THE QUARTERLY ADVISOR

CONTENTS

QUARTERLY PERSPECTIVE

There's something about this time of year that causes us to consider what we're thankful for. Maybe it's because the year has been long or because we're excited for the holidays just ahead. Or maybe it's because the word is literally in THANKSgiving?

You might be surprised that a popular goal people have is to GIVE money to help others in need. We thought it may bring you some encouragement to see what you and other like-minded individuals and families have achieved in giving to help others.

Here's the total that our ongoing advisory clients have given since the inception of FDS. This amount includes charitable gifts from 2017 through 2021.

How much money total? **$3,098,647**

- Michelle Smalenberger, CFP®, CEO

WE STARTED A PODCAST!

We started a podcast – it's called Behind the Designs! If you have ever wondered what financial professionals have to say about current economic issues, then this podcast is for you. Every other Tuesday we will share our thoughts on a relevant finance topic. You can find our podcast on our website, any streaming platform, or on Youtube!

HERE ARE OUR CURRENT EPISODES:
Episode 1: Designed for Life: Our Story
Episode 2: Investing Ahead of the Market (Part 1)
Episode 3: Is Buy & Hold Investing Dead? (Part 2)
Episode 4: Holidays and Awkward Finance Questions

Take a listen, share with a friend, and let us know what you think!

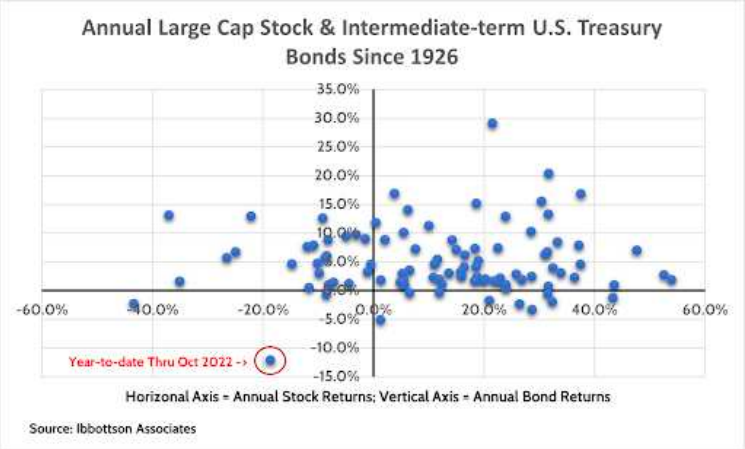
IT'S TIME TO CHANGE YOUR APPROACH TO INVESTING

BY: ROBERT STOLL, CFP® CFA

Investors have endured a rapidly shifting investment landscape over the last 12 months. As we head into 2023, we see scope for inflation to come down and for the Federal Reserve to pause its interest rate hiking cycle. But does that mean we go back to the old ways of investing that we had become accustomed to the last 25 years? Probably not. We think the next 10 years will look more like the 1970s, when investors struggled to out-pace inflation. What's going to change, and how can investors navigate that environment?

INVESTING DIFFICULTY IN 2022 HAS BEEN HISTORIC

The difficult investment environment in 2022 has been historic. We all know that. Stocks have flirted with bear market territory this year while bonds are suffering one of their worst years ever. The scatter plot chart below plots stock and bond returns since 1926. It shows that 2022 is only the third year to record lower stock and government bond prices in the same year.



Ideally, we always want to be in the upper right-hand quadrant, as it represents stocks and bonds rising together. That's the environment that has prevailed over much of the last 30 years.

Looking at the difficult 2022 environment differently, we find this year is one of the worst years for the "60/40" Portfolio. This portfolio comprises 60% Stocks and 40% Bonds and is the bedrock allocation of retirees.

