FINANCIAL DESIGN STUDIO

DESIGNED FOR LIFE

Left to Right: Michelle Smalenberger, Steve Smalenberger, Rob Stoll, Trevore Meyer

Labor Day and Community Service

We all love breaks from the routine. Labor Day, for example, we don't have to go into work and can do what we need at home. What if you did something different this year and gave away your time? You gave it away rather than doing what you wanted. Oftentimes with community service it's amazing how something that costs us nothing could actually be everything to someone else. There are a variety of ways we can serve others.

For example, we've gone to an organization and packed meals that were sent internationally. You could also help out through the local food bank, or by packing backpacks for school.

There are a variety of things to do, something like packing meals doesn't cost you anything you just show up and help. However, something where you are buying a backpack or you're giving items to a food pantry does cost you something. You can try whatever works for you. So this year Financial Design Studio is encouraging you to find something where you can be involved in the community and those around you and use Labor Day or another scheduled day of the year to celebrate your time off.

Entering a Brave New World

Written By: ROB STOLL, CFP®, CFA

In our March 2020 Newsletter – "Reassessing the Investment Landscape" – we looked at what future investment returns could look like in a low interest rate environment. The 10-year U.S. government bond yield had just declined to an all-time low of 0.60% and the Federal Reserve cut short-term interest rates to 0% in response to COVID. Low interest rates have persisted since then, and the Federal Reserve has made it clear that short-term rates will stay near 0% for an extended number of years.

There have been two additional developments that we believe warrant discussion. In our view, these events mark a shift in how investors should think about the environment they're used to investing in. The first is the increasing acceptance of what's called Modern Monetary Theory (MMT). The second is the new approach the Federal Reserve is taking to targeting inflation.

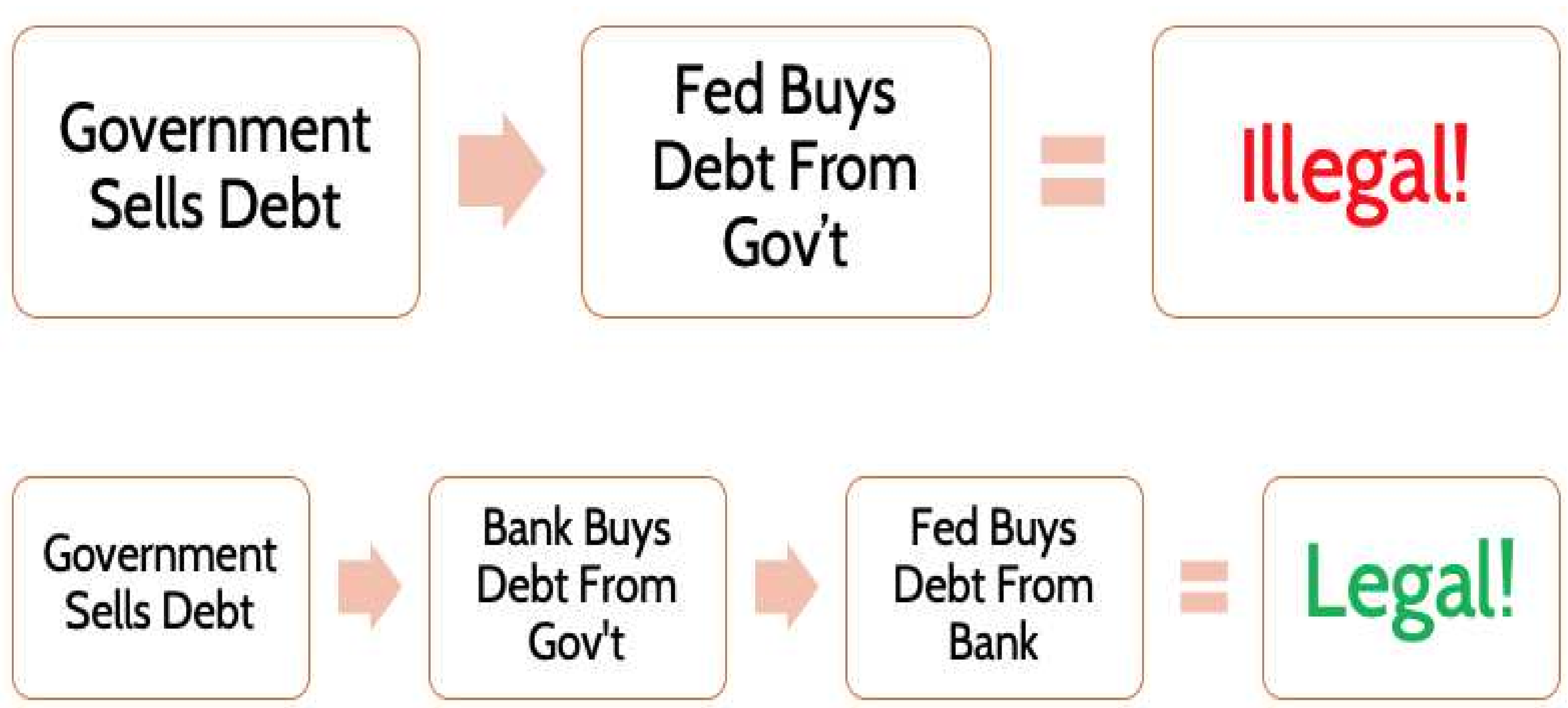
I promise not to get bogged down in the complexities of these changes. We'll go over the basics of these policy shifts so you know what's going on. But the goal with this month's newsletter is that clients understand what these shifts mean for their investments. So sit tight.

