees that the fees or suspensions "appear to have contributed to the 2020 run" because investors didn't want to be stuck and unable to withdraw cash, so they panicked.

The proposed rules implement fees when daily net redemptions exceed 5% of net assets. The SEC should probably put down the stick, imposing fees, and stay with fine-tuning the carrot, improving liquidity. In a panic, no one wants to stay for an extra hour, let alone a week, and sticks seem to make matters worse.

Private Equity Concerns

As most of our QMP readers know, we are very familiar with private equity. Within the four walls of our offices, we run operating companies in the energy industry and in financial services. We have formed new companies with substantial assets in both industries. We choose to focus the vast majority of our investable assets on high-quality US stocks. That decision has served us and our clients well.

Regular readers of QMP will also be familiar with our major objection to current private equity investing which is, since 2018,[2] a case of too much money chasing too few good deals. As predicted in 2018, the sponsors' focus has been on the management fees, "which are predictable, steady and valued

[1] *Paul Kiernan, "SEC Acts to Shore Up Money Funds," WSJ, July 13, 2023, p. B1*

[2] *Paul J. Davies, "The Real Risk in Private Equity Is Size," WSJ, February 23, 2018*

WOODSTOCK

"Investment managers at Woodstock have independence in making investment decisions for their clients' accounts."

"Weekly research committee meetings and monthly investment policy meetings test ideas..."

"Our goal is to have our performance be close to our benchmark with the opportunity to outperform."

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by public shareholders," and on "tying up investor funds for longer by running listed vehicles that never have to return capital."[3]

So, what is happening five years in? In general, the news is about endowments and pension funds freezing or decreasing their allocations to private equity. "Private equity managers are using all the tools at their disposal to avoid marking down the value of their assets."[4] As valuing portfolio companies may be more art than science, what happens when an investor, a limited partner (LP) wants to leave? "Selling LPs have to take a steep discount to the reported value of a stake to get a deal done, indicative of the mismatch between how assets are being valued and what buyers are willing to pay for them."[5]

The danger for investors is the same danger a recent letter to the editor of the Wall Street Journal described for insurance companies investing in private equity. "The danger for insurers is that they can't simply pull out of these private market positions with a snap of their fingers; these funds are normally gated for a set period of time."[6]

The Woodstock Difference

As most of our clients know, Woodstock's managers have had an impressive 10-year and 5-year run with performance through December 31, 2022. The results for our GIPS-verified growth composite are available upon request for our clients, prospects and colleagues, along with the other five composites, as required. However, the growth composite encompasses over 80% of assets under management at Woodstock and has for 10 years. Investment managers at Woodstock have independence in making investment decisions for their clients' accounts.

Internally, we try to explain this success. A former president of Woodstock stresses the in-house operations here. Weekly research committee meetings and monthly investment policy meetings test ideas and are contentious. They bring out the positive and, hopefully beneficial, negative aspects of collaboration. Also, the managers pick from the same menu of stocks, our Monitor List. In the end, when decisions are made, the individual managers come out with a thoughtful way forward.

There are some industry trends that are also probably helping. The increasing size of passive index funds allows more room to buy good companies at good prices. Other investors using the endowment model are not concentrating on high-quality US stocks, which leaves us with a large, open field. World instability most likely helps the US market.

What's happened with our performance in the last 10 years is not our goal. Our goal is to have our performance be close to our benchmark with the opportunity to outperform. We bring two other very important characteristics which we believe are as important as performance against a benchmark. The first is the ability to use tax-loss selling to increase the absolute value of an account. The second is separately managed accounts versus being in a pooled investment vehicle, meaning the client directly owns their assets, rather than merely being a creditor of the real owner.

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.

[3] *Ibid.*

[4] *Rod James, "Private-Equity Managers Reluctant to Cut Valuations," WSJ, January 31, 2023*

[5] *Ibid.*

[6] *Yann Bloch, "Is Private Equity Too Risky for Insurance Firms?", WSJ Letters, February 13, 2023*

“The stock market roared ahead in the first half of 2023, returning +16.9% and defying predictions for another difficult year.”

“It is possible that we are experiencing a rolling recession, with different sectors of the economy contracting at different times.”

“Meanwhile, the stock market has done well because inflation is falling even as consumer spending and employment have held up.”

An Unusually Strong Recovery

Adrian G. Davies, President

The stock market roared ahead in the first half of 2023, returning +16.9% and defying predictions for another difficult year. The stock market sailed through the demise of four medium-sized banks,[1] a Congressional debt ceiling showdown, higher interest rates, and widespread calls for a recession.

Market pundits have been referring to the possibility of inflation subsiding without a major impact on economic growth or employment as the “soft landing” scenario. As of this writing, inflation and economic reports are indicating that the economy appears to be landing softly. The headline Consumer Price Index (CPI) of 3.0% for June surprised many of us because it had moderated so much while job growth has remained strong and gross domestic product (GDP) growth has held up. The US economy grew an estimated 2.4% on an annualized basis in the second quarter and added an average of 270,000 nonfarm jobs to the payrolls per month through the first half of the year.

