FINANCIAL DESIGN STUDIO

DESIGNED FOR LIFE

JULY 2021 NEWSLETTER

MID YEAR REVIEW OF THE INVESTMENT LANDSCAPE

BY: ROBERT STOLL, CFP® CFA

It's hard to believe but we're nearing the half-way point in 2021. Six months ago the economy was completely locked down because of COVID. Now, airplanes are full as people rush out to vacation for the first time since 2019. With all that's happened, it's a good time to do a mid-year review of the investment landscape.

Investors Seek Inflation Safety

As we've written about in recent months, inflation is becoming a hot topic in the investment world. Prices for almost everything consumers buy have gone up, from gas at the pump to food to used cars.

Investors have reacted to these price pressures by moving into inflation-friendly asset classes during 2021. Inflation-protected bonds have done better than bonds without such protection. Real estate stocks have done well. Gold is the inflation laggard so far in 2021, but it's important to remember that gold was up +18% in 2019 and +25% in 2020.

Index	Asset Class	Year-to-date Return
S&P 500	U.S. Large Cap	13.7%
S&P 400	U.S. Mid Cap	16.9%
S&P 600	U.S. Small Cap	23.3%
MSCI EAFE	Int'l Developed Markets	10.8%
MSCI EM	Emerging Markets	6.8%
S&P GSCI	Broad Commodities Index	29.0%
Gold	Gold	-6.3%
DJ Global Select Real Estate	Global Real Estate	18.7%
Barclays U.S. Aggregate Bond	Core Bonds	-1.9%
Barclays Treasury Inflation-Linked Bonds	Inflation-protected Bonds	1.4%
iBoxx High Yield Corporate Bonds	High Yield Bonds	2.3%

Financial Design Studio, Inc.; YTD Returns as of June 24, 2021

Small U.S. Stocks Continue to Do Better

Looking at a breakdown of U.S. stocks, we can see a definite performance difference looking at large company stocks ("large caps") vs. small company stocks ("small caps"). This continues a trend that first emerged after the bottom of the stock market in late March 2020.

We believe small caps have gotten a boost from a couple of factors. First, the various COVID stimulus bills that have passed helped consumers and small/medium-sized businesses a lot.

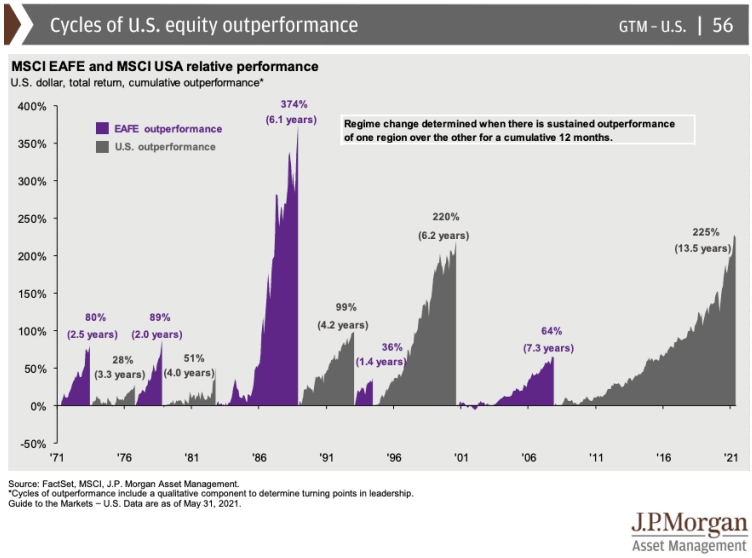
Smaller companies focus on domestic U.S. markets, so support for the U.S. economy has been good for them.

Another reason small stocks have done well is the surging investment activity of retail investors. We noted back in January that penny stocks, in particular, were seeing a lot of interest from small investors. This dynamic has faded somewhat as we've moved through 2021, but remains a factor in small cap outperformance.

The performance diversification between large caps, mid caps, and small caps is a reminder that there's a lot going on under the big umbrella of "U.S. Stocks." Investment diversification is critical to make sure you're not over-exposed to one part of the stock market. It's a big reason we're not a fan of "total stock market" index funds, which are heavily tilted towards large cap stocks.

International Lags, But for How Long?

International stocks continue to lag their U.S. peers. This dynamic has been pretty consistent in recent years and reflects long cycles that U.S. vs. international stocks go through. This chart from J.P. Morgan Asset Management shows us how long these cycles are.