The Theory Behind Modern Monetary Theory (MMT)

For as long as any of us has been alive, we've heard endless political debates about Federal budget deficits. The basic argument is that if the government spends too much, future generations will be saddled with having to repay that debt, which will hurt them. "You have to live within your means, or else!"

A new generation of academics isn't so sure. They argue that there's no limit to how much the government can spend as long as there's a dependable buyer of newly issued government debt. They call this philosophy Modern Monetary Theory, or MMT for short.

How would MMT work? The government would ramp up spending. To fund this spending, they'd have to issue lots of new government debt. Because there's a finite amount of debt that private investors can absorb, the Federal Reserve would act as buyer of last resort and buy whatever they needed to buy to keep interest rates low. There's an economic term for when a central bank (i.e. the Fed) buys government debt: it's called "debt monetization."



The interesting thing about this "modern" theory is that it's illegal for the Federal Reserve to "monetize" the government's debt. Congress prohibits the ability of the Federal Reserve to buy new government debt directly from the government. In a classic case of "rules for thee, not for me" the Federal Reserve and U.S. Treasury have a way to get around this rule: using an intermediary. A simple example is below:

What's clear in this chart is that the end result is the same: the Fed buys the debt that's issued by the U.S. government. But they can't buy directly! No, no, no...Congress prohibits that to prevent a wayward Administration from spending the country into oblivion. So big Wall Street banks buy new debt from the government and then flip it over to the Fed, earning a nice fee, of course.

Proponents of Modern Monetary Theory believe it's okay for the Fed to do this. And if the Fed can do this, then there's no longer any limit as to how much the government can spend. You can have your cake (unlimited spending) and eat it too (no consequence to issuing too much debt).

If this sounds too good to be true, it is (in my opinion). MMT seeks to turn thousands of years of human history on its head. If financing unlimited government spending is as easy as having one arm of the government buying debt issued by another arm, are we to believe it's taken until the Year 2020 for politicians to figure this out?

In fact, governments old and new have tried this strategy before and the end result is always the same: inflation. The Germans tried it after World War I and it ended in hyperinflation in the Weimar Republic. Venezuela is doing it today and they too are experiencing high inflation.