Worst 6 Years for 60/40 Portfolios

	Total Return	Following Year
1931	-26.9%	-1.4%
1937	-20.4%	21.2%
2008	-17.0%	14.9%
2022	-16.0%	???
1974	-13.6%	25.5%
1930	-12.3%	-26.9%

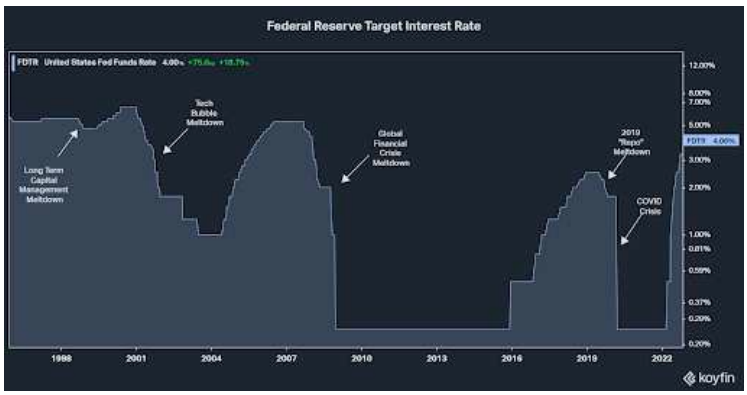
Source: Ibbotson Associates

If you're looking for good news in all this, history suggests somewhat better returns after a year like we're having (putting aside the Great Depression). And going back over the last 20 years, this 60/40 portfolio has generated annual returns of +7.3%, which includes this year and the 2008-2009 financial crisis. Meaning, long-term investors have still done well.

HOW INVESTING WILL CHANGE IN THE NEXT 10 YEARS

The investment landscape is undergoing a major change. And it's important for investors to understand why this change is happening, and what it means for the future. I'll provide more detail on certain aspects of these changes below but we first have to understand how investors have been conditioned to invest since the late 1990s.

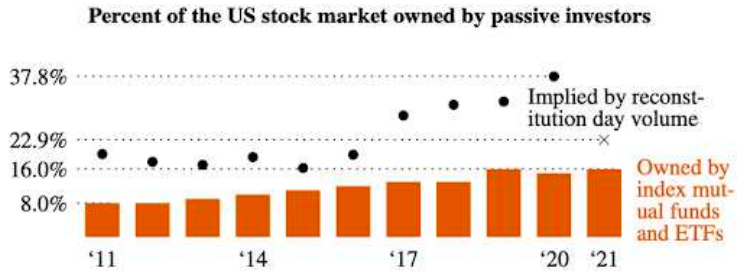
First, investors have placed ultimate faith that central banks - when faced with a crisis - will pull out all the stops to save investors. They have good reason to believe this. The Federal Reserve has repeatedly cut interest rates with every market hiccup, getting more aggressive with their easing each time.



By pushing short-term interest rates to 0% and directly supporting bonds through bond purchases (Quantitative easing), the Fed distorted markets and capital allocation. In human history, it has never been normal for money to be as "free" as it has been the last 20 years. Faced with earning 0% on their savings, they forced investors to put more money in the stock market to get decent returns.

Second, investors have been encouraged to pile into low-cost, passive index funds. Let me be clear. Lower investment expenses are a wonderful thing. And passive investing avoids having to gamble on whether or not a fund company will outperform the markets. Passive investing has helped democratize investing, wresting control away from expensive banks and fund managers.

But it's not all good news. A recent study suggested that upwards of 40% of all investments in the U.S. stock market are held in passive index funds.



Source: "Passive-Ownership Share is Double What You Think It Is" by Alex Chinco & Marco Sammon (9/26/2022)

As a greater percentage of the stock market gets tied up in passive strategies, trading liquidity decreases. And decreased market liquidity means sharper moves in the market when economic conditions change. The last 24 months have been Exhibit A of this. We saw stocks fall -35% in March 2020 at the onset of the pandemic, only to rise 120% from the bottom to January 2022.

Additionally, passive index funds aren't as well-diversified as investors believe. They represent "the market." As parts of the market become distorted, the passive funds representing these indices also get distorted and less diversified. We see this in the dominance of large tech stocks in the benchmark S&P 500 index, where the Technology sector represents almost 30% of the entire index!