Several of us at Woodstock, along with many other market observers, have been calling for a recession for more than a year now.[2] The US has not entered a recession, at least not yet. Our recession thesis was based on the US economy confronting simultaneous fiscal and monetary policy contraction. Contracting federal spending should curb GDP growth and many of us believed it would bring consumer spending down with it. Consumers are being further pressured by the rising costs of living. In this precarious state, the Fed’s aggressive tightening campaign seemed likely to tilt the economy into recession.

The Conference Board’s Index of Leading Economic Indicators has been contracting for 15 months in a row. We’ve had a manufacturing recession, but not a broader economic recession. Europe, which is experiencing comparable if not higher inflation, has been in a recession. US corporate earnings have also suffered, declining year-on-year for the past three quarters. And yet the broader US economy has proven to be resilient. It is possible that we are experiencing a rolling recession, with different sectors of the economy contracting at different times. This would spread out the economic dislocation, making it more manageable. Whatever is happening in various sectors, however, the largest component of GDP, consumer spending, has remained solid. Without showing up in the broad economic statistics yet, there may be pressures building under the surface. The cumulative effect of the interest rate increases and monetary tightening will continue to play out, slowing the economy.

What Have Calls for Recession Missed?

Those of us forecasting a recession underestimated both the backlog of demand created by supply chain constraints and consumers’ resilience. Consumers bolstered their balance sheets during the pandemic by receiving federal subsidies and by spending less. Economists have attempted to measure consumers’ “excess savings,” which is a rather spurious concept: a much bigger problem is that Americans haven’t saved enough for retirement. Nevertheless, consumers seem to have been spending the incremental savings they accumulated during the pandemic. Consumers’ excess savings, and “revenge spending”—consequences-be-damned spending because one is tired of exercising pandemic-era restraint—have helped to keep aggregate spending numbers strong. The economy could be less sensitive to interest rates than we thought, but there is Nobel laureate Milton Friedman’s caveat that “monetary actions affect economic conditions only after a lag that is both long and variable.” Meanwhile, the stock market has done well because inflation is falling even as consumer spending and employment have held up.

Fiscal Challenges

The federal deficit ballooned during Covid-19, hitting 14.9% of GDP in 2020 and 11.9% in 2021 before shrinking to 5.4% in 2022. We are fortunate that substantial cutbacks in government spending have not caused the economy to contract, at least not yet. According to the Congressional Budget Office, the deficit is due to expand to 5.8% of

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[1] *Silvergate Capital, Silicon Valley Bank, Signature Bank, and First Republic Bank, and NOT counting Credit Suisse*

[2] *Robert Sanders, “As the Fed Fights Inflation, Can Recession Be Far Behind?” Quarterly Market Perspectives, Spring 2022*

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GDP this year, with the composition of the deficit changing somewhat. Stimulus spending related to pandemic relief has been replaced by higher interest expenses and higher social spending programs. Some readers will recall that an 8.7% cost of living adjustment was rolled out to Social Security beneficiaries in January of this year (estimated to increase 3.1% in 2024). The US Treasury issues most of the federal government's debt at shorter maturities, making our government the biggest loser from higher rates. According to at least one forecast, federal debt service (interest payments) alone could surpass the defense budget by 2028.[3]

The Inflation Reduction Act, the CHIPS and Science Act and the Infrastructure Investment and Jobs Act are helping to stimulate business spending. Government and business spending have contributed to the strength in Personal Consumption Expenditures (PCE) and will likely continue to. At 5.8% of GDP, the federal deficit needs to come down further. Going forward, higher recurring deficits are likely to keep real interest rates higher. To the extent that the Fed allows short-term rates to come down, with or without an economic contraction, America's fiscal position stands to benefit.