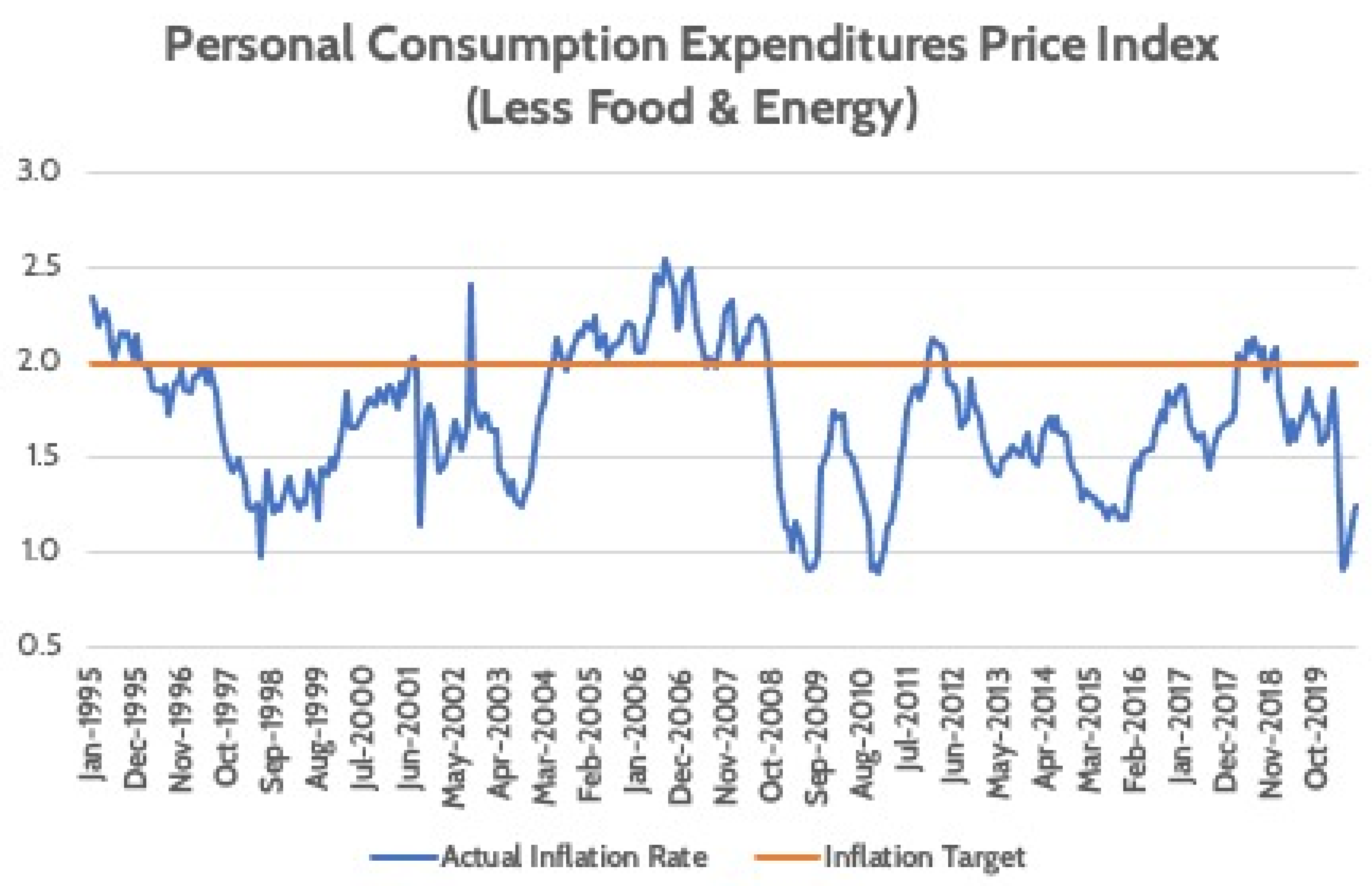
Inflation is Dead; Long Live Inflation!

After the terrible inflationary experience of the 1970's in the U.S., Federal Reserve Chairman Paul Volcker vowed in 1979 to crush inflation once and for all. To do so, he raised interest rates to 20%. This caused two recessions in the early 80's, but was ultimately successful in bringing down inflation.

Inflation eventually fell to around 2% in the 1990's and has stayed around that level ever since. Economists called this period the "Great Moderation" where the economy has been able to grow without causing inflation to rear its ugly head. Unfortunately, successive financial crises in the early 2000's and 2008-2009 caused the level of inflation to fall even further. The Federal Reserve began to panic.

To combat the potential risk of Depression-style deflation, the Fed changed course and decided that some level of inflation was good for the economy. They picked an inflation number out of a hat, stating that they'd keep monetary policy loose until inflation got back up to 2% per year.

Turns out, they haven't been very good at achieving this target. Other than a brief period during the mid-2000's housing bubble, inflation has consistently fallen short of its target.



You might think that they'd be smart enough to ask themselves whether 2.0% inflation is the right target. Why not 1.5%? If I wanted to get down to 100 pounds (currently well north of this level!) I can certainly try getting there but I'd likely starve myself and cause other health issues in the process. Yet this is exactly what the Fed is doing by blindly sticking to this 2.0% number.

