BKMWM Newsletter October 2020

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1) Markets

The S&P 500 index jumped roughly 62% off its late March lows before pulling back 8%+ over the last month (as of 09/25/20). Where do we go from here?

We continue to believe that stocks will generally do well and should be held over the long run. However, in the short run we would urge caution. We've come full circle. A year ago we encouraged investors to lean away from risk (not run away). Then, in March we encouraged leaning into risky assets. Today we're back to recommending that clients consider leaning away. Consider trimming a bit and try not to take unnecessary risks.

As we mentioned in our August newsletter, with interest rates extremely low and expected to remain low, for long term investors we believe there is no alternative (TINA) to owning some stocks.

2) Low Interest Rates

More than one half of the world's fixed income securities pay under one percent interest. After adjusting for inflation, most yields are now negative.* Recently the Federal Reserve noted it is likely to keep interest rates low for another three years. These low rates and projections have helped push investors into riskier assets like stocks. Here are some potential consequences of the persistently low rates:

- Over time, stocks may still be more rewarding than low yielding cash and bonds, albeit with considerably more volatility.
- The list of zombie companies, those kept afloat by low interest rates despite excessive borrowing, is likely to grow.
- Lower quality debt will likely benefit more than higher quality debt.
- Corporations may issue less stock and increase stock buybacks. They will fund this by issuing more long-term bonds.
- Borrowers typically are helped and savers are hurt (aka: financial repression).
- Mergers at financial institutions are likely to increase as profit margins remain very thin.

**Source: Milwaukee Journal Sentinel, August 5, 2020.*

3) Life Insurance – A Case Study

As part of our review process we encourage clients to bring us their insurance policies so we can review their structure and appropriateness. In some cases we determine that the need for the insurance has changed and/or diminished, leading us to move out of insurance altogether. However, it's not entirely uncommon to find a situation similar to the one below.

Our client is 65 years old and purchased a Variable Universal Life policy nearly 30 years ago. Back then, his intention was to provide for his young family if he passed, while also building cash value he could eventually use to supplement his retirement income. He had been making payments of $9,200/year and the death benefit was roughly $712,000. His future death benefit was dependent upon on how the policy's investments performed. If the investments did well, the old policy could last past his age 100. If the investments performed poorly the policy could have lapsed.

We requested competitive quotes and found that by doing a tax-free exchange to a new policy he could:

- Potentially reduce his future premiums to zero.
- Possibly ensure that the policy lasts to his age 120 regardless of how the investments perform.
- Lock in his death benefit.
- Withdraw towards chronic care during his lifetime should he need it.

Not every review results in such a clear path to improvement. Often the choices are difficult and involve giving up one potential benefit for another. Please contact us to discuss your situation and insurance needs.

This case study is hypothetical and for discussion purposes only. It is not intended to represent any specific return, yield or investment. Individual experiences referenced above may not reflect the future experience of any one client. The planning process discussed may not be suitable for your personal situation, even if it is similar to the example presented. Past performance is no guarantee of future results. Investing involves risk including the possible loss of principal.

Variable Life Insurance (VLI) is an insurance product and should not be considered an investment, savings, or retirement plan. Nevertheless, VLI cash values and death benefits may fluctuate, so the purchaser should be able to assume investment risks.

4) Parkinson's Second Law

Parkinson's Second Law is one of the most important concepts to help you control your money and enhance your wealth accumulation. First published in the Economist magazine in 1955, English writer C. Northcote Parkinson explained why many people retire without a substantial retirement nest egg regardless of the amount of money they make.

Parkinson's Second Law states that your "expenditures tend to rise to meet your income." When you earn more money, your needs become more and you may end up spending more money. We have seen this in our practice – today many clients are earning several times what they were earning at their first jobs. Yet somehow, they seem to need every single penny to maintain their current lifestyles. No matter how much they make, there never seems to be enough.

So, in order to create wealth, you need to break Parkinson's Second Law by setting limits. Only by resisting the powerful urge to spend everything you make can you begin to accumulate money and move ahead of the crowd. Mastin Kipp said it well, "Be willing to live a few years how most people won't, so that you can live the rest of your life how most people can't."

The follow-up to Parkinson's Second Law is: "If you allow your expenses to increase at a slower rate than your earnings, and you save or invest the difference, you will become financially independent in your working lifetime."

If you or someone you love have difficulty saving, try looking at the situation with an outside perspective. Write down all of the fixed, unavoidable monthly costs and limit expenditures temporarily to these amounts. Carefully examine every expense. Question each line item as though you were analyzing someone else's expenses. Halt all non-essential expenses. Look for ways to permanently dial back monthly spending.