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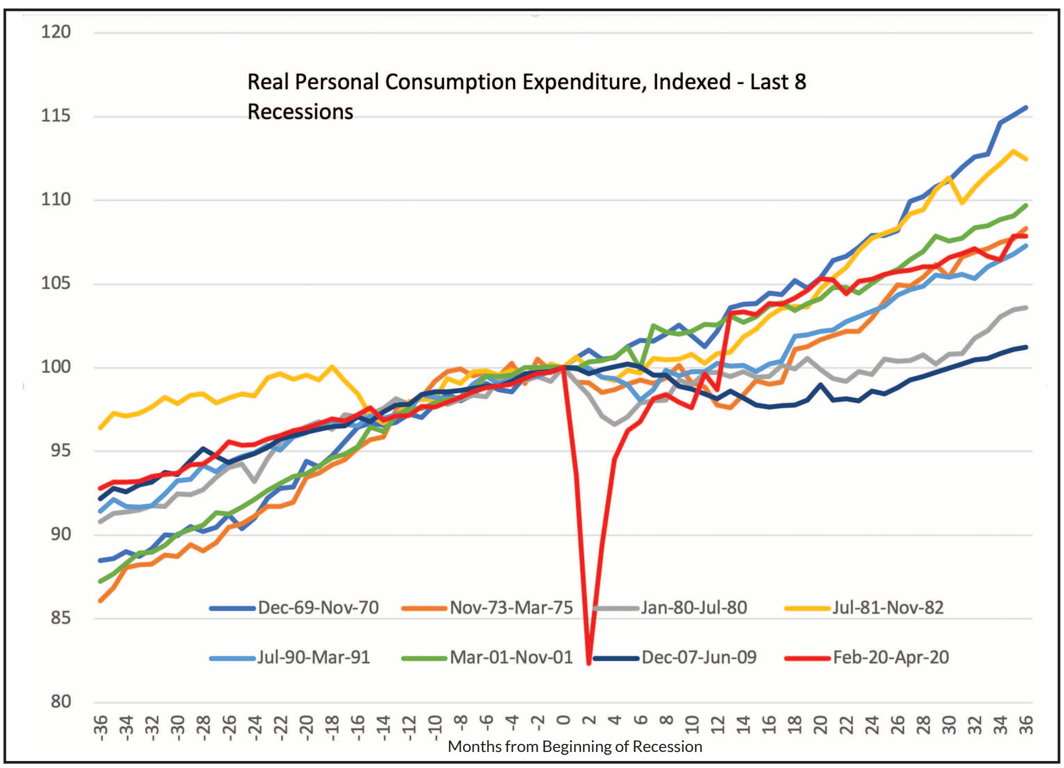
Personal Consumption Expenditures

PCE, accounting for about two-thirds of GDP, held up much better during and after the pandemic recession than it had in five of the prior seven recessions. The accompanying charts (Figures 1 & 2) show real (inflation-adjusted) PCE for the last eight recessions. The data presented are the real PCE beginning three years prior to the recession start and three years after the start, indexed to 100 on the first month of the recession (month 0).

After a recession, PCE tends not to recover to its pre-recession growth trajectory. In Figure 1, real PCE seems to have held up best for the December 1969-November 1970 recession. Note that the economy was growing rapidly before this recession. Even though real PCE recovered sharply after the recession, it did

Figure 1. Personal Consumption Expenditures Don't Typically Recover Fully After a Recession



Source: St. Louis Federal Reserve, Woodstock Corporation

[3] *Megan Henney, "Interest Costs on US National Debt to Exceed Defense Spending by 2028," Fox Business, 7/10/23.*

not match its prior growth rate until 32 months after the start of the recession. This is more evident in Figure 2, which uses the same data to compare real PCE variance against its linear trendline for start of each recession. In each case, real PCE stays fairly consistent with the trendline established from this data. Figure 2 shows the divergence from trendline during and after each recession.

The next line which stands out in Figure 1 is the July 1981-November 1982 recession. PCE recovered in short order, arguably seven months after the start of the recession, but note that this was the second part of a double-dip recession. The pre-recessionary period overlaps with the indexed data from the January-July 1980 recession. With this prior recession in its prelude, real PCE was particularly anemic going into the 1981-1982 recession, as manifest in a flatter line to the left side of Figure 1. Real PCE recovered at an accelerated rate after the recession, but mainly because economic growth had been suppressed going into it.

The December 1969-November 1970 recession and the July 1981-November 1982 recession notwithstanding, the 2020 pandemic recession stands out as having the strongest recovery (Figure 2). The pandemic recession was the shortest recession of the eight, but 22 million people still lost their jobs. Despite the sudden dislocation, real PCE rebounded back above its prior recession trendline thirteen months after the start of the recession and has mostly stayed there.

Government stimulus helped consumer spending recover. The stimulus has subsided, but consumer spending has persisted at a high level. With regard to helping PCE recover to its pre-recessionary trendline, it appears that fiscal and monetary authorities have done a good job of managing the economy. Our economic resilience could be an example of Keynesian deficit spending successfully bridging the economic output gap, but there's room for skepticism. If consumers are spending down "excess savings," then the current rate of spending probably is not sustainable. A recession isn't inevitable, but still seems probable.

