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Dodge City, Kansas

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In our most recent commentary, we used the idiom "get out of Dodge" while observing the dangers of the current investment environment. If you are over 50, you likely are familiar with the origin of this phrase. Through 20 seasons of Gunsmoke, Marshall Dillon kept peace in the dangerous frontier town of Dodge City, Kansas. Marshall Dillon quickly removed all troublemakers from Dodge. The less fortunate ended up on the wrong end of Marshall Dillon's Colt .45. Others were simply told to "get out of Dodge".

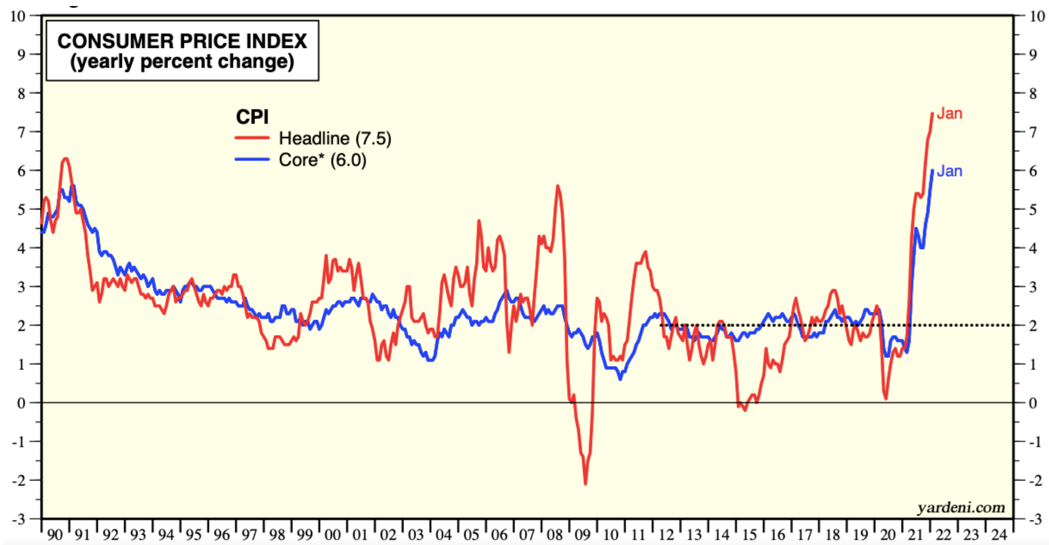
Before moving on from Gunsmoke, we must first recognize the remarkable history of this series and Marshall Dillon. One of our readers picked up on the Gunsmoke reference in our prior commentary and was kind enough to provide us with the following insights and statistics; Gunsmoke is the longest-running drama in television history with 635 episodes. James Arness (Marshall Dillon) was a real-life war hero. He stormed the beaches in WWII and suffered significant injuries from machine gun fire. During the 20-year run of Gunsmoke Marshall Dillon shot 407 bad guys, was himself shot 56 times, knocked unconscious 29 times, and stabbed 3 times. Dodge City truly was a dangerous place.

We suppose comparing the current investment environment to Dodge City is a bit of a hyperbole. Nonetheless, the spirit of our point is still valid. This investment town is becoming increasingly dangerous and we need to remain vigilant in order to keep the peace. Let's start with perspective.