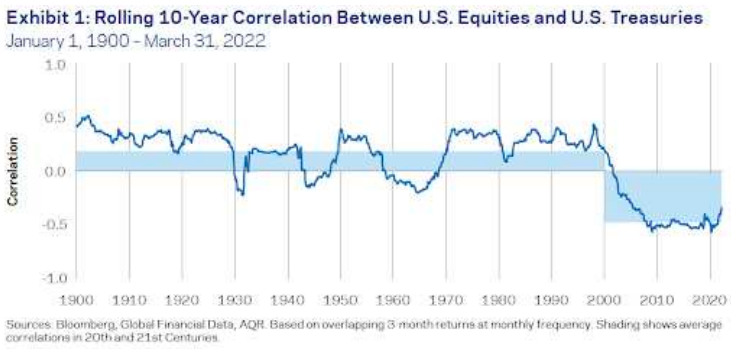
Higher inflation severely challenges these two dynamics. Investors can no longer rely on the Fed to bail them out when stocks go down. If the Fed cuts rates with high inflation, they only encourage more inflation. And because many parts of the market became so distorted over the last several years, passive "buy & hold" investors are facing years of poor returns as those markets - and by definition, those funds - work out the excesses.

WHAT'S CHANGING: STOCKS AND BONDS BECOMING CORRELATED

The most obvious - and significant - change in the market is the rising correlation between stocks and bonds. In layman's terms, a positive correlation means that two things will rise/fall in the same direction. Ice cream sales are positively correlated with rising temperatures. Negative correlations mean that when one thing rises, another thing falls. Sales of boiling hot soup are negatively correlated with rising temperatures.

For the last 20 years, we've gotten used to stocks and bonds having a negative correlation. This has been most clear during market downturns, such as the post-Tech Bubble period and the Great Financial Crisis. In each of those crises, stocks fell materially but bonds performed well, rising in value as interest rates fell with the Fed cutting rates.

2022 has shattered the illusion of stocks and bonds being negatively correlated. Both stocks AND bonds have performed poorly. Is this a temporary aberration?



The excellent chart above by fund management firm AQR shows stock & bond correlations going back to 1900. What we can clearly see is that the last 20 years of negative correlation between these two asset classes has been a historic aberration. The "norm," so to speak, has been for stocks and bonds to move in value together.

It's important to note that the 'normal' correlation between stocks and bonds is still low, even if it has been positive. That means there's still diversification benefits from owning both asset classes through the cycle.

But what this means is that the days of "winning" with a simple "Total Stock Market" fund and "Total Bond Market" fund are over. That worked great when stocks and bonds were negatively correlated. It won't work so well in the future as correlations return to normal, positive, levels.

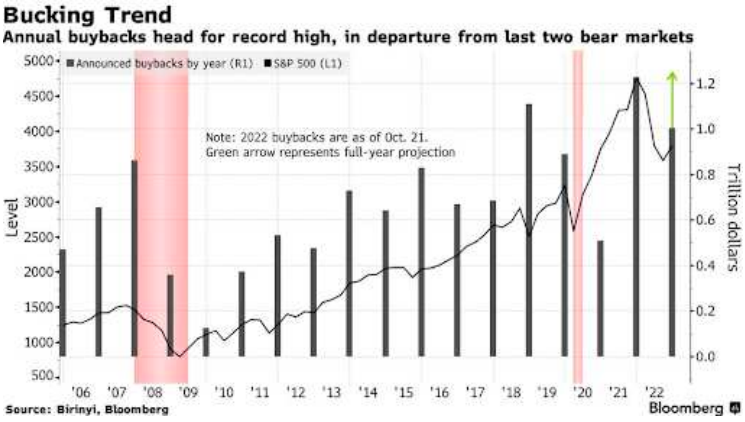
The way investors deal with this normalization of correlations is to be as well-diversified as they can get. There are dozens of asset classes underneath the big headings of "stocks" and "bonds." Investors will have to create portfolios that are more diversified by asset class than they've been used to having. And they'll have to manage those portfolios more actively as different asset classes become cheap or expensive versus other asset classes.

WHAT'S CHANGING: HIGHER INTEREST RATES REDUCE CORPORATE STOCK BUYBACKS

Historically low interest rates have distorted many parts of our society. Companies that normally would have gone bankrupt in recessions were kept alive due to abnormally low borrowing costs. But one of the biggest distortions that low rates wrought was the rise of debt-fuelled stock buybacks.