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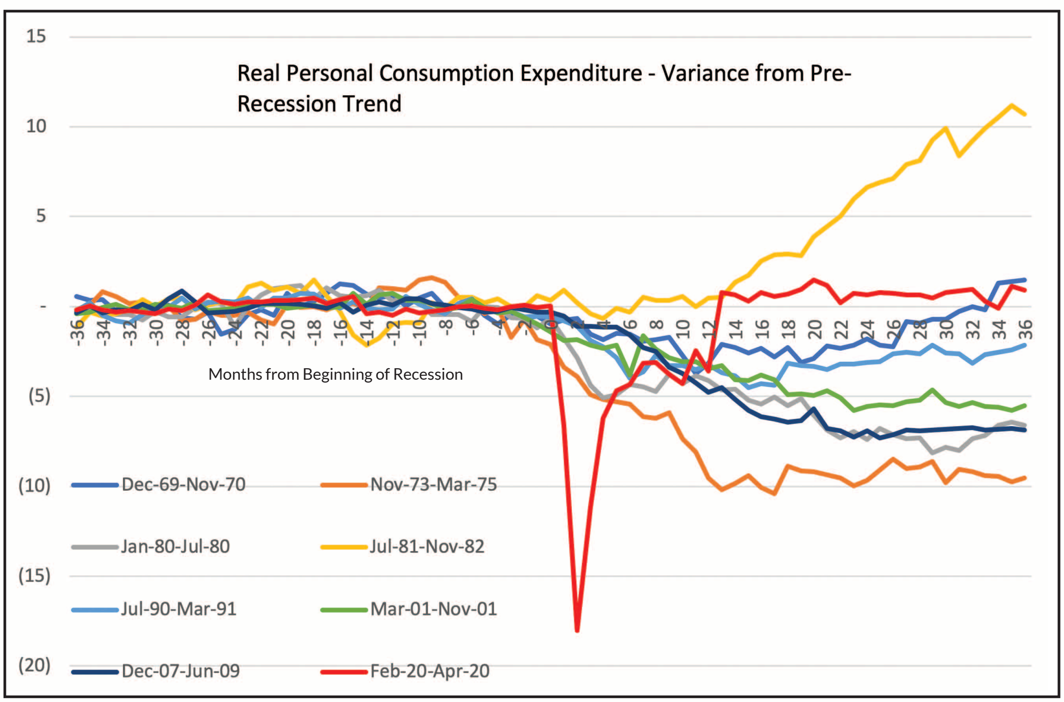
Figure 2. Real PCE Variances from Pre-Recession Trend



Source: St. Louis Federal Reserve, Woodstock Corporation

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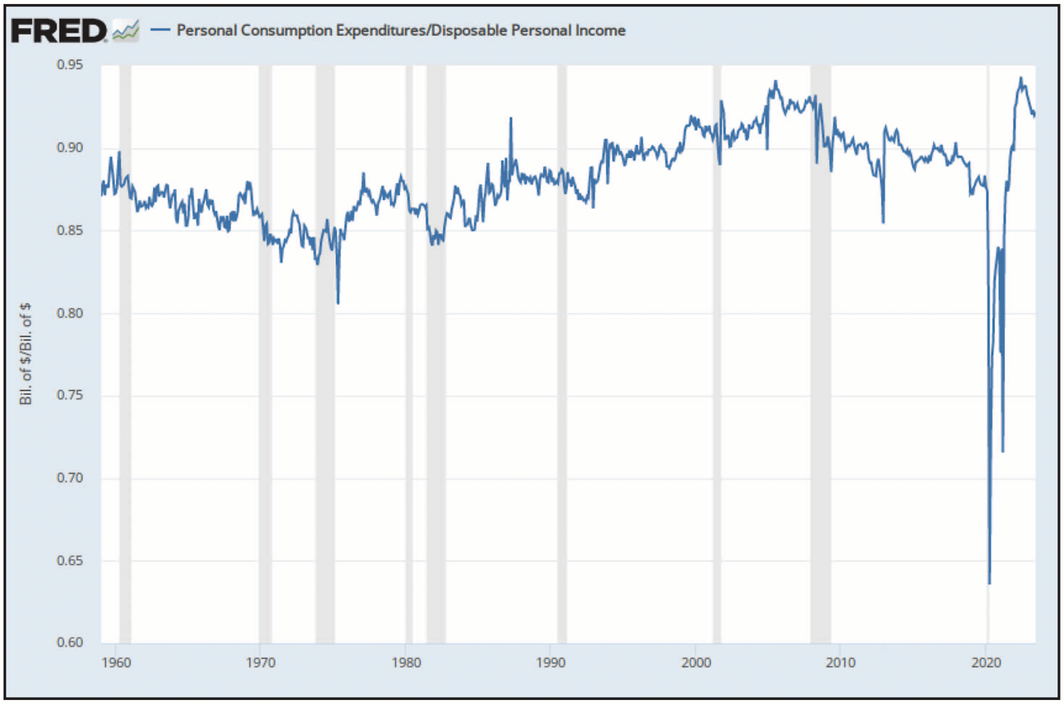
Figure 3. Consumer Spending as a Percent of Income



Source: St. Louis Federal Reserve

Figure 3 shows PCE as a percentage of Disposable Personal Income (DPI). The pandemic and related shutdowns caused a unique cessation of spending. The ratio rebounded to a sixty-year high (94.3%) as consumers spent their excess savings. PCE has declined from its peak, but at 92.2% in June, remains at the high end of its historic range. Consumers are still spending in rare form.

Will the Fed Pivot to Lower Rates?

Inflation appears to have been caused by the pandemic, our policy responses to it, the ensuing supply chain challenges, and the war in Ukraine. Factors related to the pandemic are now normalizing. Inflation statistics, in their multifarious permutations, have mostly been on downward trends and seem likely to continue to moderate, at least for the next few months. Perhaps the headline CPI rate of 3.0% and the PCE Price Index, also 3.0% for June, are low enough, or are trending down close enough to the Fed's 2% target, for the Fed to stop raising rates. Core CPI (excluding food and energy prices) remains uncomfortably high at 4.8%, as does the core PCE Price Index, up 4.1 percent. The statistics excluding food and energy price changes followed their corresponding broader indexes up last year, and so far are following them down this year.