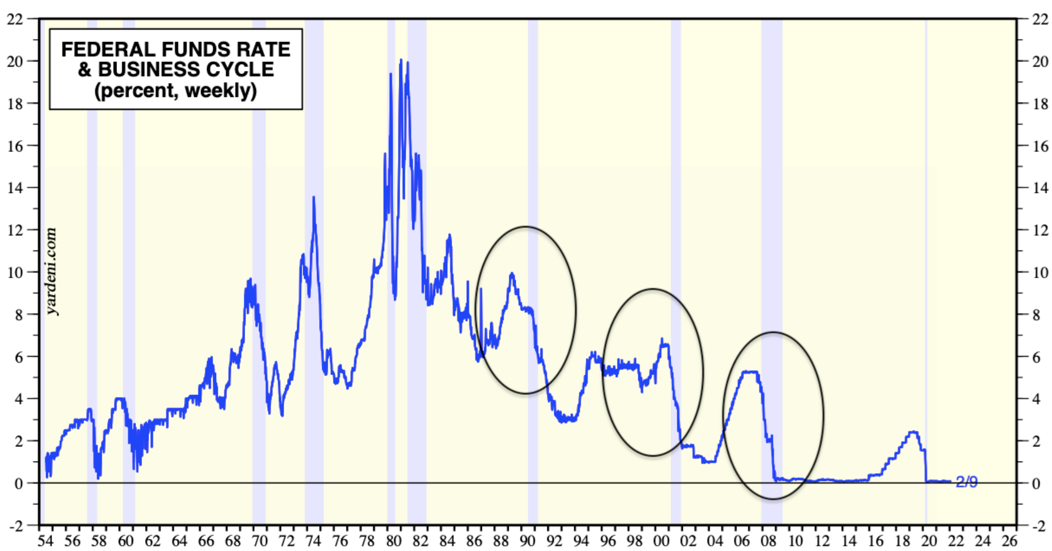
We often communicate the importance of focusing on longer-term investment returns while not letting short-term volatility emotionally impact decision-making. Our reasoning is that short-term movements have little to no explanatory power. However, econometric modeling continues to prove to be an effective tool in forecasting financial markets over longer time frames. Below are financial market returns YTD; they are negative. The columns that follow show longer-term financial market performance, which is materially positive.

	March 23 2020			
Asset Class	YTD	Pandemic Lows	1 Year	3 Year
Mid Cap Growth	-13.40	84.27	-3.92	53.53
Large Cap Growth	-11.87	86.58	10.34	68.42
Small Cap Growth	-10.32	90.67	-6.26	36.63
High Yield	-5.07	31.37	-1.52	14.31
European Equity	-4.35	71.64	7.22	33.77
Asian Equity	-3.98	48.84	-6.67	22.16
Small Cap Value	-3.61	104.87	9.34	35.23
Investment Grade	-2.84	16.49	-3.62	11.35
Gov't Bond	-2.49	-3.46	-4.52	7.10
Mid Cap Value	-2.15	93.27	17.36	41.01
Large Cap Value	-2.02	73.70	17.11	42.12
Cash	-1.34	-1.50	-1.99	4.36

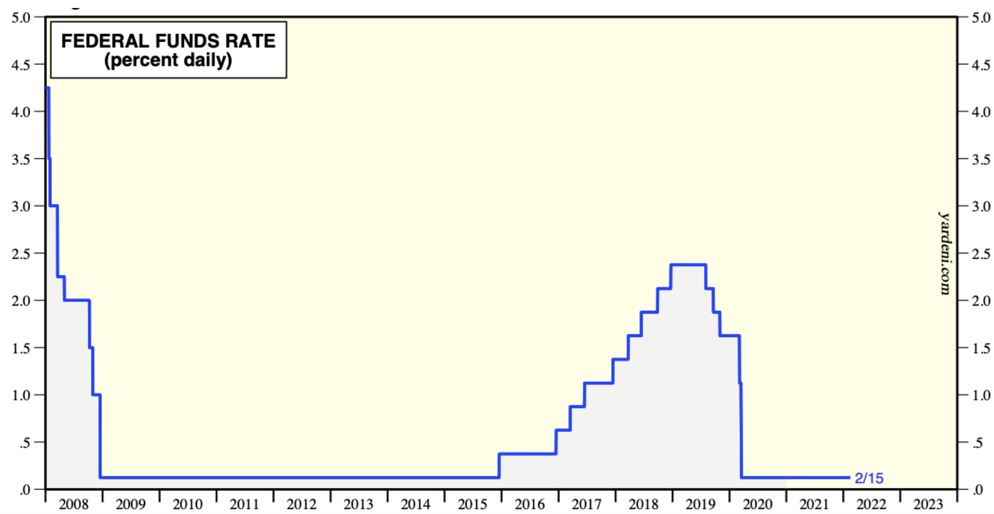
Ideally, we would remove assets from client portfolios at market peaks and replace them at market troughs. Simply put, we aren't that good. Importantly, we understand this. We don't believe anyone is that good and numerous studies on investment manager performance support this. This is a widely referenced study from Cambridge University. The perma-bears often brag about being in cash when markets retreat but often neglect to recall being in cash during periods of massive market appreciation. This is known as Selective Memory Bias. Selective Memory Bias enables casinos to be extremely profitable and gamblers to overlook losses while recalling wins. As much as we would love to spare investors from short-term volatility storms, we know on average we would do more harm than good to long-term portfolio performance if we focused on short-term market timing rather than long-term fundamentals. Most of the explanations for this recent pull-back, such as inflation, aren't new. The inflation warning has been in place for many years and throughout this period of massive appreciation in financial markets and portfolios. We continue to adjust portfolios to reflect what will almost certainly be a higher inflation environment going forward. We still don't believe the apocalypse is imminent. Our expectations are that investors will still earn modest single-digit returns over the next year and therefore shouldn't settle for cash returns. We will need to continue adjusting portfolios to reflect this new economic and investment environment. We will also need to tolerate quite a bit of short-term volatility.