Next, set a goal to save and invest 50 percent of any increase you receive in your earnings each year. Learn to live on the rest. This still leaves you the other 50 percent to do with as you desire. Do this for the remaining years of your career if you want to increase your retirement savings.

Please contact us if you'd like to discuss how to formulate a plan to save and invest more while spending less. We are here to help you break Parkinson's Second Law.

5) Taxes Today or Taxes Tomorrow?

We can't always decide when we pay taxes. If you have earned income from a job or pension, you can't just decide when you pay taxes on that income. However, if your company offers a 401(k) or 403(b) plan you may be able to do just that. Many company retirement plans allow for both pre-tax (Traditional) contributions and after-tax (Roth) contributions. If you choose to make Traditional contributions then you're choosing to pay taxes later at an unknown tax rate. If you make Roth contributions then you're choosing to pay taxes on that income today at a known tax rate.

Similarly, if you already have pre-tax money in an IRA or company retirement plan, you may be able to convert some, or all of your balance to a Roth IRA. You would owe taxes based on the amount you convert. Future withdrawals would then be tax-free to you and/or your heirs.

This topic is important to consider right now because there is an election coming up and the two leading candidates have expressed disparate viewpoints on the future trajectory of income taxes. If you feel that your tax rate today is lower than it will be in your future withdrawal years, then perhaps "locking-in" today's tax rates (contributing to a Roth IRA/Roth 401(k) and/or converting to a Roth) will prove to be a prudent move. Please call us to discuss your situation and options.

Current 2020 Tax Brackets

Rate	For Single Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over
10%	$0	$0
12%	$9,875	$19,750
22%	$40,125	$80,250
24%	$85,525	$171,050
32%	$163,300	$326,600
35%	$207,350	$414,700
37%	$518,400	$622,050

Source: www.irs.gov

6) Broken Eggs

We all know the old adage "Don't put all your eggs in one basket," and intuitively apply it to our investments by diversifying. Let's dissect this common knowledge a bit further. Imagine you have ten eggs in just one basket and you tend to drop that basket 10% of the time. There is a 90% chance that you will arrive home without a single casualty. There's also a 10% chance of an unmitigated calamity. If, instead, you spread your eggs across 10 baskets, it is overwhelmingly likely that you will reach home with most of your eggs intact – you'd average nine surviving eggs if you did it enough times – but you also created a 90% chance that you'll break an egg.

If you're anything like most people, you really wanted all 10 of your eggs. By diversifying you actually increased the likelihood that you wouldn't be completely satisfied. It turns out that the more effective you are at spreading out your risk, the more likely you are to experience partial losses and fractional disappointment. This is why in the investing world, diversification could also be called "efficient, intelligent regret."

So, why diversify when investing? Answer: Modern Portfolio Theory

It is easy to see why diversification – the reduction of portfolio risk by spreading exposure across asset classes – is an effective way to mitigate risk in your portfolio. The Capital Asset Pricing Model gives us the not-so-surprising premise that all investors are inherently risk-averse, and a rational investor will only take on more risk if there is the potential for a higher return. The marriage of diversification and risk aversion yields a concept known as Modern Portfolio Theory.

Modern Portfolio Theory (MPT) is a framework for constructing portfolios so as to maximize the expected return for a given level of risk.* Each of us has a certain degree of risk we are willing to take with our investments. We base our risk tolerance on things like life situation, time horizon, and personal preference. With MPT if you help us determine how much risk is appropriate for you, we will attempt to construct a portfolio with the highest potential return given that degree of risk.

The key insight of MPT is that when analyzing a portfolio, it is not sufficient to evaluate each investment's risk individually. Each investment must also be viewed in relation to the overall portfolio in order to optimize efficiency. In practice, this is primarily done through the examination of correlations: how different asset classes move in relationship to each other. It does your portfolio no good to own two different investments if whenever one goes down, the other moves in lockstep, even if the risk of each investment is appropriate when viewed individually. In an ideal portfolio, we find a combined harmony of investments that both move opposite of each other, and have no correlating movement at all.

Building a portfolio of harmonizing correlations takes the emotional tribulations of diversification even a step further. Diversifying greatly increases the chances of having singular disappointments. Diversifying with uncorrelated and negatively correlated assets virtually guarantees it. Thankfully, Modern Portfolio Theory tells us that these idiosyncratic investment shortcomings are merely essential growing pains on the road to maximizing your portfolio without adopting undue risk.

So, while none of us would expect to see underperforming assets in our portfolio and smile, the smartest among us just might!

**Source: The Journal of Finance, volume 7, issue 1, p. 77 – 91. 1952.*

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Financial advisors whose mission is to positively impact lives.