Fed officials will need to have confidence that inflation will stay low before they cut rates. They are still worried about the tight labor market having a more lasting effect on inflation. Even with supply chain pressures easing, average hourly earnings are still up 4.4% year-over-year. Higher wages are of course good for workers, but with labor being a significant part of most every company's cost structure, they can be a critical driver of cost-push inflation. Tight labor market conditions are caused at least in part by baby boomers and others permanently retiring from the workforce.

With various frictions in the system including the tight labor market, getting inflation down from 3% to 2%, "the last mile," may prove as challenging as getting inflation down to 3 percent. Can the Fed tolerate 3% inflation, if only temporarily, or is it worth incurring a

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recession in order to get inflation back to their 2% target quickly?

Fed officials have said and acted as if they are willing to incur a recession in order to get inflation down to target. Allowing observers to perceive that they are willing to tolerate anything higher than their target could itself be counterproductive, and yet Fed Chairman Jerome Powell said he didn't see inflation getting back to the Fed's target rate until 2025.[4] He is being patient. Believing it will take until 2025 to bring inflation back to 2%, it is hard to imagine the Fed cutting rates much before then. Conditions are of course subject to change. If inflation falls faster than expected, the Fed could adjust policy accordingly.

As long as the economy is growing satisfactorily, any additional stimulus afforded by cutting rates would risk fueling inflation. The Fed doesn't want to be in the business of inflating asset prices—the stock market—either. They will cut interest rates if the economy deteriorates enough, but they are reluctant to squander their ammunition unless there is an evident need. The closer inflation gets to 2%, the stronger the argument becomes for cutting rates. The stock market may continue to respond favorably to lower inflation, anticipating a pivot in Fed policy.

Even as some inflation metrics may continue to fall in the near term, there are longer-term pressures driving inflation higher. Some of the more prominent secular pressures include: baby boomers retiring, companies restructuring their supply chains as geopolitical tensions rise, more extreme climate events causing economic dislocations, and rebuilding our infrastructure to accommodate alternative energy. With greater investment needs, interest rates could enter territory that looks more like the 1980s and 1990s than the 2010s. That is, higher on a secular basis.

Do We Still See a Recession?

Several of us at Woodstock still see a recession as the most likely outcome. Borrowing is more expensive. We have yet to feel the full economic impact of the now 5.25 percentage points of rate hikes which are working their way through the system. The four banks that collapsed this spring may have been most exposed to the challenges brought about by higher rates, but all banks are facing similar financial pressures to a greater or lesser degree. Higher interest rates are causing funding issues for banks, which in turn are constricting credit. The credit contraction has started to show up in the prices of commercial real estate transactions, and should be evident to anyone trying to get a commercial loan. Highly leveraged companies are affected as well. Loan delinquency and default rates have started to rise, although they are still at low levels.

Inflation may very well fall further. Those of us expecting a recession doubt the Fed's ability to wield its tools, which operate with a one-to two-year lag, deftly so as to manage a soft landing without also denting economic growth. If the economy stays strong, inflationary pressures would likely stay with us, in which case the Fed would continue to keep monetary conditions tight, or even tighten them, until signs of economic weakness become evident. On the other hand, the broader economic outlook has improved greatly since the start of the year. Economic growth has persisted despite inflation falling. The possibility of a soft landing appears more realistic. Manufacturing, having been down for so many months, seems due to turn up, and the bank crisis has at least so far been contained.

[4] *Nick Timiraos and Tom Fairless, "Powell Says Fed's Inflation Fight Could Take Years," The Wall Street Journal, 6/28/23*

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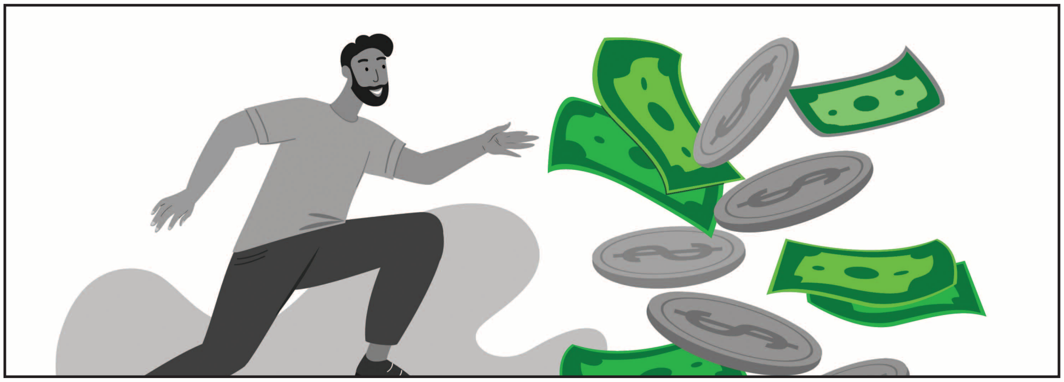


"Our aggressive policy response may have been instrumental in navigating the pandemic recession well, but the verdict is still out."