Historically, the stock market has done okay during the first year of a Fed tightening cycle. More specifically, stocks tend to be very volatile, often losing value, when the Fed first raises interest rates and enters into a monetary tightening cycle. Despite this initial volatility, stocks are usually higher a year later. It is not until the economic impact of the Fed tightening takes effect that stocks start to experience systemic issues, potentially leading to a longer duration bear market. The blue shaded areas in the chart below represent recessions. Note how long it takes for a recession to start after the Fed initially raises rates.

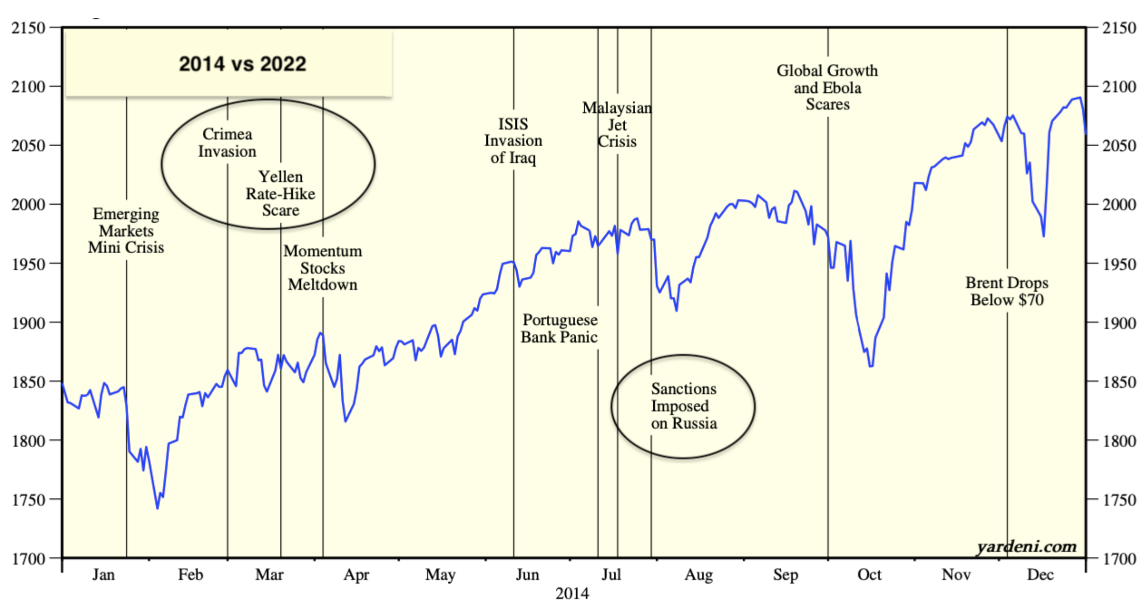


Even though the Fed has not raised interest rates yet, they have clearly indicated that they intend to do so during their March meeting. We would classify the current market period as the start of a Fed tightening cycle and our expectations are for stock markets to follow a similar pattern as they have during previous tightening cycles. The multi-trillion dollar question is whether or not the Fed can orchestrate a "soft landing". A soft landing is when the Fed successfully slows down the economy and gets inflation under control, without causing a recession. We believe the Fed is well behind the inflation curve and they kept their ultra-easy monetary policy in place for much too long. Despite this, we still like their chances of bringing this economy in for a soft landing. The moderating base effects of the CPI index and improved supply chains should do much of the Fed's dirty work for them. We don't expect the Fed Funds Rate will need to be raised at a faster pace than economists anticipate.