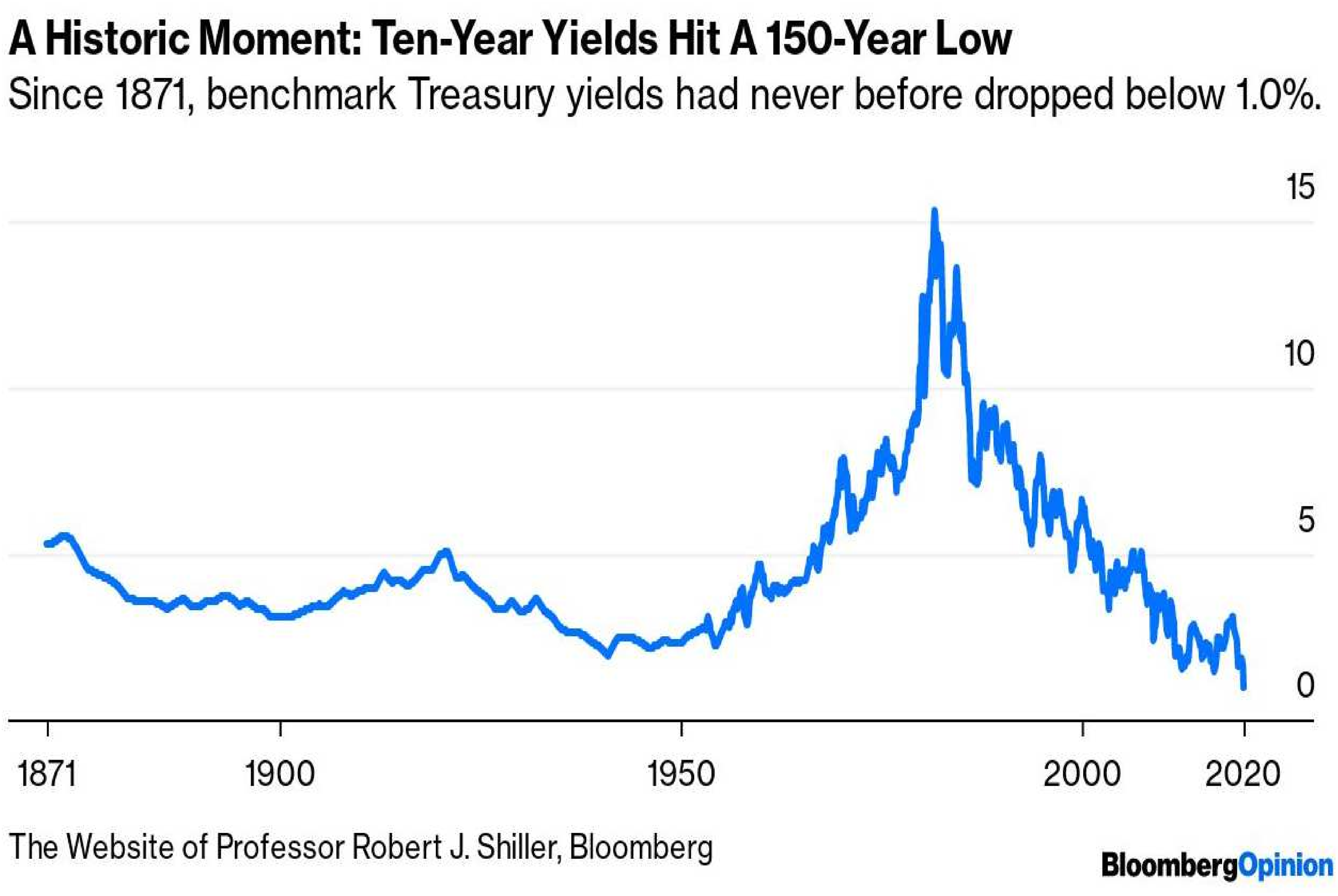
Having failed to achieve 2.0% inflation, current Fed Chairman Jerome Powell gave a speech at the end of August which laid out a new strategy: the Fed will now target an average of 2% inflation over time. Instead of getting back to 2.0% inflation, they want inflation to average 2.0% over some undefined period of time. Why does this small shift in wording make a big difference? We all know how averages work: they're a product of some numbers below the average and some numbers above the average.