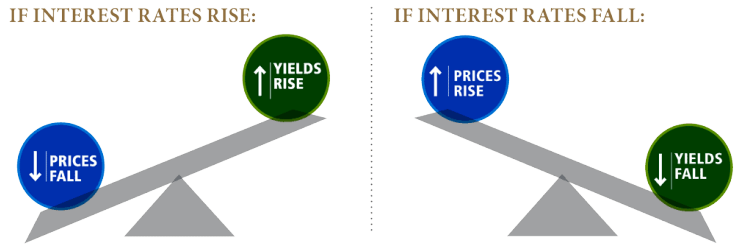
The chart above is looking at international stocks in developed markets, such as Europe and Japan. Emerging markets also have their own cycles doing very well or poorly, as we've noted in the past.

Most of our clients have investment time horizons measured in decades. It's why we include allocations to international stocks in client portfolios.

Bonds Down, But Still the Key to a Diversified Portfolio!

There's an old adage amongst advisors that if your clients have well-diversified portfolios, you'll always be apologizing for something. Leading this year's "apology tour" are core bonds. Core bonds are U.S. government bonds, mortgage bonds, and high-quality corporate bonds.

Why have bonds struggled in 2021? The answer is very simple: interest rates have gone up. We shared this chart in a post on managing interest rate risk in your bond investments. It's very simple but very much to the point!



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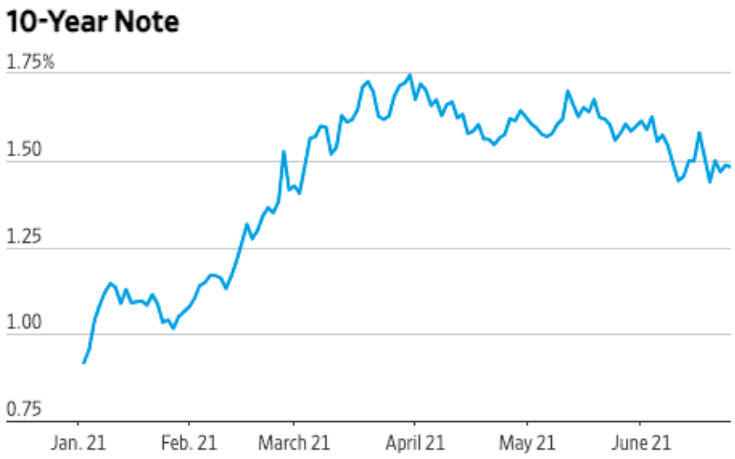


Interest rates are still very low from a historical standpoint, but have risen in 2021. If inflation proves to be sticky, then future rises in interest rates are likely.

No one likes to see a minus sign in front of their investment returns. But it's important to realize that – at least for 2021 – it's a sign that investment diversification is working. When stocks were down over 25% in March 2020, core bonds were actually UP.

Owning non-correlated assets like stocks & bonds together allows us to take advantage of relative moves in these asset classes. Trimming winners and buying losers and then waiting for the trend to reverse itself.

Seeking Inflation Protection

An interesting aspect of what we're seeing in bonds is that inflation-protected bonds are doing much better than bonds that don't have that protection. Inflation-protected bonds are actually up +1.4% year-to-date vs. a -1.9% decline in core bonds.

Gold has lagged after having strong years in 2019 and 2020, but Real Estate has picked up nicely as an inflation hedge. The reason real estate likes inflation is because of the leverage (debt) that's used to buy and hold real estate. If I borrow $100 today to buy real estate and inflation is 3%, I get to pay that $100 back with future (inflated) dollars.

We're in a period of consolidation for the "inflation trade," as many investors call it. The Fed admitted last week that inflation might be a problem, but a lot of inflation-friendly assets sold off on the news. On Wall Street they call that, "Buy the rumor, sell the news." We continue to believe this inflation story is in the very early innings, so keeping some inflation protection is appropriate.

Stay Diversified; Rebalance When Necessary

Well-diversified portfolios help your long-term savings grow with less volatility than if you had all your eggs in one or two baskets. This only works if you have a process to rebalance when your investments stray too far from their targets.

As we head into the summer doldrums, it's not uncommon for markets to tread water. This will especially be the case this year after last year's shut-downs and this year's many summer sporting events, like the Olympics. Traders on Wall Street will be distracted.

But we stand ready to rebalance and make changes if markets start moving. It's what we do, so you can focus on doing life, including having some summer fun!

WILL LABOR SHORTAGE PUSH INFLATION HIGHER?