Other portfolio adjustments we are making to better position portfolios for this new economic environment include shortening duration (lowering interest rate risk) and reallocating to stocks with more attractive price-to-earnings ratios. In what likely isn't a surprise to anyone, when the Fed increases interest rates, interest rates go higher. Traditionally, the Fed has only controlled short-term interest rates. With the advent of quantitative easing, they now effectively control both short and long-term interest rates. When interest rates go higher, bonds lose value. The reason we continue to maintain some exposure to government bonds despite our negative outlook is the importance of bonds in the portfolio construction process. Government Bonds are the only negatively correlated asset to stocks. This helps to lower the volatility of the aggregate portfolio which in turn allows investors' portfolios to compound more efficiently and accumulate more wealth. (Editorial note; Our editorial board had a heated debate on whether or not readers would be interested in more details regarding efficient compounding and portfolio construction. The central theme of which is the mathematical differences between the geometric and arithmetic mean. Unfortunately, the prettier team lost the vote and this fascinating topic did not make it into the main body of this commentary. Please see the addendum of this commentary for a more detailed explanation about these differences.)

Another reason for the recent sell-off in stocks is the Russia-Ukraine situation. Although we recommend against using geopolitical events as the basis for investment decisions, we also understand we can't ignore events that impact markets. Understandably, markets are unnerved over the threat of war. Despite the potential human tragedy, it's hard to see this event having a significant economic impact, in particular domestically. Of course, if this conflict escalates into a global war that assumption is greatly flawed. Our expectation is this conflict will follow the path of the Crimea conflict. Interestingly, 2014 is looking a lot like 2022. This year is starting off with the Federal Reserve threatening to raise rates, Russians threatening to invade neighboring countries, and lingering concerns about a pandemic. Just like 2014, markets are responding with a late January into February sell-off. There were several more material sell-offs during 2014, including a largely forgotten Ebola scare, but markets managed to finish the year at higher levels than where the year started. We think it's likely 2022 will follow a similar pattern. Both years featured strong economies, tightening monetary policy, and geopolitical unrest. The major economic concern related to the Russian tradition of invading countries during the Olympics is rising energy prices. It's far more concerning for Europe than the United States. Domestically, we aren't reliant on Russian energy and have the ability to increase our domestic energy production to offset global supply issues that would likely arise. If stock markets continue to dip, we will likely increase stock allocations in portfolios in anticipation of an eventual rebound. If geopolitical fears continue to drive long-term interest rates lower, we will further decrease duration.



In summary, it appears the U.S. and global economies are doing just fine despite numerous economic and political concerns. By far, the biggest threat to the economy and financial markets are inflation and the actions of the Federal Reserve. Although the Fed is well behind the inflation curve, they should be able to get inflation under control without crashing the economy. Please reach out to us with any specific concerns you may have regarding your individual portfolios.

Still in Dodge,

The Mommaerts Mahaney Team

Geometric vs. Arithmetic Mean (average) - When measuring investment returns it is the geometric average, not arithmetic average, that matters. Oftentimes investors will reference the arithmetic average not realizing that an arithmetic average is inaccurate and overstates investor returns. The inaccuracy is caused by volatility and that investment returns (ending wealth) are a result of compounding. Understanding this greatly improves investment returns.

Ending wealth is the result of a sequence of return numbers, called terms, arranged in a specific order. Arithmetic sequences measure the difference between each number in the sequence while geometric sequences measure the ratio. Investment returns must be calculated as a geometric average in order to be accurate. The compounding of each successive term is dependent on the previous term. A general principle of the geometric average is that volatility erodes ending wealth. For example;

When an investor gains 50% then loses 50% they often mistakenly believe they have broken even, even though they have lost 25%. An investor that starts with $100 and losses 50% now has $50. A 50% increase only brings them back to $75. The arithmetic average would calculate the return as 0%, the geometric average would properly calculate the return as -25%. The order of the returns is irrelevant. A 50% increase on $100 brings them to $150 but the subsequent 50% decline would bring them back down to $75. This is why we work hard to control the volatility of your portfolios. We are often asked why we hold bonds despite their subpar long-term return average to stocks. As a negatively correlated asset to stocks, bonds help to control volatility during volatile times such as these. This helps to lower volatility and increase returns at the portfolio level.

Jon C Mommaerts, CFP®: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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