Previously, the Fed indicated that it would start to raise interest rates when inflation got to 2.0%. But now they're saying they'll tolerate inflation getting above 2.0%. Put another way, they'll keep monetary policy very loose (i.e. 0% interest rates) until they get inflation above 2.0% consistently. And they'll do whatever they can to see that happen. The 0% interest you see on your savings is likely to be with us for the next 5-10 years. Just like MMT, this policy shift is designed to promote future inflation.

Investing in an Inflationary World

Whether the Fed's new policy or MMT actually results in future inflation is hotly debated in policy circles. But in our view, there's been a seismic shift in mindset in our policy intelligentsia within our country this year that all points in the same direction: inflation. Given that we haven't experienced an inflationary investment environment in 40+ years, it's worth taking time to think about how investors can manage around this risk. What I'm going to outline below are my early thoughts about how we may shift client investments to accommodate this new environment.

First, we need to look at 'duration' of bonds in our portfolios. By duration, I mean there's short-term bonds that mature in 1-3 years, intermediate-term bonds that mature in 5-7 years, and long-term bonds that mature in 10 or more years. The longer the duration, the more sensitive the bond is to changes in interest rates.



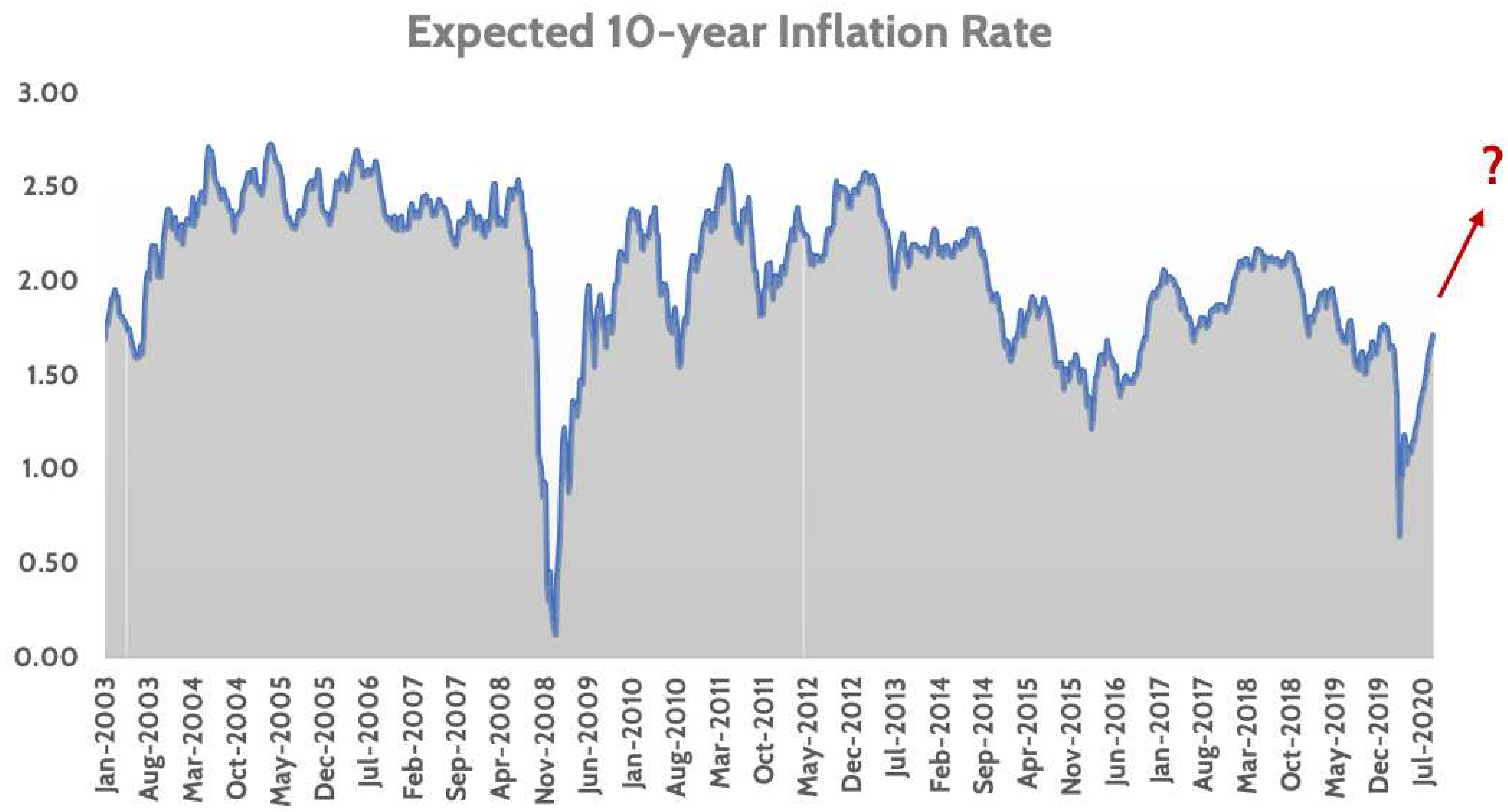
With long-term interest rates at historic lows and not that far from 0%, there's a great deal of interest rate risk from holding long-term bonds if interest rates were to start rising again.

