notes from the Assabet Vol. XX No. 1

First Quarter, 2022

Long Time, No Inflation

Getting familiar again with inflation. How do you like paying $4-5 a gallon for "regular?" Economic news coverage aside, that's where our inflation sensitivity begins: with gas and food. In the grocery store, awareness can grow slowly. An increase of 55 cents for cereal, a relatively low cost product, doesn't get our attention. But as we begin to note the climbing amount of the total grocery bill, we notice the inflation rate. Over time, sometimes a short time, the inflation rate escalates and becomes painfully apparent in high cost items such as cars or houses. We are affected in intimate ways. Inflation is personal.

Consumers suffer when the inflation rate climbs. Yet we have a generation with little inflation experience. In the first half of 2022, the inflation rate reached a 40 year high of 7.9%, February 2021 to 2022. This followed a fairly comfortable 10 years of economic expansion and an average annual inflation rate of 1.6%. Since 2008, inflation remained within the desired target range of the Federal Reserve whose focus at the time was also to keep extremely low interest rates. The Fed's basic goal is to maintain employment and stable price levels by moving interest rates up and down in response to economic conditions. Until recently, the policy has been moving interest rates down.

Few policies are wrong in and of themselves. It's a matter of balance which is hard to secure. The ideal economic situation would be stability, in which inflation tends to persist at a rate of around 2%. In fact, moderate inflation as a balancing factor has benefits. In a stable economy, businesses produce products and hire workers, consumers buy goods and services, and supply and demand work in equilibrium. But because circumstances can't help but change, stability isn't a constant option. We were witnessing instability before the tragedy began in Ukraine. Now we live in considerable uncertainty in several directions.

Affected by Inflation. High inflation reduces the purchasing power of currency. All of us lose real monetary value in an inflationary period. Rising inflation impacts individuals differently. Workers' income buys less. Creditors receive less real value than promised by the loan agreement. The uncertainty of rapid shifts in inflation rates discourage long term contracts. Middle-class savings may be eroded. As with stock market declines, investors with a long time to recover the lost value are not hurt to the extent of retirees who are living on their savings. Families living hand to mouth must do without necessities.

Responding to Inflation. Consider your own behavior as prices rise. We react based on our wealth, our personality, the elasticity of products, and timing. Those with necessarily strict budgets may cancel certain purchases, while some with substantial wealth may disregard the rising cost. A consumer's flexibility in buying products at heightened prices represents the "elasticity of demand." To what degree are you willing to substitute a preferred product when a lower price is available? If the tab on your favorite Cabernet suddenly reaches so high that you replace it with a lesser bottle, your demand is *elastic*. You can stretch your options. Ultimate elasticity is the willingness to drop the product altogether, waiting for a lower price. Some products are rigidly *inelastic*, insensitive to price. An example of perfect "inelasticity" is cigarettes. However costly, the consumer will buy.

Other responses to inflation are affected by time. Sometimes, when high inflation lingers, consumers' impatience softens enough to buy goods they had rejected earlier. They had grown accustomed to the frustration, perhaps as some Americans dispensed with masks or isolation while covid remained quite active. They'd had enough.

Long Time, No Inflation continued p.2

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Long Time, No Inflation continued

Backward Look at High Inflation in the US. The inflation rate rose from the middle 1960s until reaching the longest period of sustained high inflation, from 1973 to 1981. The period is an example of two major features of inflation: Unexpected events, either domestic or global, can cause sudden turmoil in the US economy, drastically impacting the rate of inflation. And individual and business lifestyle modifications resulting from that shock, can be substantial and prolonged. Do you recall this decade?

In the 1960s and 70s, Americans paid less than 50 cents a gallon for gasoline. In love with their cars, the larger the better, they drove for recreation at 12 MPG. In 1973, OPEC raised the crude oil price by 70% and an embargo was placed on oil trade, one of the most important commodities, by Middle Eastern states. The 1979 "Second Oil Crisis," linked to the Iranian Revolution, also caused fuel shortages and upsurges in crude oil prices. In the most frantic times, consumers lined up for gas, for an hour if needed. They need to get to work, among other things. Flags at gas stations alerted drivers to the supply, (green flag: "you're in luck", red flag: "sorry") Drivers despaired at having to waste gas while searching for an accommodating gas station. Some states had rationing systems, some drivers carpooled, some arrived at the station before sun up. The government, citizens and businesses adopted cultural changes, most aimed at reducing the cost of energy use. Driving speed was reduced to 55 MPH for the sake of fuel efficiency. For the same reason, in time, cars became smaller, and much higher MPG became a key feature. Homes were kept chillier in the winter and warmer in summer.