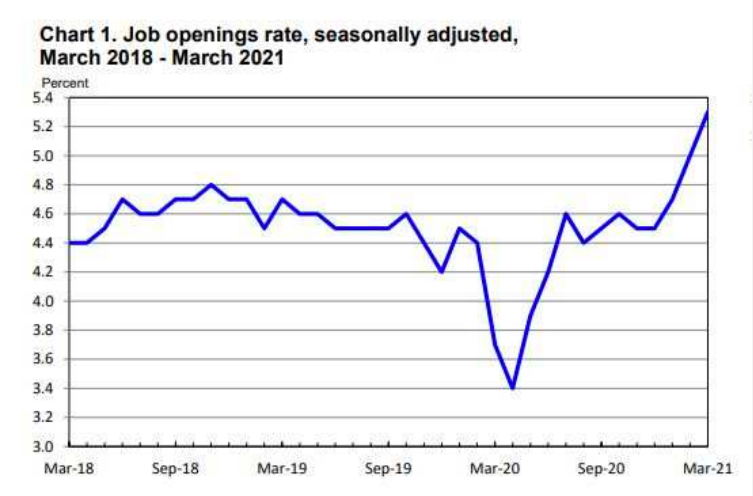
BY: ROBERT STOLL, CFP® CFA

The government reported disappointing employment numbers for April, leading many to question what's going on. Anyone who's been out and about at restaurants and stores has likely seen plenty of Help Wanted signs. Yet jobs growth continues to fall short of expectations. This is causing employers to raise wages, so costs to end-consumers move higher. More and more, inflation is in the news, as we noted last week regarding the global computer chip shortage. The key issue now is whether this emerging labor shortage will push inflation even higher?

Jobs Data in April Was Disappointing

The government released jobs growth data for the month of April last week. With many states reopening from Coronavirus lockdowns, expectations for jobs growth were high. Some analysts were even expecting 1 million new jobs!

Actual job growth in April came in at "just" 266,000 new jobs. While that's a good number in normal times, it was very disappointing to many economy watchers. The unemployment rate actually rose to 6.1%.



There isn't a lack of jobs out there. According to JOLTS, job openings haven't been higher in several years. Small business surveys say the same thing. There are LOTS of jobs out there for anyone who wants one.

Are Higher Unemployment Benefits Holding Jobs Growth Back?

The government responded to the loss of jobs from COVID by enacting extra unemployment benefits. In 2020, this amounted to $600/week of extra unemployment payments. Those extra benefits are now $300/week through the end of September.

Three hundred dollars might not seem like a lot, but if you divide that amount by a 40-hour workweek, that's $7.50/hour. For low-income workers, that's a big boost to their normal unemployment benefit.

This explains why many restaurants, small business, and even big box stores are having trouble finding workers. The days of offering $11/hour starting wages aren't enough to overcome what workers can get on unemployment.

For example, the Chipotle near our FDS office is offering daily, walk-in interviews for anyone that wants a job. They're not only offering $15/hr on Day 1 but also tuition reimbursement, 401(k), paid sick time, and yes, free burritos.

This is a welcome development for many low-income workers who've been left behind over the last 20 years. But there is a cost.

Will Labor Shortage Push Inflation Higher?

Rising wages is a big issue for businesses that run on thin profit markets, as is the case for many big boxes and service-oriented businesses. If they're paying more for labor, someone has to make up the difference. That means higher prices.

Inflation numbers reported this week came in higher than expected. We warned that inflation in April and May were likely to look bad due to "base effects" from the onset of the pandemic a year ago. Economists were quick this week to note these base effects, arguing that bad inflation numbers today are transitory. But are they?

If a real labor shortage emerges, as it appears to have, then that's going to mean higher, stickier inflation. If you're a business having to boost your starting wages from $11/hour to $15/hour, you aren't likely to cut their wage back to $11/hour when the labor shortage ends. That's a permanent increase in wages and prices.

I believe economists are way too sanguine about this labor dynamic. Yes, extra pandemic unemployment benefits will end in September, which would presumably push people back into the job market. But there's a new, monthly cash benefit coming in July for families with children.

How Big of a Boost to Incomes Will the Advance Child Tax Credit Be?

The stimulus signed into law in March, which gave us another round of "stimmy" checks, increased the Child Tax Credit for 2021. The increased child tax credit amounts to $3,000 for children ages 6-17 and $3,600 for children under the age of 6.

A little-noticed wrinkle to this tax credit is that the bill allows people to collect the tax credit ahead of the April 2022 deadline to file 2021 taxes. Starting July, families can receive 50% of this credit as a monthly cash payment.