Higher inflation almost always results in higher interest rates. Given that the Fed and MMT proponents are hell-bent on generating higher inflation, there's reason to believe that interest rates may move higher at some point. To combat this potential risk in client portfolios, we may look to shorten the duration of bond holdings.

Second, a shift to Treasury Inflation-Protected Securities (TIPS) may be advantageous. TIPS help protect the "real" value of the bond by increasing its principal by inflation each year.

For example, if you buy a TIPS bond for $100 and inflation is 2% over the next two years, you'd get paid $104.04 when the bond matures in Year 2. With normal bonds, you'd just get your initial $100 investment back plus interest.

There's a trade-off, however. The cost to get inflation protection is that you don't get much interest income along the way. So current income suffers but at least you're protected if the government loses control of inflation, 70's-style.



Source: Federal Reserve Bank of St. Louis; 10-year Breakeven Inflation Rate

The benefit of owning TIPS is that if inflation expectations rise, then they'll perform better than traditional government bonds. Given how low inflation is today, coupled with these pro-inflation policies, it's not unreasonable to think that future inflation expectations will be higher than where they are today.

Third, keeping a well-diversified portfolio of stocks. From a 'duration' perspective, stocks are very long-duration investments. There's no "maturity date" on a stock. Growth stocks that trade at expensive valuations are even more "long duration" as they tend to pay little in dividends.

In our August Newsletter, we talked about the Nifty Fifty Era of the early 70's and how those growth stocks experienced very poor returns starting in 1973. It's no coincidence that their poor performance coincided with the ramp-up of inflation during the 1970's.

Today's stock market is increasingly dominated by very large, expensive, growth stocks. Names like Apple, Amazon, Netflix, and Facebook are great companies. But their stocks have soared so high that we believe they're susceptible to poor performance if inflation starts to take hold.

To combat this, maintaining a well-diversified stock portfolio is critical. We pay close attention to your stock holdings to make sure you're not overly exposed to any one type of stock. As certain asset classes – such as large cap stocks – become dominated by fewer and fewer growth companies, it may be prudent to find other funds that give access to large cap stocks without being dominated by these names.

Finally, there's Gold. In our weekly market update from July 30, 2020 we described Gold as "an odd fellow." It doesn't generate any income, and its value is entirely dependent on what investors think it should be worth. There's no earnings to "value" it on.

Yet we've included an allocation to Gold in client portfolios over the last year as a small hedge against the Fed's current monetary policies. You don't have to read too many of our weekly updates or newsletters to know that I take a dim view of what the Federal Reserve is doing.

Our concern has been and continues to be that the Fed is undertaking policies that will lead to inflation. Gold has traditionally provided protection against higher inflation. Don't be surprised to see Gold and other precious metals remaining in your portfolios for the foreseeable future.

Flip the Switch?

The purpose of this month's newsletter is to give you an idea of our thinking on the evolving investment landscape and how that may impact the investments we include in your portfolios. Any changes won't happen at once. Shifting from a low-inflation investment regime to a potentially higher-inflation environment is monumental shift, and we want to be very careful and pragmatic with how we express these views in client portfolios.

Nor should you expect any shift to be dramatic. It would be wholly irresponsible to put all your money in Gold and TIPS, for example. There's always a risk that the views I outlined above turn out to be completely wrong. Hubris is dangerous when it comes to investing!

Yet these developments since the COVID crisis started increase our conviction that there's an important shift underway. We're becoming more convinced that the combined impact of MMT plus the new Fed mandate gaining wider acceptance in DC policy circles will ultimately be inflationary. With that, a 'tilting' of portfolios in the direction of these inflation-friendlier asset classes is making more sense.

