360 Insights

Going Up:
The Return of Inflation and How to Manage It

By Jonathan Scheid, CFA, AIF®

There is no way to hide that prices are rising for the goods and services we use. A day doesn't seem to pass without hearing of a new shortage, a supply disruption, or an increase in demand that is impacting the price we pay for something. From a shortage of semiconductors affecting the price of new and used cars to higher oil prices raising the cost of gas and backups at ports restricting supply, it is no wonder that inflation and inflation expectations are on an upswing.

The most recent report on core Personal Consumption Expenditures (PCE) price index, the Federal Reserve's preferred measure of inflation, showed that prices were up 3.1% at the end of April versus a year ago. This increase is much greater than the average rate of 1.6% over the past 10 years, and it is well above the 2.0% rate that the Fed is targeting for long-term inflation.

Yet, the Fed isn't overly concerned about this sudden uptick for two reasons. First, the Fed believes the number is temporarily inflated because we are comparing values from today's healthier economy versus last year's struggling economy. Consider, for example, that the price of oil was about $20/barrel at the end of April last year during the early part of the pandemic, and it was about $65/barrel this April, which is pretty close to where it was pre-pandemic. But that big price increase from last April to this April shows up as inflation. So, the Fed feels that we're seeing temporary sticker shock and that the rate of inflation will fall once we are past the lows of the pandemic.

Second, the Fed feels that temporary events caused by the slowdown and restart of the global economy will dissipate once everything is up and running again. Just like paper towels and toilet paper eventually returned to stores, events like the semiconductor shortage for cars, the underproduction of lumber that led to huge price increases, and the backups at ports will all get worked out and no longer cause supply issues.

How Our Portfolios Protect Against Inflation

With the Fed's wait-and-see approach on inflation, consumers and investors run the risk of the economy overheating and inflation getting out of control. This is concerning because it could cause the Fed to increase interest rates at a faster pace than it otherwise would have, and it potentially means that the items we purchase would more quickly increase in price.

Fortunately, we seek to manage inflation risk in the design of our portfolios. Stocks are one of the few assets that generate a meaningful return after adjusting for inflation, and that growth potential is why we include some allocation to them in almost all of our portfolio recommendations. Growing wealth in excess of inflation is critical to most people's financial and life goals. Additionally, our preference for investing in value (i.e., inexpensively priced) stocks acts as quasi-inflation insurance, because value stocks have historically performed well during past periods of heightened inflation.

The use of short- to intermediate-term bonds in your portfolio not only helps stabilize the ups and downs that come from stock investing, but these bonds also perform better versus long-term bonds when interest rates rise. Because bond prices fall when interest rates rise, anytime the Fed considers increasing interest rates or investors push interest rates higher, the bonds in our portfolio will likely (continued on page 3)

Stay Invested to Reap the Harvest

By Daniel Campbell, CFA

Historically bad to historically good

Value investors who chose to stay the course through the last few years were finally rewarded for their discipline!

Although it's hard to believe, if we back up just a few months, the one-year period ending September 2020 was the worst return ever for small value stocks relative to larger, more growthy companies, with small value underperforming by a whopping 52%. The three-year returns were also abysmal, with small value underperforming large growth by nearly 26% per year, which is close to the performance disparity we saw during the tech bubble in the late 1990s. However, with the benefit of hindsight, we now know that September 2020 was the low point, as value stocks roared back to earn nearly 50% more than large growth stocks over the next two quarters.[1]

Premiums show up in waves

Despite clocking in at an annual average of 4% per year since 1927, the value premium is not earned steadily.[2] Rather, it comes in quick waves. The last few years have reminded us that trying to time the market, or even the value premium, can be detrimental to a portfolio's overall growth. Looking at returns since 1972, Graph 1 shows that a dollar hypothetically invested in small value stocks would have grown to over $400 compared to just $173 for the same dollar invested the total U.S. stock market, a healthy premium of almost $240. But by missing just the five best months for small value stocks during that period, your hypothetical dollar would have only grown to $160, falling short of growth in the total stock market. That's why the best way to capture the value premium is to stay invested consistently – even through the inevitable underperformance.

