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WISDOM *for* GENERATIONS

THE GREAT UNWIND

By Lloyd K. Wong
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Flash back ten years ago to late 2007 and early 2008. George W. Bush was serving his second term as President. Crocs were in style. The new Apple iPhone supplanted the Blackberry as the mobile phone to own. You could stream Netflix shows on your Roku device. Amazon introduced its Kindle e-reader. And, as we all remember perhaps too well, the subprime mortgage crisis was wreaking havoc on the markets, resulting in the fall of Bear Stearns and Lehman Brothers. The economy was losing hundreds of thousands of jobs each month and the future appeared bleak as the U.S. faced its worst financial crisis since the Great Depression of the 1930's.

In response to a weakening economy, the Federal Reserve (the "Fed") took extraordinary monetary policy actions to bring some semblance of stability and liquidity back into the markets. The first "tool" the Fed pulled from their monetary policy toolkit was the Federal Funds Rate. The Federal Funds Rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to each other for overnight loans of funds, and represents the cost of very short-term borrowing. Through a series of interest rate reductions during unscheduled emergency meetings, the quick-acting accommodative Fed attempted to both stimulate the economy and stabilize financial markets by lowering the Federal Funds Rate from 5.25% in August 2007 to 1.50% in October 2008—a dramatic difference of 3.75% over a 14-month period (see the shaded portion of the chart below).

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Impact of Federal Reserve Actions on Interest Rates

Sources: Federal Open Market Committee, Federal Reserve Bank of St. Louis

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While financial markets stabilized due to the sharp cuts in the Federal Funds Rate during this period, the economy still did not respond to the Fed's efforts to support it. With real interest rates (the amount of interest a saver or lender receives after adjusting for the impact of inflation) approaching zero, starting in November of 2008 the Fed embarked on "Plan B" through the first of three rounds of unconventional "quantitative easing." Quantitative easing is another "tool" the Fed used to stimulate the economy. By buying up both short-term and long-term U.S. Treasuries and mortgage-backed bonds, the Fed sought to increase the money supply (the total amount of money in circulation in the country) and bank lending. As a result, between 2008 and 2015 the Fed's balance sheet grew from $900 billion to $4.5 trillion (see the chart on the previous page, right-hand scale).

As the Fed continued to monitor progress toward its dual goals of low inflation and low unemployment, it managed to stimulate the economy and provide liquidity while maintaining a stable inflation range (neither deflationary nor inflationary). About a year after the first round of quantitative easing began, the economy rebounded and Gross Domestic Product (GDP) has since grown at a "not too hot, not too cold" Goldilocks rate of approximately 2.2% per year. The Federal Funds Rate remained at a record low targeted range of 0.00%-0.25% for seven years. Recognizing that it was important to gain some amplitude in interest rates so that they would have some ability to lower rates in the event of a recession, the Fed started hiking interest rates again in December 2015. The Fed has raised interest rates five times since then. The Federal Funds rate currently stands at 1.50%-1.75% and the Fed is expected to raise rates at least two more times this year. The Fed has approached interest rate hikes in a gradual and methodical manner, being careful not to raise rates unless the economy is healthy enough to sustain them. The challenge for the Fed remains, as they continue the delicate balancing act of trying to increase borrowing costs enough to prevent the economy from overheating but not so much as to push the economy into a recession.

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We are now at the next chapter in a grand experiment as the Fed begins unwinding years of unprecedented quantitative easing—the "great unwind." In October 2017 the Fed began allowing billions of dollars of securities on its balance sheet to mature each month without reinvesting the proceeds; the amount of maturing bonds will gradually increase each quarter over the next year. Undoubtedly, this will be a slow multi-year process and may contribute to higher interest rates due to this consequential increased supply of Treasuries. Remember, bond prices and bond yields have an inverse relationship; as prices decrease, yields increase. Therefore, if supply outstrips demand, Treasury prices could potentially decline and Treasury yields increase.

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Contributing further to supply, recently-passed tax cuts and increased government spending have necessitated the issuance of additional Treasury debt. The Treasury Department is poised to sell an additional $27 billion in new debt issuance, as well as introduce a new two-month Treasury bill later this year.

Demand is another important variable in the equation. During the Fed's rounds of quantitative easing, foreign demand of U.S. Treasuries remained high and kept downward pressure on interest rates. From 2000 to 2015, foreign central banks bought anywhere from 50% to 80% of all new marketable debt issued by the Treasury. Since 2015 foreign demand of U.S. Treasuries has waned; during the past 12 months, foreign central banks and the Fed bought the equivalent of 18% of new issuance. And, if this past April's ten-year auction where foreign and international investors' purchase of just 13% is any indication of this continuing trend, there are growing worries that some of the U.S.'s biggest (foreign) creditors may be stepping aside, just as the Treasury is ramping up sales and the Fed continues its "great unwind." Continued weakening demand for Treasuries could potentially further boost supply. It remains to be seen whether other buyers will step in or if supply will outstrip demand, putting upward pressure on interest rates.