"The bull case for stocks seems to involve the Fed having a change of heart, pivoting to looser monetary policy."

"Being relatively safe assets and generating healthy yields, cash and bonds deserve consideration as components in most portfolios."

Opportunities in Cash, Bonds, and Stocks

The recovery from the pandemic recession has been unusually strong. That is encouraging, although it begs the questions of what has led to the strength and how sustainable it is. Our aggressive policy response may have been instrumental in navigating the pandemic recession well, but the verdict is still out. Consumer spending seems extended and may very well retrench, a scenario which could easily be triggered by the Fed's tightening. The backdrop of high federal deficit spending seems to allow less room for error. The deficit isn't sustainable at this level of GDP, and needs to be reduced even if cutting it would be a headwind to economic growth.

For now, the Fed is trying to achieve tighter monetary conditions. The bull case for stocks seems to involve the Fed having a change of heart, pivoting to looser monetary policy. The portfolio managers at Woodstock heartily debate whether inflation will revert to the Fed's target of 2% without a recession, and a number of us do not see the Fed loosening policy in the absence of a recession. While stocks typically benefit from looser monetary policy, earnings and stock prices go down when there's a recession. We can hope against precedent that this time is different, or that last year's stock market decline fully anticipated a recession which has yet to come. The good news is that if the US enters a recession, the Fed would likely ease policy, with easier policy likely pushing stocks higher, making a recession a great opportunity to add to stock portfolios.

Cash and bonds are yielding about 4%–5%, levels not seen since the mid-2000s. Being relatively safe assets and generating healthy yields, cash and bonds deserve consideration as components in most portfolios. They also raise the bar for what returns investors should expect from risky assets. One can expect higher returns when starting from lower valuations. The stock market is currently expensive, with the S&P 500 Index trading around 19.7 times forward earnings, and those earnings are based on ambitious growth expectations. However, there is a lot of optimism that is focused on a small number of very large capitalization stocks. Most members of the S&P trade at much more modest multiples than the exalted seven largest capitalization US stocks,[5] which make up more than 25% of the index. We believe there are always opportunities to find companies that have great potential.

The market factors contemplated in this article are subject to many variables which are difficult to forecast, and could play out in myriad ways with very different implications for your portfolio. It usually isn't worth taking the capital gains to make major allocation shifts, nor are investors likely to be successful trying to time the market. Stocks generally go up over the long term, and we encourage clients to stay focused on the long term. Whatever happens, your portfolios are broadly diversified, populated with high-quality stocks, preparing you for an array of possible market conditions.

[5] *Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta Platforms*

Artificial Intelligence: Possibilities and Pitfalls

Adrian G. Davies, President

Artificial intelligence technology (AI) made headlines in 1997 when IBM's Deep Blue beat chess grandmaster champion Gary Kasparov and then again in 2011, when IBM's Watson competed against and beat prior *Jeopardy!* television game show champions. The general public woke up to the enormous potential for generative artificial intelligence with the launch of OpenAI's ChatGPT in November 2022. ChatGPT is a large language model which learns to respond to user requests in plain English or another language.

If you are not familiar with the technology, we encourage you to experiment with any of the following:

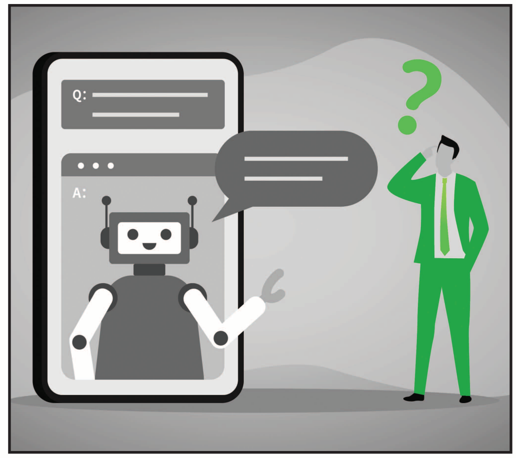
chat.openai.com

bing.com > Chat

bard.google.com

AI has been gradually permeating many aspects of our daily lives. For instance, recommendation engines use AI to suggest merchandise, movies, and music based on what service providers know we already like and what we share in common with other users. AI is used for word suggestion, dictation, language translation, GPS navigation, facial recognition, and fraud detection, to name a few applications. It can read and process forms. It can write legal briefs, movie scripts, poetry, and computer code, with varying degrees of success.

At its core, AI is just software that uses a lot of computational power to generate results probabilistically, most likely to comply with parameters input by users, having culled through large databases of resource data. The chatbot services described above pull from broad resources across the internet which are then scrubbed for appropriate content. Interestingly, these chatbots don't always generate factual results. Some mistakes are generated because the technology draws from unreliable data on the internet. But chatbots can also make mistakes based on what to them seems like appropriate responses, whether or not the responses are



accurate. If AI draws from a database that has biases (and arguably there are some biases which span content across the internet), these biases will be reflected in the chatbot's responses.