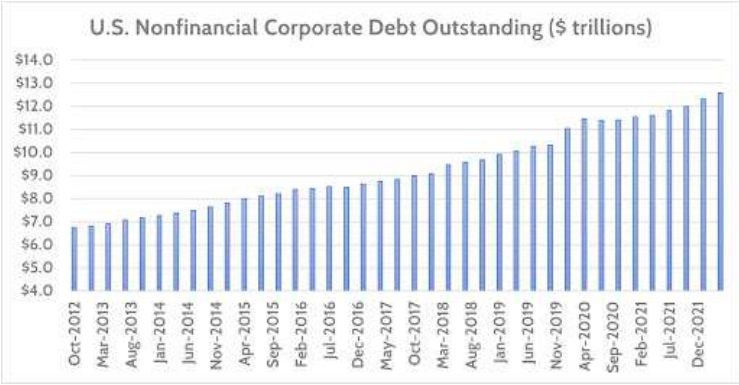
When companies earn a profit, they have a choice how they use those profits. If they're a growing company, they can recycle profits back into the business to fund new investments and growth. If they're a slower-growing company, they can increase the dividends they pay to shareholders. Or, they can "return capital to shareholders" by repurchasing their own stock on the open market.

Stock buybacks have been a key support for stocks for the last 10 years, creating a constant "bid" in the market for stocks. For 2022, it's expected that companies will spend over $1 trillion to buy back their stock, the third time over the last five years that buybacks topped that level.



Buying back stock is a perfectly fine way to create value for shareholders. But the problem is that many companies have engaged in financial engineering to artificially boost their capacity to buy back stocks. They gorged on cheap debt and then used that money to buy back stock.

To put numbers on this, since 2012 companies have increased debt by $5.7 trillion and bought back $8.8 trillion of stock. Not every dollar of new debt has gone to buy back stock, as many companies generate a lot of cash to fund these buybacks. But they wasted a good portion of this debt on non-productive share buybacks whose primary beneficiaries are C-Level management.



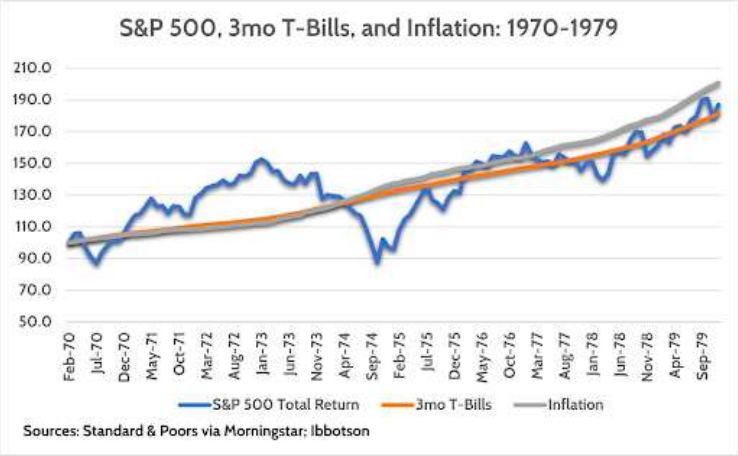
As borrowing costs rise, companies cannot engage in this type of financial engineering like they used to. "Rolling over" this debt (i.e. issuing new debt to pay off old debt) will be cost prohibitive. Worse, they face the prospect of having to divert cash flow away from share buybacks in order to pay off debt as it comes due.

The impact of this is that higher interest rates will remove a large buyer of stocks from the market.

WHAT'S CHANGING: REAL, INFLATION-ADJUSTED RETURNS WILL BE LOWER

The experience of the 1970s taught us that higher inflation makes life difficult for everyone. Lower-income workers without savings see their cost of living diminish as prices on rent, food, and gas eat up a greater proportion of their budget. Higher-income households with lots of savings suffer lower inflation-adjusted returns on their savings and investments.

Speaking frankly, the investment experience of the 1970s was poor. Not only did stocks fail to keep up with the pace of inflation, but they also suffered a lot of volatility throughout the decade.



