Kenneth A. Gilpin CFP

Sound Investments Inc.

1st Quarter 2022

DJIA 34,678.3 S&P 500 4,530.4 Nasdaq 14,220.5

An Uncertain Start

Rising interest rates and the Ukraine war drove a steep stock selloff and a brief rally in the first quarter. In our January client letter we predicted at least 6 or 7 rate increases which, at that time, seemed a bold prediction. Yet, on March 16th, the Federal Reserve Bank raised interest rates ¼ of 1% and announced more rate hikes to come. Consequently, the S&P 500 ended the quarter down -4.7%, the Dow Jones was down -3.3%, the NasDaq was down -8.8%, and the Russell 2000 Small Cap was down -9.5%.

In Barron's Magazine, Randall Forsyth gave a good run down of the economy by asking the question, "Are we in a boom or bust?" He quipped that anyone traveling over Easter would perceive the economy as booming with nary an empty airline seat. But for consumers earning less than $50,000 a year, fuel costs are restraining discretionary spending. A sharp drop in trucking activity indicates a slowdown in big ticket items (i.e. furniture and electronics.) Meanwhile, a hot economy is serving up low unemployment, strong housing starts, and for now, good quarterly earnings. Forsyth, the Barron's writer, is unsure if a recession will take hold but he believes higher rates are needed and control inflation.

Volatility is Normal

While there is no way to predict the future, market history can help us to set expectations and better understand what is normal for the market. The 42 year old chart on the back of this page reminds us of 3 key facts:

1. Gains are common. The S&P 500 was up in 35 of these past 43 years, or 83% of the time.
2. Declines are normal too and have occurred every year, but some years (such as 2020) have been steeper than others (2021). See the chart on the back of this page.
3. Not every decline turns into a bear market. In our last client letter we discussed the effects of higher interest rates and we have gradually been switching out of growth stocks and into value stocks. Value stocks have low price to book ratios and higher dividend yields. The result was that most accounts were down ½ as much as the indexes.