Other websites such as Dall-E and Midjourney charge fees, offering to create artwork based on parameters suggested by the user. They draw from images and artwork that are already available on the internet. Such image generation has created copyright infringement issues which have yet to be resolved.

Uses and Abuses

AI is useful because it finds patterns in data. Sometimes these patterns are unconventional or not what humans might detect. That can create opportunities to analyze data differently, but it also creates a risk that the results may transgress social norms, such as inappropriate content for advertisements, suggestions for where ads might be placed, or the use of stereotypes. AI needs oversight. Despite its shortcomings, it's plain to see how AI can revolutionize much of what we do, at least as a productivity tool, and especially as the technology improves over time.

Autonomous driving is another technology based on AI. Although many people don't trust AI to drive cars, one of the leading arguments for autonomous driving is that it ultimately promises to be safer—computers don't get distracted the way people do. Alphabet's Waymo division initially trained its database for autonomous driving by driving cars around and observing the traffic around them.

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It has since augmented this database by having AI create hypothetical situations in a virtual world with intentionally wild drivers, pedestrians, and obstacles, concocting the worst possible scenarios with which an autonomously driven vehicle would ever have to contend. I don't understand why they don't just use the streets of Boston as their model, since the city generated the original obstacle of being "Storrowed."

Companies are making large investments in AI to help them improve customer call centers, teaching, advertising, paralegal case research, cybersecurity, disease diagnosis, drug discovery, and psychological analysis. The technology will displace people from jobs and change industries—that's what technological advancements do. Technological advancements can raise our quality of life by providing better products and services, or by making them more broadly available at lower cost. The economy builds on such progress, finding new ways to employ displaced workers. That's not to say we shouldn't give some consideration to individuals displaced by AI, but society should be optimistic that we can adapt and will be better off for the technology.

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Just as any other tool, AI can be helpful, but it can also be misused. Authoritarian governments will use AI to control their citizens. While AI will help computer hackers to hack more effectively, it will also be used to stop them.

One important danger lies in having too much confidence in AI. Well-trained AI might make the right decisions 99.9% of the time, in which case human overseers might decide to flout their oversight responsibilities. Depending on the application, that 0.1% error rate could have very bad consequences.

AI can be used to make "deepfakes"—altered photographs or videos that are very convincing. It can synthesize voices to sound like those of our loved ones. We won't be able to believe everything we see or hear, and the gullible will be swayed. AI may lead to further political polarization. The next few years will be a period when we learn what limits need to be put on AI, and what needs to change when we can't put limits on AI.

Investment Implications

We are only beginning to understand AI's potential. Because it requires a large amount of computational power, the "picks and shovels" providers are clear beneficiaries. These include Nvidia, the dominant provider of AI semiconductors, as well as the cloud computing providers Amazon, Microsoft, and Alphabet. There will be many other beneficiaries. The industry is developing a large service business comprised of data scientists and consultants to help others set up AI systems, define objectives for them, and manage the results.

Beyond the technology providers, companies are looking to use AI to increase sales and cut costs. Since AI requires large databases from which to learn, companies with large databases—larger companies—may have an advantage. Many smaller companies will partner with larger companies to focus on AI development. What specific companies do with AI will depend on their ability to execute—some will find useful applications to exploit and others will miss them.

To the extent that many companies are looking to exploit the same opportunities afforded by AI, the technological innovation may raise the performance standards for whole industries. Competition within an industry might mean the users of AI cede the benefits to their customers, such that customers benefit more than the companies investing in it. Databases may prove to be more proprietary than the AI algorithms that learn from them, and maybe those databases won't prove to be particularly proprietary in the fullness of time either.

There will be pitfalls along the way. There will be mistakes, maybe even tragic mistakes, as well as regulations and lawsuits. The technology will progress in fits and starts, but we are excited by its prospects. It holds the potential to make our lives better, and it will accelerate technological advancement. With eyes wide open, Woodstock will certainly take AI into account when evaluating individual companies for your portfolios, as AI will change many things.

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> *"We're not quite sure what the government has against retirement plans, but two recent changes to long-established rules raise the question."*

> *"Generally, the IRS 'has two essential functions: responsible tax collection and enforcement.'"*

Tax Update: IRS Changes the Rules of the Game

William H. Darling, CPA – Chairman & CEO

Jeanne M. FitzGerald, CPA – Tax Manager

A tax expert who taught both of us used the phrase "as you'll remember" when either of us would forget a key point in the tax analysis we might be doing. His other favorite saying was "the government is always your partner." He meant that we should not forget the payment of taxes. Income incurs taxes, so don't forget to pay on time and include them in your analysis.

To keep a steady stream of income coming into the US Treasury, your "partner" probably shouldn't change the rules of the game too many times, should probably be polite and civil, and should probably be fairly clear about what they expect.