This is the nature of investing for the long-term. We have great decades where investors gain excess returns (80s, 90s, 2010s) and then some "lost" decades like the 70s and 2000s. If inflation proves to be sticky and high in coming years, we may face one of those "lost" decades.

What's an investor to do? Again, it comes down to being invested in many asset classes. There are some non-traditional asset classes such as commodities, real estate, and industrial mining companies that have exhibited decent performance in inflationary periods.

Probably the biggest change for investors will be to see good ol' cash as an asset class once again. We've endured 20 years of earning nothing on our savings, but that's changing. Deposit and money market rates may reach 5% in the next 12 months.

Cash isn't a good long-term investment as history shows it only keeps up with inflation. Meaning, you earn nothing above the rate of inflation. But in the coming years we see scope to use cash more strategically when managing portfolios. Stocking up on cash in an uncertain market environment and then reinvesting that cash back into markets during downturns.

One thing is clear: Investors have to come to grips with the fact that the "buy & hold" philosophy that worked so well the last 20 years is dead, at least for the next few years. If you're in your 20s or 30s, you can still take that approach and do well, as your retirement is decades away. But if you're in your 40s and 50s approaching retirement - or in retirement already - then taking that approach can really hurt your retirement prospects. A "lost decade" in retirement eats up a good chunk of your remaining investment time horizon.

IT'S TIME TO CHANGE YOUR APPROACH TO INVESTING

We are facing the most significant shift in the investment landscape since the early 1980s, when high inflation from the 1970s was defeated. Instead, we're in the early stages of a new, sustained period of higher inflation. The investment strategies that worked so well when inflation was low and the Federal Reserve was accommodative - buy & hold investing, and passive investing - need to be unlearned to be successful in the coming decade.

To achieve investment success over the next 10 years, you're going to have to be much more engaged with how you're invested. More investment diversification. More active management of your portfolio. More attention paid towards taxes. Little details are going to add up to a big deal when it comes to generating positive investment returns.

It's equally important to approach the coming decade with wide eyes. It's going to be more difficult to make money above the rate of inflation. The days of markets going up double-digits every year - as they've done over the last 10 years - are over.

The most important thing you can do is to engage with a firm like Financial Design Studio to manage your investments. We live and breathe portfolio management every day. Watching market trends,

investing clients in well-diversified portfolios, all while keeping a close eye on taxes. It takes a lot of work, but that's what we're paid to do.

The ongoing financial planning we do for our investment management clients also adds value to your financial life. We help you identify goals and then put real math behind them so you can be confident in the goals you can achieve. Is it time to reach out and see how we can help you?

12 TAX THINGS TO DO BEFORE 12/31

BY: STEPHEN SMALENBERGER, EA

Here are 12 Tax Things to do before 12/31. As we approach the end of the year what should you be thinking about? This is the second most common time people start to think about their finances. It could be because you are spending more money due to Christmas shopping. So you pay attention to how much is available to spend. It could also be that the year is mostly behind you so now you know what total income and deductible items are. Here is a helpful list to guide you through year-end, tax efficiently.

THE LIST OF 12 TAX THINGS TO DO BEFORE 12/31:

INCOME TAX PLANNING ITEMS:

1. **Tax Analysis –** This one is key. Get an understanding of what your tax return is going to look like before you actually file it. This means working with your accountant or CPA. Maybe it's even putting something in Turbo tax yourself, so there are no surprises or "sticker shock" when you actually file your return. Each of the following items will impact what you do so knowing where you stand currently and whether or not you should do any of these other 11 items will be really helpful.

2. **Adjust Tax Withholding –** After you have put that analysis together you will know if you are on track or behind on your withholdings or quarterly payments. You can still make a final quarterly estimated tax payment if you need to, to avoid any underpayment penalty. We discuss how to avoid these underpayment penalties. Or you may consider making adjustments to begin the new year by adjusting your withholdings from your paycheck.

3. **401(k) & Employer Match –** Look at any benefits your employer is offering. If you haven't contributed enough yet to your 401(k) it might make sense to start. Or you can at least get to a point where you meet the company match. You don't want to leave free money on the table.