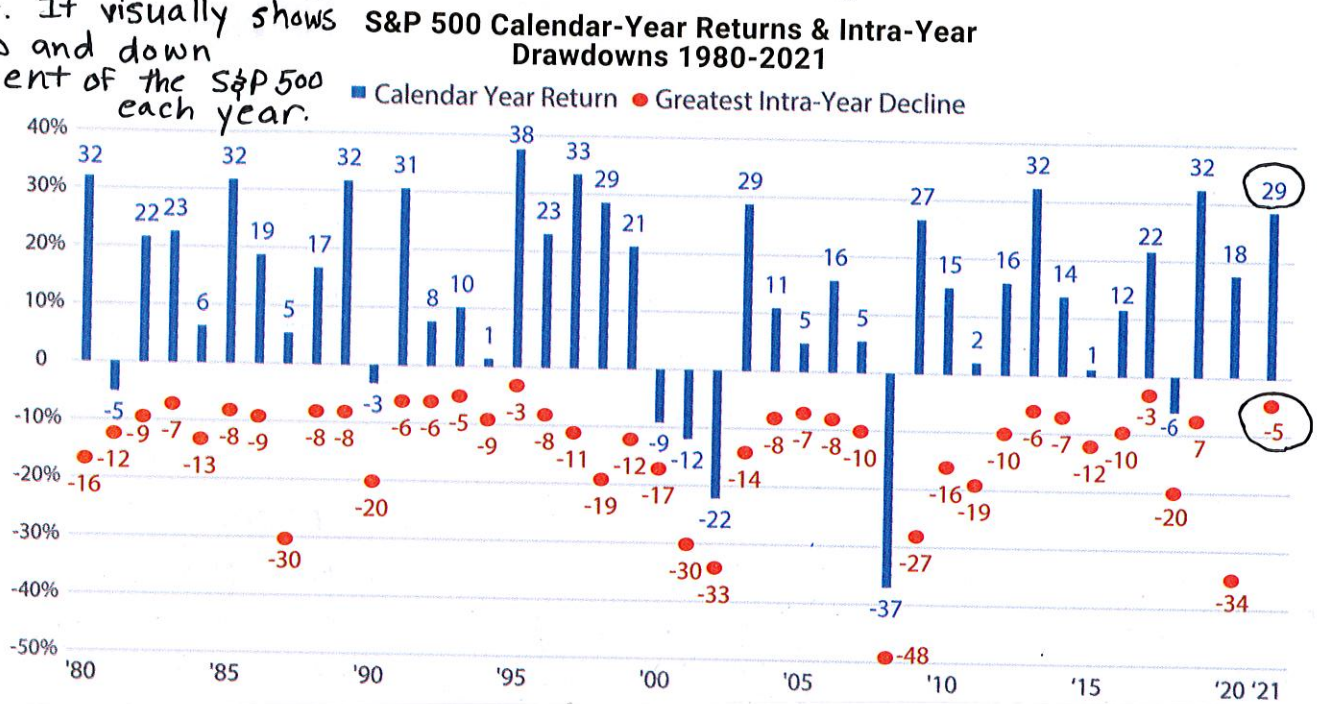
Summary

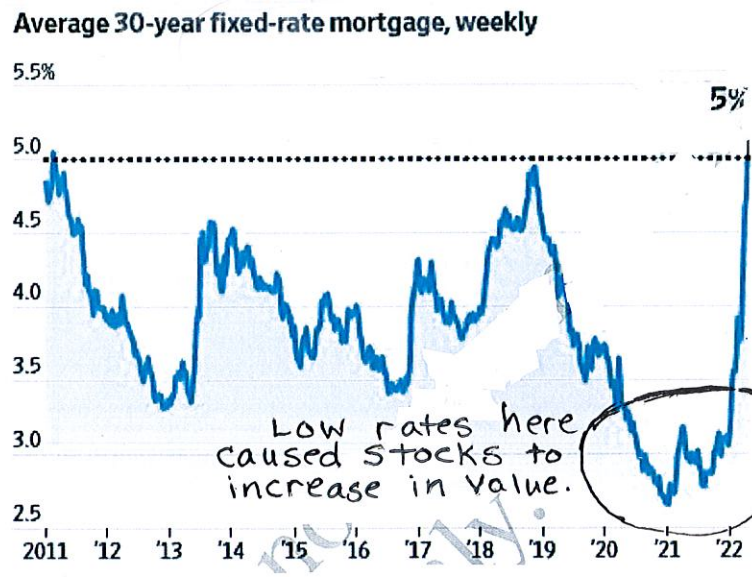
We think interest rates were held down artificially by the Federal Reserve Bank, during the pandemic, to stimulate the economy. For instance; 30 year mortgage rates were below 3% but are now slightly over 5%. Higher interest rates effect a key measure on how stocks are valued, the price earnings ratio. It measures the stock price divided by its earnings. Another way to look at it is how much will investors pay for $1.00 of earnings. Over the last 2 years, interest rates have been low and price / earnings ratios have been above their historical norm of 18 to 19 times to over 22 times earnings. As can be seen on the chart at the bottom of the last page, higher interest rates tend to lower Price / Earnings ratios which reduce equity values. The stock market is trying to recalibrate or come up with a reasonable value to reflect the higher rates.

I hope this letter is not too gloomy. The market has a lot to digest. It's trying to come up with an appropriate price / earnings multiple to reflect the increase in interest rates. We feel that better investment opportunities may be down the road.

This investment letter is mailed quarterly to our clients and friends.

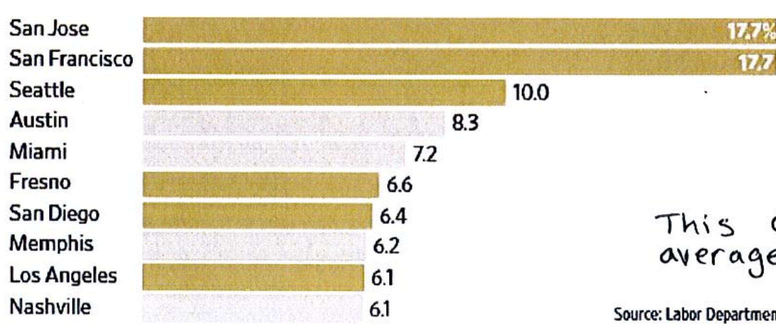
This is a remarkable chart. It visually shows the up and down movement of the S&P 500 each year.





Interest rates fell during the pandemic but since Dec. 2021, rates have spiked up 40%.