When to Incorporate: Credit Protection

TREVORE MEYER, CFP®, CKA®

When people think about incorporating their business they tend to think of the tax advantages they may get instead of the liability protections. That's actually what I want to encourage you to think about today.

Let's use Mary as an example. Mary started her consulting business 3 years ago and has been doing great consulting work for a number of different clients. When Mary was just getting off the ground she set up her business simply as a sole proprietorship. Now 3 years down the road Mary has a challenging client. Whatever Mary does she can't seem to satisfy this client and now something has gone wrong. Mary is concerned about what is going to happen to her business and her personal assets. Because Mary started her business as a sole proprietorship, all of the assets of her business and her personal net worth are at risk from any lawsuit Mary's challenging client may bring. What Mary could have done is incorporate her business as an LLC or an S-CORP.

There are some things that Mary should be considering before incorporating her business. First, there are going to be additional administrative tasks that she is going to need to make sure get taken care of each and every year. This typically involves an admin cost. In Illinois it typically costs about $150-$300 a year to continue operating an LLC or S-CORP.

Secondly, if Mary were to file as an S-CORP her tax return preparation would change quite significantly. She would now have a tax return for herself and for the business. It's important to note that even though there may be more "busy" work after incorporating your business, the protection that's offered by separating yourself from your business is significant.

Honing in to figure out which makes sense for your business an LLC or an S-CORP really depends on a number of factors. If you would like help trying to figure out which makes the most sense for your business, please reach out and let us know. We'd would love to help!

Custodial Accounts: Non Tax Advantaged Savings Accounts

Written By: MICHELLE SMALENBERGER

Maybe you're trying to plan for your child's future and all the options you look at help you cover college expenses but you just want to save for their future, not only college. You understand that there are tax benefits to saving in college savings accounts, but you want flexibility for how the funds will be used.

Provides flexibility in that funds just need to be used for the child listed on the account. Uses could be for lessons or education costs even though there's no tax benefit. This could also be used for a first-time home purchase if the funds haven't been used yet.

Custodial accounts can be used to save for your child with flexibility in how the funds are used. Here are a few points you want to be aware of when considering this type of account:

So this would become beneficial for a child who gets a full-ride scholarship to a college and now that money saved for them can be used on something else. You avoid the 529 penalty on funds not used for college. While you are the custodian on the account you may even have to submit a receipt to prove the funds are being used for their benefit.

These funds are **fully theirs**. At their age of majority, which in most states is 18 or 21, the funds actually become theirs. So up to this age you are the custodian for the account, but at their age of majority the funds are now completely theirs and you are removed as the custodian. This is important because many parents question whether their 18 or 21 year old will spend the money wisely.

We've seen these accounts handled very well by many young adults who finally end up using the funds for a first-time home purchase. Of course, like any money that belongs to a 21-year-old, parents and grandparents might hesitate with this option. While it is true we've seen these accounts managed well after the now-adult child legally owns the funds we have seen cases were the funds were spent pretty quickly too. These accounts work best when parents work hand-in-hand teaching their children about money so they are ready to handle it well at their age 21.

This is another great account type that provides you some flexibility in saving for your child's future!

Frequently Asked Questions (FAQs)

Are you a Fiduciary?

Yes, we are! This means we have a **duty** to act in **your** best interest. A person acting in a **fiduciary** capacity is held to a high standard of honesty and full disclosure in regard to the client and must not obtain a personal benefit at the expense of the client.

You're Fee-Only: What does that mean?

We have chosen to be a fee-only advisory firm. This means we do not accept any fees or compensation based on product sales. While we know our clients need products like insurance we do not receive any benefit from any source when you buy a product.

How does Financial Planning Work Virtually?

It's amazing how many of our clients move away as we work together. After all, that was part of your goal! We are able to share everything we do in person, virtually. We simply use screen sharing and video software so we can see you and look at the same documents, together.

Are you taking on new clients?

Yes! We are happy to work with friends or relatives that you think would benefit from a Financial Advisor relationship. A quick phone call is all it takes to see if they are a great fit.

Want to share this with someone?

- Know someone who wants to receive this newsletter? Send us the mailing address at team@financialdesignstudio.com
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21660 W. Field Parkway
Suite 118
Deer Park, IL 60010