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Just how much control the Fed has over interest rates through its mon-

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> "The yield on the ten-year U.S. Treasury bond briefly breached the 3% level intraday in April 2018—a level not seen since 2013—and is breaching it again at the time of this writing."

etary policy is debatable. The yield on the ten-year U.S. Treasury bond briefly breached the 3% level intraday in April 2018—a level not seen since 2013—and is breaching it again at the time of this writing. In fact, the ten-year Treasury has been hovering in a trading range right around 3% for a few months now. Why does this 3% level matter? Many bond traders consider the 3% level to represent a psychological hurdle, which, if exceeded by a key yet unknown amount, could free interest rates to go higher.

Let's consider the impact raising rates might have on various players in the economy.

WHAT DO HIGHER INTEREST RATES MEAN FOR THE U.S. GOVERNMENT?

For the government, higher interest rates will result in higher interest costs, as interest payments currently comprise 37% of the discretionary portion of the U.S. budget deficit. As interest rates creep higher, the interest on interest payments could increase exponentially, further increasing the deficit.

WHAT DO HIGHER INTEREST RATES MEAN FOR BUSINESSES AND CORPORATIONS?

For businesses, higher interest rates mean higher borrowing costs on loans. Coupled with a record 17-year low unemployment rate of 3.9% and possibly higher inflation, higher interest rates could result in higher labor costs and higher inputs for costs of goods. Business spending may decelerate if it is too costly to borrow to grow and expand. Poorly executed capital ventures, mergers and acquisitions may prove to be costlier if they are made with leverage during an environment of higher interest rates.

WHAT DO HIGHER INTEREST RATES MEAN FOR CONSUMERS?

It depends. For pensioners, higher interest rates would mean higher savings rates and, perhaps, more disposable income, which may help boost the economy. Higher interest rates could translate into higher coupon rates and reinvestment rates for bond investors. Savers would also benefit, but it is highly unlikely they will see Certificate of Deposit rates approach 18% any time soon, as they did in the early 1980's. Conversely, it is equally as unlikely that borrowers of credit would experience the high double-digit credit card rates of that same era. While interest rates have inched higher, they are still at relative historical lows and the "great unwind" will be a slow and steady process. For home borrowers, higher interest rates will translate to higher mortgage costs. Spenders may see higher prices on goods and services as corporations and businesses try to push their higher labor and goods costs through to the buyer.

WILL THE "GREAT UNWIND" LEAD TO HIGHER INFLATION?

It remains to be seen whether the "great unwind" and its corresponding increasing interest rates will have an inflationary effect on the economy. A bustling economy will foster higher domestic demand as well as higher imports, both of which could possibly have an inflationary effect. Trade tariffs and higher oil prices may fuel inflation as well.

However, other factors stemming from demographics, technology, and globalization may serve to dampen inflation. As an increasing number of Baby Boomers retire from the work force, their younger counterparts, who typically earn lower wages, will replace them and minimize wage pressures. Technology and innovation have improved productivity and lowered the costs of goods and services, putting a lid on inflationary pressures. The recently passed tax bill may motivate corporations that are benefitting from lower taxes to increase spending on technology, boosting productivity and muting inflationary pressures further. Global competition has given businesses the flexibility to suppress wage pressures, as they are able to source low-cost labor from abroad. If we experience inflation, its practical impact will depend on the degree of influence held by the multiple factors at play, the impacts of which often counterbalance each other.

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The only thing that is certain is that there will be uncertainty. This equates to higher volatility in both credit and equity markets. We recommend a defensive posture in the face of heightened volatility. To achieve this, we suggest that interest rate sensitivity be minimized in bond portfolios. Additionally, balanced portfolios of stocks and bonds ought to be constructed with enough equity exposure to earn sufficient returns to beat inflation in order to preserve purchasing power. As always, we advocate maintaining a high-quality, diversified portfolio and a long-term perspective. ◆

A VERY SHORT COURSE IN BEHAVIORAL FINANCE

By Roger L. Gewecke, Jr.
CFA

Behavioral finance is the study of traditional finance theories coupled with the study of psychology. Three Nobel Prizes in economics have been awarded to professors for their advances in behavioral finance. One of the recipients, Professor Daniel Kahneman of Princeton University, wrote a *New York Times* bestseller, *Thinking, Fast and Slow*, and was the subject of another, *The Undoing Project*, written by Michael Lewis. Reflecting the increased importance ascribed to the field, college courses in behavioral finance are now common at top universities across the United States.