While the extra unemployment benefits go away after September, this tax credit will continue into December. Congress is currently negotiating extending this tax credit benefit through 2025 as part of the next round of stimulus.

The takeaway with this is that pressure on wages will continue. And as wage pressure continues, so will the pressure on prices at restaurants and stores. And that means durable inflation for consumers.

The investment implications of a sustained increase in inflation cannot be exaggerated. It turns the investment environment we've been used to over the last dozen years on its head.

We at FDS started making moves in Fall 2020 to protect client investments against this emerging inflation risk. We've made further moves in 2021 as well.

As the investment environment changes, it's important to make sure your investments are keeping up with the changing times. Many investors have a set-it-and-forget-it attitude towards their savings. That mindset isn't wrong, but it can lead to missed opportunities. Our job is to make sure we're keeping client investments up to date with the times and reacting quickly when the market gives us opportunities.

ADVANCED CHILD TAX CREDIT DECISION TIME

BY: MICHELLE SMALENBERGER, CFP®

It's that time; time to make the Advanced Child Tax Credit Decision!

You've heard about the upcoming advanced credits that will be paid out starting in mid-July. You can read our earlier article that explains the details and what you need to know. It's important that you reach out to your accountant or tax advisor to make sure you are considering how these tax credits will affect you.

What to consider with the Advanced Child Tax Credit Decision

Here's a short list of items to consider for this decision:

- Is your income the same for the 2021 tax year as it was in 2020? Or did you experience a large increase or decrease due to employment changes?
- How many children do you have and what ages are they?
- Do you normally owe money or receive a refund when you prepare your tax return?

Decision Based on Levels of Income

After researching this for our clients we have come up with a general analysis for varying levels of income and how you may want to respond to receiving these credits. Again, these are not the answers for everyone so be sure to consult your tax professional to confirm your decision.

Group #1: *For Families that earn under $150,000 of annual income (Married Filing Jointly)*

Based on your 2020 Tax Return, we suggest that you do begin collecting the advanced child tax credit that will be sent. Therefore, there is nothing you need to do.

Group #2: *For Families that earn over $150,000 but under $400,000 of annual income (Married Filing Jointly)*

We anticipate that you will be phased out from receiving the full additional child tax credit payments. However, you will still qualify for the $2,000/child credit. Since the credit has been used to reduce your tax liability in the past, we suggest that you opt-out from receiving any advance child tax payments and rather claim on your 2021 Tax Return

Group #3: *For Families that earn over $400,000 of annual income (Married Filing Jointly)*

You will be phased out from receiving the additional child tax credit payments and may potentially be phased out from receiving the $2,000/child credit as well. Having said that, there's nothing that you need to do.

It's important to remember these are simply guidelines! We hope this helps provide general guidance so you can make a decision and for these credits you'll receive soon. This is one example of how we help our clients as questions with finances come up.

SHOULD YOU REFINANCE YOUR HOME?

BY: TREVORE MEYER, CFP®, CKA®

Should you refinance your mortgage? This is a question we've been getting more and more frequently as interest rates have come down. But like any good financial planning answer – it really depends!

It depends on a lot of different variables.

Namely, *what are the interest rates?* What is your current interest rate and what is the new interest rate you might be eligible to qualify for?

Secondly, *what are your closing costs going to be?* How much is it going to cost to close on a refinanced loan?

And finally, *how long do you plan to stay in your existing home?*

Once we have these pieces of information, we can say – in what case is this scenario better than that scenario? We like to look at a couple different ones just know know that we will meet somewhere in the middle.

Refinancing Interest Rates

The things we are evaluating when we are reviewing these is how much interest are you going to pay over the remaining life of the loan. So that is really important because if you are paying more interest, that is more money we are paying to the bank and we don't necessarily have to be paying otherwise.

Refinancing Closing Costs

Next is how long is it going to take to earn back how much we paid in closing costs? If we closed on a loan, but it is going to take 10 years to earn what we paid on those closing costs and we plan to move within 5 years, then maybe it's not the best deal.

Refinancing Monthly Payment

And finally, we want to include, how much your new monthly payment is going to be. If your monthly payment is going to drastically change, then maybe that's not going to work so well for cash flow.