New Retirement Plan Rules

We're not quite sure what the government has against retirement plans, but two recent changes to long-established rules raise the question. We've previously discussed changes made to inherited IRAs, which were once a staple of Americans' estate planning but now no longer last for the life expectancy of the beneficiary, perhaps a generation. They are now limited, in most cases, to ten years. The other major retirement plan change came recently to 401(k)s. Because Americans' peak earnings and savings years come close to retirement, "catch-up" payments to 401(k)s and other retirement plans have been important tools helping people save enough for retirement, if they were not able to do so earlier. Changes to catch-up payment rules for 401(k)s take effect in January 2024 and limit payments into a 401(k) to those earning less than $145,000 in the prior year.[1] Those payments are allowed to go into a Roth 401(k), however. As we've noted before, the government likes contributions to Roth accounts because they generate current taxes. The financial advisory world touts Roth IRAs because these contributions "grow and can be withdrawn tax free"[2] under current rules. Given government's history here, why would it be assumed that current rules for Roth IRAs will be the same when you want to withdraw "tax free"?

Mission Creep at the IRS?

Two recent incidents of taxpayer run-ins with the IRS, one a newspaper reporter[3] and one a businesswoman[4] illustrate that the IRS and its agents have great latitude about giving their correct name, entering property, accurately describing a tax situation or searching for unrelated personal information. As one commentator put it, "is it now standard for an agent to show up unannounced at your door – in absence of any proof of lawbreaking?"[5] As this was being written, the IRS announced that it is "ending a decades-old policy of making unannounced home and business visits."[6]

As we've described before, "mission creep" is a problem at the IRS. Generally, the IRS "has two essential functions: responsible tax collection and enforcement."[7] What they expect from taxpayers is compliance. When tax payers err, the route back to freedom means becoming a "compliant taxpayer." What is one to think of the recent suggestion from the IRS that it "create an IRS-run electronic tax filing system" to compete with, say, H&R Block, which called the pilot program an unnecessary "solution in search of a problem"?[8] The conflicts of interest for the IRS in determining the "correct tax due" or in correcting its own errors would seem to be insurmountable. One letter to the editor suggested making this service "optional, especially for affluent people who say they don't pay enough. I'm sure the IRS can fix that problem for them."[9] As you'll remember, the rules of the game are changing constantly, the IRS agent "is not your friend," and the government is confused about what it should do.

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

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[1] *Anne Tergesen, "High Earners to Lose A 401(K) Tax Break," WSJ, 7/17/23, p. A1*

[2] *Ibid.*

[3] *Kimberley A. Strassel, "IRS Needs a Cage, Not More Cash," WSJ Opinion, 5/26/23*

[4] *Betsy Sanz, "What IRS Employees Can Do Under the Law," WSJ, 6/23/23*

[5] *Kimberley A. Strassel, "IRS Needs a Cage, Not More Cash," WSJ Opinion, 5/26/23*

[6] *Fatima Hussein, "Unannounced IRS Visits End," Associated Press, 7/24/23*

[7] *Jason Altmire, "The IRS Wants to Prep Your Taxes," WSJ, 6/1/23*

[8] *Richard Rubin, "IRS Will Offer Free Online Tax Prep for Some," WSJ, 5/17/23*

[9] *John Trickett, "Bad Ideas from the IRS to Collect More Taxes," WSJ, 6/8/23*

"Julie was recently recognized by the Women's Federation for Peace USA with their 'Her Story Award.'"

"'The meaning of life is to find your gift. The purpose of life is to give it away.'"
— Pablo Picasso

Shining a Bright Light on an Unsung Hero: Julie Phippen

Maureen J. Murphy, Vice President and Portfolio Manager

We are pleased to shine a well-deserved spotlight on our colleague Julie Phippen, Executive Assistant at our sister company Agawam Trust Company. Julie was recently recognized by the Women's Federation for Peace USA with their "Her Story Award," bestowed on her in recognition of her good works with Sewpportive Friends, the not-for-profit organization she founded in May 2016. Sewpportive Friends is dedicated to health, education and gender equality for young women in rural Zimbabwe who do not have access to feminine hygiene products. We invite you to watch the video on https://www.wfwp.us/herstory (click on "more" under Julie's photo) to celebrate Julie's well-deserved award and hear her extremely humbling and inspiring story. Julie clearly is an unsung hero amongst us!

While many of us spent our summer vacation recharging our batteries at the beach or lake, or sightseeing in Europe or the United States, Julie, along with a small group of dedicated volunteers, headed to Zimbabwe to continue to spread the good works of Sewpportive Friends. This was Julie's seventeenth trip to Zimbabwe. (See *QMP Winter 2021* for more of Julie's story.)

"The meaning of life is to find your gift. The purpose of life is to give it away." These words from Pablo Picasso are so appropriately included on the Sewpportive Friends website. Clearly, Julie appears to have found her gift and she tirelessly channels her heart and energy in giving back.

Congratulations, Julie! We at Woodstock are extremely proud of Julie, and also of her volunteers. To learn more about Sewpportive Friends, visit www.sewpportivefriends.org.

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**.