Traditional finance studies a fictional person known as "rational economic man," an automaton who possesses perfect information and is able to perfectly process that information in order to reach his personal economic goals and, by the way, is also able to flawlessly adjust to new and contradictory information as it appears. Do you know anyone like that? Neither do I!

Behavioral finance studies what *real* people do and why they do it. Unlike traditional finance—which assumes that any deviation from rational economic man means that humans are irrational—behavioral finance assumes that we are rational and normal. It utilizes observed investor behavior, using things like actual studies of investors' brokerage statements, in the hope of finding ways to optimize investing results going forward. It has been found that investors make errors that are consistent and predictable due to a variety of common biases.

This article describes a few of these biases so we can be aware of them and hopefully minimize their impact on our investing efforts. The astute reader will notice these same biases are present in many other areas of human life. There is great value in being able to recognize and correct these biases in your thinking processes, but admittedly it is far easier to spot them in other people than it is to spot them in yourself!

The first behavioral bias we will discuss is ***overconfidence***. Although well-founded confidence is a fine thing and is quite useful in many ways, studies have shown that many of us, including company CEOs, physicians, lawyers, students, and Wall Street analysts, are overconfident in their ability to predict the future. They maintain that overconfidence by only remembering their accurate forecasts while conveniently forgetting those that don't turn out as they expected.

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How does this overconfidence hurt investment returns? Overconfident investors tend to trade more frequently, purchase higher-risk stocks, and have under-diversified portfolios. These investors have a high level of conviction in their ability to make the right call at the right time. After all, if you *just knew* which stock would perform the best over the next few years, you would simply buy that one and diversification would be unnecessary. The only problem with that is, as the old saying goes, "the only thing difficult to predict is the future," and most of us would not want to risk our future standard of living on a few high-risk investments.

Excessive trading also hurts long-term investment results. Professors Brad Barber and Terrance Odean studied 38,000 brokerage accounts and divided them into quintiles based on their level of portfolio turnover, which is the rate at which the investor bought and sold stocks. They found that those whose turnover was in the lowest 20% group had an 18.4% average annual return over the time period measured from 1991 to 1997 versus those whose turnover was in the highest 20% group and whose annual return was 11.5%, almost 7% lower per year. The study also did not reveal good results for men, who traded more often than women did and consequently showed lower portfolio returns.

Traditional finance also assumes that investors understand risk and return, and wish to earn the highest level of return available for the amount of risk they are willing to take. But surveys of investors show that investors' ***perceptions of risk and potential returns*** change based on recent returns in the markets in which they invest. In February 2000, after a prolonged stock market rise, Gallup (a management consulting company known for the public opinion polls it conducts) polled investors as to whether it was a good time to invest in the financial markets; 78 percent said that it was. After the markets suffered a 50 percent decline over the next three years, Gallup asked the question again; this time, with much lower prices for investors to prospectively take advantage of, only 41 percent answered that it was a good time to invest. The same principle can apply to other investments as well, such as gold and real estate. Maybe former heavyweight champion Mike Tyson was right about not only boxing but also investors' risk tolerance when he said about a vanquished opponent, "They all have a plan until they get hit."

Traditional finance assumes that investors view their investments and

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wealth-producing ability as one unified whole, with all the elements fitting together perfectly and the risks and returns from each perfectly offsetting one another in order for an investor to safely reach their individual goals. Certainly that would be an optimal way for one to operate, but is that how people really manage their money?

Behavioral finance asserts that people often use ***mental accounting***, with different pockets of money being saved for different purposes with different time frames, such as daily living expenses, college funding and retirement funding. Mental accounting leads to a pyramid-like approach to money management, with different layers of the pyramid representing different types of investments to serve their individual purposes. The base of the pyramid represents safer investments, such as cash and emergency funds, which are used in order to fund daily living expenses and to insure oneself against loss of income. Intermediate-term investments, such as college funding, might represent the next level of the pyramid, and are funded with more growth-oriented investments until the child gets closer to college age. Retirement funding would reside on the next and higher level, with even more growth-oriented investments in order to fund an even longer time frame. If there is money left over for the top of the pyramid, investors might select a few speculative "get-rich quick" types of investments if they feel there will be no threat to their standard of living.

Though many Nobel Prize winners and finance professors might frown upon this pyramid approach and the mental accounting that leads to it as suboptimal, it works well for many people, and isn't that the point? It is, after all, *your* money.