RETIREMENT PLANNING ITEMS:

4. **IRA's –** This is both traditional and Roth IRA's. Maybe you need to put some into the traditional or some into the Roth IRA. You could also put a combination of the two until you reach your full amount. If you are budgeting it's probably easier to do this all year. But this is one you actually have until April 15th after year-end. You don't have to make a contribution by 12/31, but if you are budgeting and like to stay on track then doing it before year-end is great.

5. **Roth conversions –** This is where you are taking a pre-tax account like a traditional IRA and transferring these assets or investments to a tax-free Roth IRA. It's called a conversion. You have up until 12/31 of each year to accomplish this.

6. **Gains and Loss harvesting –** This involves looking at your investments in your taxable account. What have you sold at gains this year and do you have anything you can sell at losses to offset those? Otherwise if you're in a really low tax bracket, take advantage of the zero tax for capital gain/loss harvesting. You may even want to sell things at gains on purpose to fill up some of the lower brackets that could be taxed at a zero tax rate.

7. **RMDs (Required Minimum Distribution) –** If you are in your retirement years meaning you are 70 ½ plus or 72 years old with the new rule you have to start taking money out of those IRA accounts. If you are no longer working this includes your 401(k). If you are still working you can wait to take the 401(k) RMD. This is money that has to come out of these pre-tax accounts by the end of the year. Don't get overwhelmed that this is just one of the 12 tax things to do before 12/31.

8. **Charitable –** This is one area it is really easy to get behind on supporting the charities and organizations that you appreciate. Look at what you have given year to date. Are you behind? Do you want to catch up? Many organizations can use your support. This can be in the form of cash, a check, non-cash (household items, clothing) donations to goodwill or salvation army, or even with appreciated stock.

If you have investments that have really appreciated over the years you can give those in a really tax efficient way. It can even come from your IRA's. If you are 72 and you are starting to take those RMD's you can do that directly from your IRA and send that to charity. Those are called qualified charitable distributions.

EMPLOYEE BENEFITS & GIVING-RELATED ITEMS

9. **HSA's –** These are Health Savings Accounts. These accounts you put money into are specifically for medical expenses. You can do this through your employer which is the preferred way as it reduces your payroll taxes. Or you can contribute personally with a check. This is one where you have until the end of the year, through payroll, or you have until April 15th of the following year if you are contributing funds by check on your own.
10. **FSA –** A Flex Spending account is another medically related account. This one is known commonly as use-it-or-lose-it. You deposit money in and have until the end of the year to use it or it's gone. There are a few types of plans that allow $500 to be rolled to the next year or there is a grace period, but essentially you need to use it or you'll lose it. Maybe you have some medical procedures you are planning for early next year and if you have met your deductible you could get it done now while you have FSA funds to use.

11. **Gifting –** If you want to help a family member or a friend you can give up to $16,000 a year per person without any tax implications. As long as you stay under the $16,000 per person per year there is no gift tax requirement you have to file.

12. **529's –** Whether you are a parent or a grandparent you may want to start setting up some education funds. Here in Illinois and some certain other states you can contribute funds and also receive a state tax benefit. It doesn't have any effect on federal tax and each state has some different thresholds that have to be met. But you could be allowed to take a state deduction with this contribution too.

REACH OUT IF YOU NEED HELP!

So those are the 12 tax things to do before 12/31. See which ones apply to you or make sense given your current situation. Maybe others are not for this year but other years ahead. We can put together a tax analysis so you know which of these would really impact you. It's never too late to get started either. Even starting a new year ahead you can make changes! If you have any other questions we are always happy to help!

WANT TO SHARE THIS WITH SOMEONE?

Know someone who wants to receive this newsletter?

Send us the mailing address at **team@financialdesignstudio.com** If you prefer to no longer receive this newsletter please email us at **team@financialdesignstudio.com**

$3,098,647

HERE'S THE TOTAL AMOUNT OF CHARITABLE GIFTS THAT OUR ONGOING CLIENTS HAVE GIVEN SINCE THE BEGINNING!

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