Low rates here caused stocks to increase in value.



This chart shows the average increase in wages over the last year.

Source: Labor Departmen

Some Observations

I. The biggest Challenge for employers today is finding enough qualified employees. In prior client letters we discussed how the level of job openings and the quit rate are at an all-time high. Inflation, for the past 12 months was 8.5% while wages grew only 5.6% so in real terms, wages actually declined. This may create a wage spiral that leads to more inflation and higher interest rates.

II. The war in the Ukraine is producing an alarming effect on the world economy. Ukraine and Russia provided about 30% of the world's wheat, around 20% of the world's corn and half of its sunflower oil. Russia is a major producer of oil and gas and exports about 20% of the world's fertilizer. The chart on the back of this page shows the immense price increase of commodities, ranging from gas to copper. Funds or monies are going to be diverted to help increase the supply of these items and that may keep interest rates higher.

III. We think interest rates were held down artificially by the Federal Reserve Bank, during the pandemic, to stimulate the economy. For instance; 30 year mortgage rates were <u>below 3% but are now slightly over 5%</u>. Higher interest rates affect a key measure on how stocks are valued, the price earnings ratio. It measures the stock price divided by its earnings. Another way to look at it is <u>how much will investors pay for $1.00 of earnings.</u> Over the last 2 years interest rates have been low and price / earnings ratios have been <u>above their historical norm of 18 to 19 times to over 22 times earnings.</u> As can be seen on the chart at the bottom of the last page, higher interest rates tend to lower Price / Earnings ratios which reduce equity values. The stock market is trying to recalibrate or come up with a reasonable value to reflect the higher rates.

IV. A recent survey of consumer attitudes fell to a decade-long low on concerns about inflation and the Russian invasion of Ukraine.

I have attached an article from the WSJ discussing how much money one can withdrawal from their retirement plan. Morningstar is suggesting the old rule of taking 4% plus an adjustment for inflation maybe high and may have to be reduced. It's worth the read.

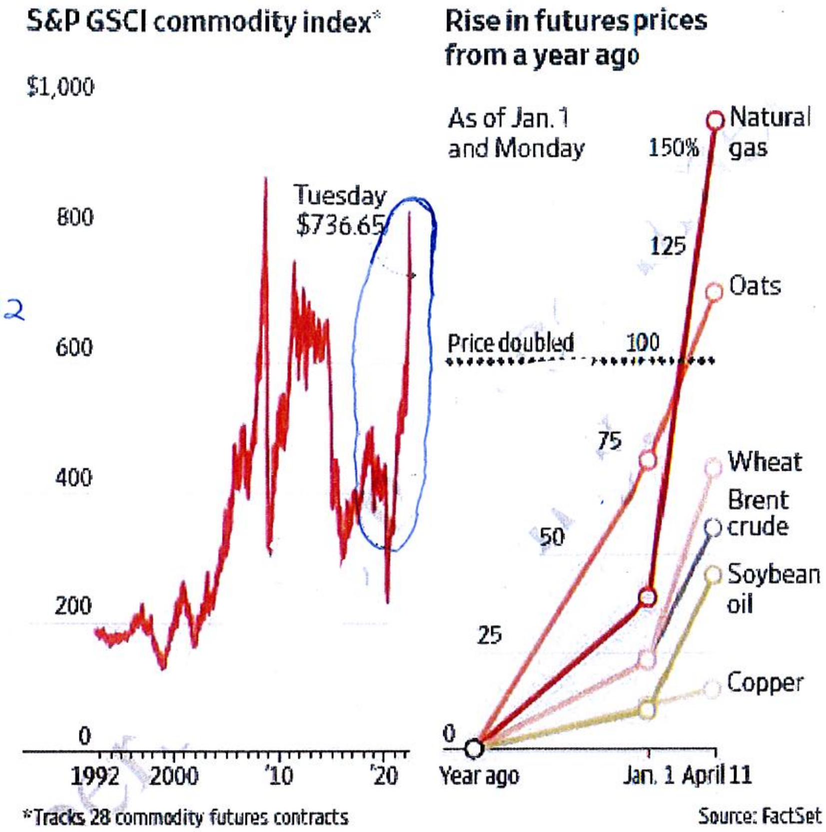
Conclusion

I hope this letter is not too gloomy. The market has a lot to digest. It's trying to come up with an appropriate price /earnings multiple to reflect the increase in interest rates. We feel that better investment opportunities may be down the road. In January, we trimmed the equity exposure and are preparing to trim some more. In the short term, we may lose some return by going to cash but we feel a better opportunity may be a head. Generally, there are good buys a couple of months before the mid-term elections.