Hyperinflation. 17 "hyperinflations" (defined as when inflation rates exceed 50% per month) have occurred in the 20th century, in Europe, Latin America, Central and Southeast Asia, and in Zimbabwe. They frequently followed wars which left countries with mammoth debt, dissolved trade opportunities and faulty fiscal policies. They have been caused by government budget deficits related to new currency, or by crises that hinder the collection of tax revenue. The economic chaos moves rapidly. You may recall hyperinflation stories of Germany in 1923 when a wheelbarrow loaded with currency could not buy a newspaper. Starting in 1999, currencies in Zimbabwee sank to half the prior value in only 24.7 hours. Hyperinflations have occurred in Latin America in recent years. Venezuela, now with the highest inflation rate in the world, has faced uninterrupted and double digit inflation since 1983. Inflation caused extreme misery over time and place, fortunately not in the US.

What will we learn about inflation by this experience?

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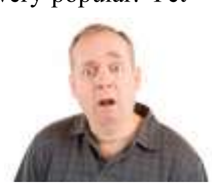
I Didn't See it Coming!

LTCI or "Long Term Care Insurance." There's something so comforting about that phrase. It describes an insurance product that helps policyholders meet the costs of personal daily needs in old age and/or disability. It promises a reassuring solution to those senior worries. If paid on an annual basis, the $2,600 premium starting 15 years ago (example), felt heavy but worth the expense for the assurance. However, in the past decade, both policyholders and the insurance carriers have experienced worries. The actuarial assumptions that calculated premium expenses, had underestimated several key factors: the high number of clients, the extremely low number of those who would discard contracts, the rise in healthcare costs, the increase in Alzheimer's and other "lingering diseases," and the longevity of policyholders. Those oversights caused companies to spend far more in claims than anticipated. At the same time, the lengthy period of very low interest rates significantly diminished the companies' investment revenues. This has been a long term problem, leaving carriers unable to meet the promised claims. LTCI was a fairly new product, sold throughout the U.S in the late 1970s. By the early 1990s, it was very popular. Yet today, the number of companies currently offering the original product has shrunk to fewer than 10.



In the past several years, Policyholders have been asked to meet one or two premium increases, so far. Some increases are as high as 50% or 70%, others more around 20%. All have been approved by the local State Insurance Commissioner. Policyholders may accept the increases as is, aware that more may follow, or they may agree to reduce or repeal various benefits in the contract. Or they may outright cancel the contract, recovering the paid-up amount. Neither party is happy, not the client whose expectation of financial security in old age has been diminished or entirely withdrawn, not the insurer who is stuck without profits, and with more trouble ahead. What to do? Anger and discouragement are understandable but likely not helpful. If you are a policyholder, you might consult an insurance professional for advice. But consider why you wanted this contract in the first place.

Economic and Financial Overview

2022 began with unsettling news. Following a strong stock market year, all major stock benchmarks had their largest losses in 2 years. Early in the quarter, investors tended to maintain their bright outlook on the market. Along with many analysts and Fed representatives, they assumed that the expected inflationary boost would not be very lengthy, nor would anticipated interest rate increases be particularly aggressive. People who had lived for a while with consistently low interest rates as well as controlled inflation rates, began to experience uncertainty. Employers urgently sought workers. Wages increased, encouraging consumer purchasing. Higher consumer demands and disrupted supply chains also contributed to rising inflation.

Jerome Powell planned to raise interest rates slowly, hoping to control inflation, lower unemployment and sustain economic growth. He hoped that a rise in interest rates would make borrowing and spending harder, reducing consumer purchases and business investments, perhaps giving supplies a chance to catch up. His intention was to begin tapering, or reversing quantitative easing, thus achieving price stability. That may have been unattainable in any case, but the ultimate unexpected event was Russia's appalling assault on Ukraine on February 24, and since. As Powell noted, this was "a game changer." Effects of the combat as well as economic sanctions, have weakened global supply chains. New inflation waves disrupted have factories. Commodity prices skyrocketed while some agricultural harvests are threatened. Slowly mounting interest rates would not be enough to bring interest rates down. Consumer prices rose 8.5% in 2022 through March. Now observers worry that the Fed's more aggressive policy could cause a yield curve inversion, and move the economy towards recession.