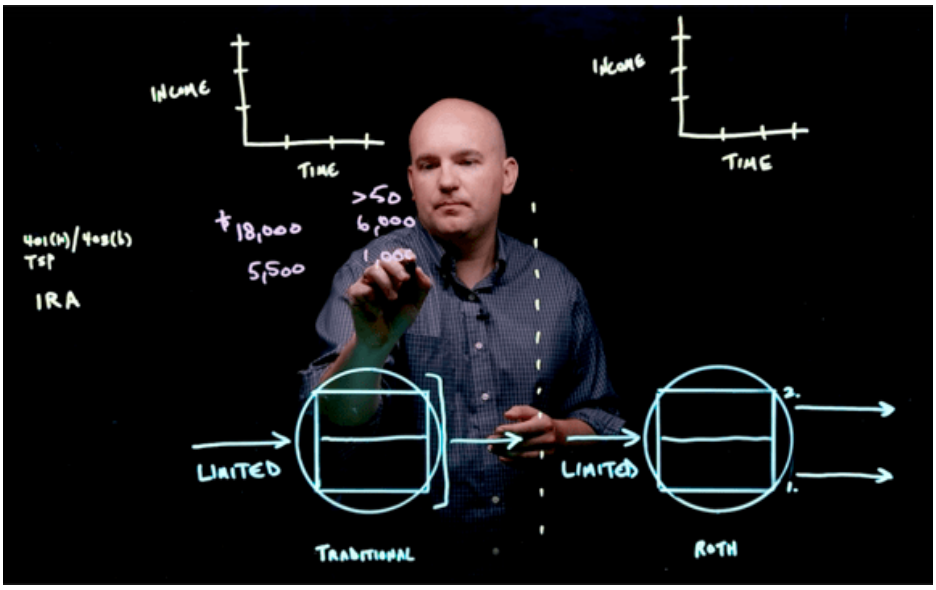
You want to keep in mind all these different factors when evaluating the plan and what makes the most sense for you and your family and help give you the best answer possible.

So if your current mortgage rate is high and it has been some time since you've evaluated your loan, give us a call. We'd love to sit down and help you figure out should you refinance or what makes the most sense for you and your family.

HOW TO DECIDE BETWEEN A TRADITIONAL IRA/401(K) & ROTH IRA/401(K)?

BY: STEPHEN SMALENBERGER, EA

In a prior video we talked about the three different types of account registrations to decide between when saving: Taxable, Tax-Deferred, and Tax-Free. Let's focus on tax deferred and tax free. Both of those are retirement focused so let's walk through how much you can put in, when you can put it in, and the benefits of doing so.



With Tax-Deferred contributions there are annual limits:

- Traditional 401(k), 403(b): You can put in $19,500, plus an additional catch-up of $6,500 if you are over 50 years old.
- Traditional IRA: You can put in $6,000, plus an additional catch-up of $1,000 if you are over 50 years old.

With the Tax-Free contributions there are also annual limits along with income limits:

- Roth 401(k), 403(b): You can put in $19,500, plus an additional catch-up of $6,500 if you are over 50 years old.
- Roth IRA: You can put in $6,000, plus an additional catch-up of $1,000 if you are over 50 years old.

These are both different than taxable accounts where there aren't any limitations on how much you can put in or take out.

Taking a step back to look at these, the amounts you can contribute are the same, so there's no benefit between the two in this area. So then why would you want to put money into a Tax-Deferred (Traditional) versus a Tax-Free (Roth) account?

This really depends on your situation. First, look at your income and how you expect that to be over your career.

If you're a high earner now and then in the future, maybe retirement, it levels off or reduces you may focus your contributions into the Tax-Deferred (Traditional 401(k) or IRA) because you want the benefit of reducing taxable income in these higher earning years.

If you're starting off your career right now with lower income than you expect in future years then the benefit of a Tax-Deferred contribution into a 401(k) or IRA wouldn't be as high. So you could make contributions into a Tax-Free (Roth 401(k) or IRA). Then when the money comes out the funds are tax-free.

In Summary, when would you choose Tax-Deferred over Tax-Free?

With Traditional 401(k) or IRAs these may work best for a high earner in a high tax bracket, so you can get the benefit now of lowering your taxable income. Your funds are also growing tax-deferred so later when withdrawn it will be taxable, but you got the benefit of lower taxes in earlier years.

With a Roth 401(k) or IRA while you are in early years of your career earning less than you will in the future, it can make sense to contribute to a Roth account and receive tax-free growth now.

There are a lot of decisions to make and one of these accounts or some combination of the two may make sense for you. We've seen people miss opportunities along the way. If you feel working with us, laying out a plan and looking at the numbers to make an educated decision would be beneficial, please let us know we are happy to help you!

FREQUENTLY ASKED QUESTIONS

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?
With advances in technology, it is amazing how much we can accomplish virtually! 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. Most forms can also be electronically signed.

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.

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