We welcome your calls.

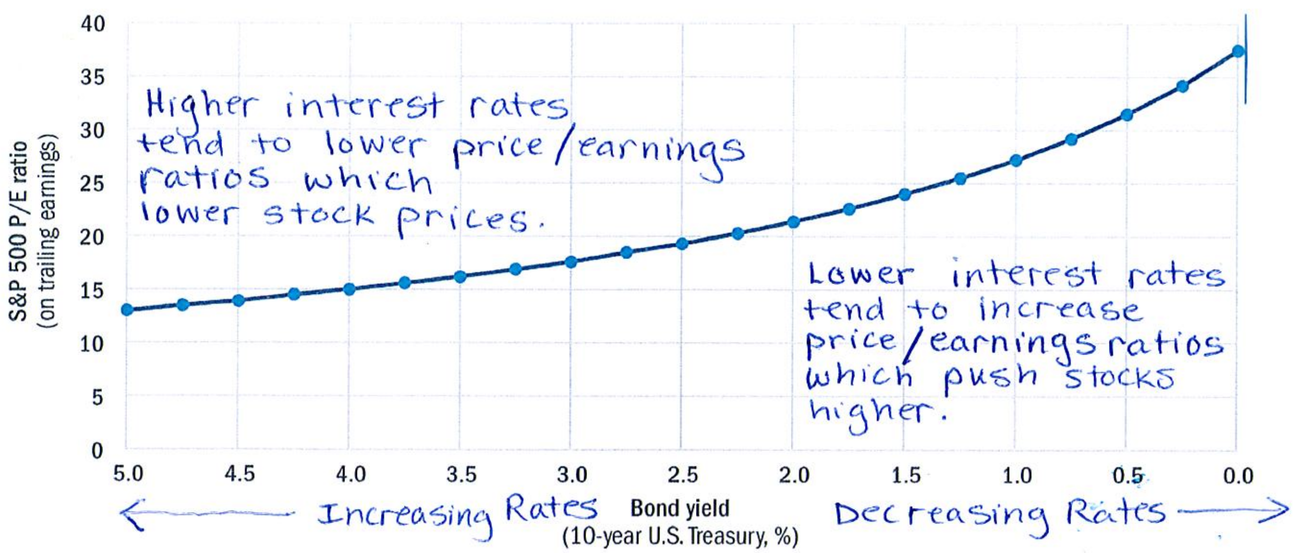
Kenneth A Gilpin CFP, Sound Investments Inc. 913-908-4366

Prices have spiked or doubled in 2021 / 2022



Energy tops the list with oil and gas showing huge gains.

Food costs alone have increased 34%.



Source: Bloomberg, as of 03/31/21. The calculation for P/E ratio takes into consideration the average spread (from June 2003) of 267 basis points between the S&P 500 Index earnings yield and U.S. 10-year bonds. A basis point is 1/100th of a percent. The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. **Past performance does not guarantee future results. It is not possible to invest directly in an index.**

- When bond yields drop, stocks can look more attractive, drawing in investors who are willing to pay more. As a result, the S&P 500 tends to have a higher P/E multiple when interest rates are lower — that's the key point we are at today. If interest rates rise, stock P/Es should head lower.

THE WALL STREET JOURNAL.

The 4% Nest Egg Rule Is Cracking

A strategy for funding our golden years is no longer foolproof. Retirees need to get creative.

BY ANNE TERGESEN

Alongstanding rule of retirement spending is getting a pay cut. But there are ways to ensure the income you receive in your golden years doesn't take a big hit—if you're willing to be flexible.

Conventional wisdom recommends spending no more than 4% of savings in the first year of retirement and adjusting that amount annually to keep pace with inflation. The math behind that rule is changing as market forecasters predict lower returns ahead, potentially shifting the way that millions save and spend for their later years.