The domestic stock market was volatile in the quarter, with the S&P 500 down by -4.95% and the Russell 2000 of small stocks by –7.8%%. Value stocks have outpaced Growth. Barclay's Aggregate Bond Index lost -5.93% in Q1. The bond market had the worst 3 months since Q3 of 1980. Rising rates cause bond prices to fall, but lift bond yields.

Developed international equity markets dropped –5.91%, while emerging markets lost –7.79% in Q1.

"Democratization of Investing" [1]

When Assabet Advisors opened for business in 2002, we chose Fidelity as our custodian. In part, we were impressed by Fidelity's wide range of highly proficient services. We also liked being nearby, able to meet Fidelity staff and other clients at their frequent instructive and social gatherings. Proximity offered an advantage, we believed. And frankly, Fidelity is a big name locally, assuring confidence for our (mostly) New England based clients.

Edward Johnson III, the iconic leader of Fidelity Investments for nearly 4 decades, died at 91, on March 23. "Ned" was raised in Milton, educated in prep schools and Harvard, and grew up in a house in which his grandmother had raised her family. He was altogether a Yankee. In 1957, after college and serving in the Army, he went to work in 1957 at the family firm started by his father 8 years prior. Ned rose to president in 1977. For much of his adult life, he lived in Beacon Hill, Boston.

Although a part of a "Boston Brahmin" family, the importance of his work throughout was to make it possible for "ordinary people," not just the rich, to engage in investing. Corporate pensions were fading in the early 70s while personal savings were moving to bank or Individual Retirement Accounts (IRA). Johnson attracted this growing client base offering a new approach in many directions: highlighting Fidelity's fund managers, creating so many number of funds there would always be winners to promote, offering a toll free phone access for clients, marketing money market funds for which investors could write checks. He pushed money market funds when interest rates were soaring and stocks worrisome. Mutual funds were sold directly to the public, not through brokers, while investors were offered discount brokerage services. He was early into the 401(k) business and built the largest of many competitors. Although he was never one to make a show of himself with interviews, or at conferences, or to allow his name to go on any of his enormous philanthropic gifts, Ned encouraged advertising, and keenly marketed his star fund managers such as Peter Lynch.

Ned was a visionary, who because Fidelity remained privately held, was able to move fast without much debate. He played a long game, ahead of innovations and up to date with technology. Obsessed with Kaizek, the Japanese philosophy of continuous improvement and attention to detail, he expected excellence from himself and employees. He wasn't easy. But he was amazing.

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Should You Manage Your Own Money?

Many people, men especially, think that they should be able to manage their money. Yet investment journals are full of precautions against personal mismanagement of money. Here is a summary of the general guidance offered:

There are people who enjoy managing their own portfolios and have the skills to do so. They have a keen sense of their personal situation now and ahead, so they can build a sound investment plan. They have an intricate knowledge of investments, including the tools, and the laws. Their investment responsibility interests them almost like a hobby. And they have the time and temperament to maintain the effort, keeping up with both research and implementation. Jason Zweig of the Wall Street Journal, writes that expert portfolio management requires these “cardinal virtues:” curiosity, skepticism, discipline, independence, humility, patience, and courage. Does that describe you? Would those qualities equip someone to manage a portfolio in the potentially next 2 years, for example?

How much do you really know? Do you keep up on your knowledge? What resources do you use?

Are you busy with other interests and activities?

Do you have the knowledge but not the energy to concentrate on your investments?
Will you stay committed to managing your portfolio?

Some eager individuals get excited at the thought of investing. They read about the markets when they are soaring, or are encouraged by friends to try a new investment opportunity, that is not fully understood. They feel indestructible until they suffer losses, then make hasty decisions. Managing ones own money is a nerve-wracking job, complete with stress and uncertainty.

Perhaps they could make an interesting, if risky, investment with an amount of money that they can afford to lose, just for fun, or for enlightenment.