It is our hope that you have enjoyed our little trip into these few areas of behavioral finance and can utilize some of these principles to benefit your financial future. Clifford Swan's investment team works hard through its due diligence processes in an effort to minimize these biases for the benefit of our clients. Those who might wish to delve deeper into these topics should consider reading the aforementioned *Thinking, Fast and Slow* or *Finance for Normal People: How Investors and Markets Behave* by Meir Statman. ◆

CALL TO ACTION: LET'S TALK TO OUR KIDS ABOUT MONEY

By Linda Davis Taylor

Give your children money, and they'll usually find a way to spend it. *Teach them* how money *really* works, and they can change the world.

This modern-day take on an ancient proverb is not the lesson that most young people are taught. Despite increased focus on training for a competitive global economy, an essential ingredient our kids need to succeed is often left to chance: financial responsibility.

$59 trillion will transition from older generations to Generation X and millennials over the next 30 years. Thanks to the convergence of societal trends—including higher educational attainment rates, greater earning power of women, and longer lives—Generation X and millennials will have more influence and control over greater amounts of wealth than any generation before. The growing number of inheritors making more financial decisions of all kinds will have a compounding impact on what they do with the increased financial assets they will earn, own and control.

Yet there's a huge problem at the crux of this transition: young people still aren't taught about money and investing, and this knowledge gap puts many of them at a distinct disadvantage when they get into the driver's seat for significant financial decisions.

This is exactly why the recent research by the Women's Philanthropy Institute[1] (WPI) about the generational transmission of philanthropy, especially between parents and daughters, is a wake-up call and offers a new way to think about kids and money.

The research found that when parents practiced charitable giving, their children as adults were significantly more likely to give themselves. This relationship is especially significant for daughters, who are even *more* likely to follow in their parents' footsteps when it comes to philanthropy. Giving habits formed early in life stuck with these young people, long after they had left their parents' homes. They kept giving, and they kept giving more.

WPI's research suggests that parents can use charitable giving as a means of creating a dialogue about money with their children, and that dialogue can be

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an effective way to teach other money skills as well, such as spending, saving, and investing. If giving habits can be learned from family members then why not other money lessons? Financial literacy + generosity = good results.

If this powerful triumvirate—money, investing, and philanthropy—can be harnessed as a means of engaging our children to be bold economic leaders, future generations will be better prepared to use their considerable financial influence to create the lives they want to have in the world they want to inhabit, through a strategic combination of conscious spending, wise investing, and philanthropy. The long-term impact on families and society can be huge.

All the top philanthropists with whom I have worked have supported these findings. They have told me that they learned a crucial lesson from their parents: that having sound financial skills goes hand-in-hand with achieving significant philanthropic impact. These influential citizens were fortunate to have parents who served as financial and philanthropic mentors, and were as such well-positioned to make big financial decisions once they took over the reins.

My experience working with affluent young people has revealed that they don't lack interest in making good financial decisions; they know that money is key to their progress. Contrary to those who characterize the next generation as undisciplined and without focus, I've found these young people inspiring and passionate. They intuitively want to use their financial resources to advance the concerns they *care* about, whether that is their family, career, community, or a larger societal issue.

The challenge however is that many young people experience a disconnect between the concept of having a worthy goal and the knowledge of how to take the financial steps necessary to make a dream a reality. This can partly be attributed to our educational system's failure to teach money skills. Financial education falls squarely on the shoulders of parents, and it's a hard job to do.

As parents, most of us want our kids to have "better" lives than we've had. "Better" is often translated to "more" and the "more" we give our kids, the less likely it is that they develop the financial skills needed to build and grow wealth to achieve financial security. Our admirable desire to "give them the best of everything" can encourage excessive dependency and a lack of purpose.

Ironically, this tendency can create an unfortunate blind spot for them. Without the financial skills to understand how the whole system works—both its potential risks, and its rewards—young people may not adequately understand their true financial picture. Unless we take clear and tangible actions to teach them to link spending, saving and investing to reach specific financial goals, they may put their own financial security at risk, or their big plans on permanent hold.

"So, it's not surprising to me that when our kids DO receive training, encouragement, and opportunity, they respond with interest and follow through on that interest with effective actions."

So, it's not surprising to me that when our kids DO receive training, encouragement, and opportunity, they respond with interest and follow through on that interest with effective actions. The next generation will be better prepared and highly motivated to act if we continue to mentor them. Clifford Swan Investment Counselors can be a resource for you and your family for financial education.

WPI's findings, therefore, offer a compelling path forward. Encouraging our children to embrace the power of money will enable them to enjoy the majesty of it, and create the change they want to see in the world. Teaching family values isn't out of style; it's needed now more than ever. ◆

This article was adapted from "Women's Rising Power: More Money Means More Giving," published by Thrive Global on May 17, 2018.

1. Mesch, Debra, et al. *Women Give 2018: Transmitting Generosity to Daughters and Sons.* Women's Philanthropy Institute, Indiana University Lilly Family School of Philanthropy, 2018.

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