People retiring now who want a high degree of certainty their money will last should spend no more than 3.3% of their savings in the first year of a three-decade retirement, and adjust for inflation after that, according to a report released Thursday by investment research firm Morningstar Inc. So someone with a $1 million portfolio would spend $33,000 in the first year of retirement. Assuming 4% inflation, the investor would increase annual income to $34,320 in year two and $35,690 in year three, regardless of the market's formance.

The 4% rule emerged as the wealth-management industry's standard in the 1990s. In the subsequent decades, millions of Americans came to rely on that figure to guide their retirement spending, and with good reason. The 4% strategy would have enabled investors holding 50% in stocks and 50% in bonds to make their money last over the vast majority of 30-year retirements from 1926 to 2020.

That, however, is no longer as likely because future returns are expected to be lower following an extended period of above-average gains. Morningstar researchers simulated future returns over a 30-year period and found that in a quarter of the simulations a half-stock, half-bond portfolio would run out of money if withdrawals stayed at 4%.

One indication the current market may be overvalued is the S& P 500's price/earnings ratio, which measures the price investors pay for a dollar of corporate earnings. It is 23.88 when calculated using recently reported earnings, according to FactSet. That is significantly higher than the 17.35 average over the past 20 years.

"It's counterintuitive, but when the stock market and stock valuations are high, it's the worst time to retire," said Morningstar personal finance director Christine Benz, a co-author of the firm's report.

Morningstar isn't the only corner of the wealth-management universe counseling an adjustment to the 4% rule. Some researchers agree returns are likely to fall, complicating withdrawals. If inflation, which is at a 30-year high, remains at or near today's level for an extended period, even a reduction to 3.3% could prove ..mistic.

There are ways retirees can still spend more than 3.3%, if they are willing to be flexible. They can opt to work longer, reducing the number of years in which they'll have to rely on their nest eggs. They can also delay the year they start taking Social Security; the longer they wait, the higher the monthly check when benefits begin. That, in turn, will reduce the amount they need to withdraw from retirement portfolios.

Some advisers also recommend varying your portfolio withdrawals in response to market moves—taking more when the market is up and less in down periods. How retirees pull that off depends on their tolerance for complexity, how much they wish to leave for heirs and their ability to cut spending.

The simplest version of this plan is to forgo inflation adjustments in any year after which your portfolio incurs losses. The advantage of that tactic, aside from its simplicity, is that it allows for a higher starting spending rate than 3.3%. Assuming you hold 50% in stocks and 50% in bonds, you can withdraw 3.76% at the outset of retirement and still have a 90% chance of not running out of money over 30 years, according to Morningstar.

The method produces a more predictable income stream and leaves more for heirs than most other variable strategies. But there is a downside: While your nominal income may remain steady, your inflation-adjusted income is likely to decline over time—a more painful prospect when inflation is high.

A more complicated approach is to spend more at the outset of your retirement, pull back when markets do badly and raise your withdrawal amount when stocks rise. This so-called guardrails strategy allows someone with a 50% stock and 50% bond portfolio to withdraw 4.72% at the outset of retirement and still have a 90% chance of making their nest egg last 30 years, according to Morningstar.

There are risks, though. Some cutbacks could be large, and a higher starting rate means less money is likely to remain for heirs.

Here's how it could work: Say you retire with $1 million and withdraw 4.72%, or $47,200, in year one. If your portfolio declines from $1 million to $750,000, your $47,200 withdrawal—plus an annual adjustment for inflation—now represents more than 6% of your new $750,000 balance.

Any time your withdrawal rate rises to 5.7% or higher, the guardrails strategy imposes a 10% pay cut for the next year. So after adjusting the $47,200 initial withdrawal for inflation—to $49,088, assuming a 4% inflation rate—this method cuts income by 10%, or $4,908. You would take a $44,180 withdrawal in year two—which could mean forgoing a vacation or putting off a car purchase.

You can give yourself a 10% raise following years in which your withdrawal rate falls by 20% from the initial 4.7% level, to 3.8% or below. Any spending cuts would be suspended in the final 15 years of a 30-year retirement, Ms. Benz said.

In years in which your withdrawal rate is between 3.8% and 5.7%, adjust your most recent withdrawal to keep up with inflation. (Skip the inflation adjustment following a year in which your portfolio sustains a loss.)

"Many of today's retirees will have to be more resourceful to support their income needs," Morningstar said in its report.