Hypothetical Growth of $1 Since January 1972
Impact of Missing Best Months for Small Value

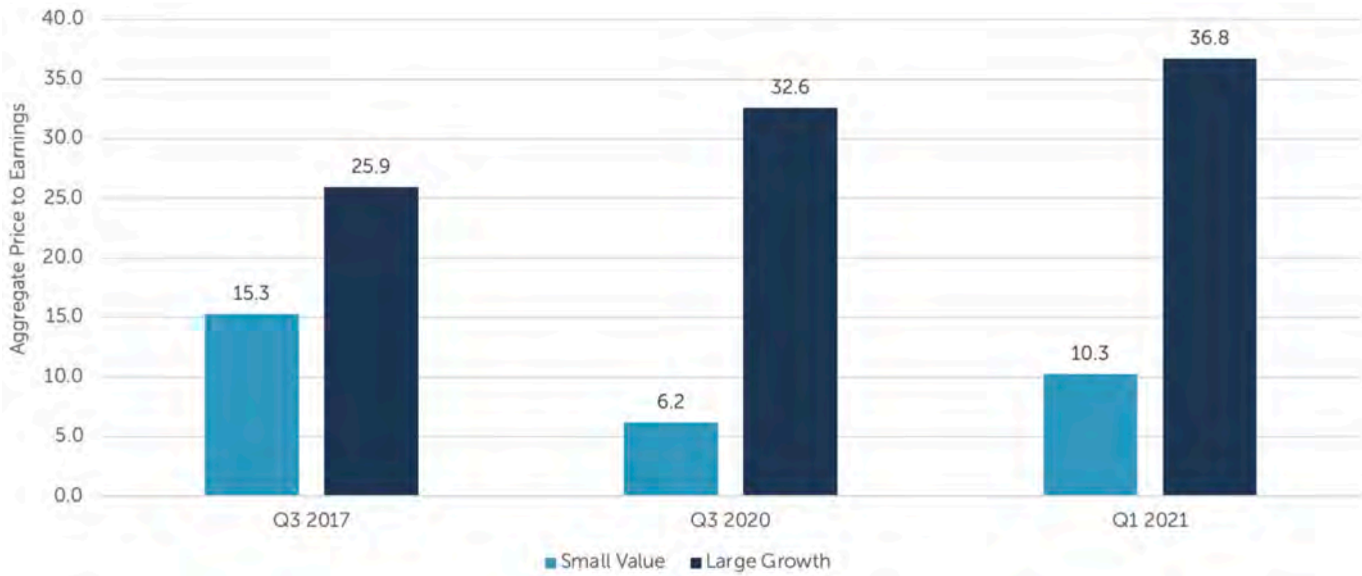
Missing just a few of small value's best months relative to the total stock market can drastically impact a portfolio's growth.

Source: Morningstar Direct, Dimensional Returns Web. See important disclosures.

Relative earnings show potential for more outperformance

Despite their exceptional performance recently, we know that prices continue to be depressed for small value stocks relative to history. One way to gauge whether stocks are expensive or cheap is to look at the difference in price-to-earnings ratio between small value companies and large growth companies. Historically, a dollar of earnings from large growth companies has cost roughly twice as much as a dollar of earnings from a small value company.[3] However, we can see in Graph 2 that earnings from large growth companies have become more than 3.5 times as expensive as earnings from small value companies. From this perspective, small value companies have yet to recover to where they were in late 2017, when the drastic underperformance started.

Relative Price of Earnings in the U.S.



Using the aggregate price-to-earnings ratio, we see the cost of earnings for small value stocks relative to the cost of earnings for large growth stocks has yet to recover to the 2017 levels.

No one can reliably predict what markets will do next. And many factors could cause small, distressed companies to fall in price again. But with valuations at historically high spreads, we can be optimistic about seeing favorable performance from small value stocks that allows disciplined investors to continue reaping the rewards of their patience.

1. Morningstar Direct. Small value returns are measured by the Russell 2000 Value Index and large growth returns are measured by the Russell 1000 Growth Index.
2. Ken French Data Library. Represents the average annual premium from 1927-2020.
3. Ken French Data Library, Dimensional. The historical average price-to-earnings ratio from June 1963 through March 2021 was 10.8 for small value compared to 21.7 for large growth companies. June 1963 is the first month of data.

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(continued from page 1) decline in value. Short- to intermediate-term bonds are less sensitive to this risk than long-term bonds.

Like it or not, inflation is always present in our world. As the economy emerges from the pandemic, we should expect inflation to be higher than we've seen in the recent past, and, if the Fed is correct, it should moderate at some point in the somewhat not-too-distant future. The good news is that we have considered these risks and proactively build financial plans and investment portfolios with strategies to help mitigate some of the potential challenges that inflation presents.

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5 Life Events Where Planning Is Paramount

Your estate is made up of all your money, property and assets – and it's alive. Not literally, but think of it like a beautiful, low-maintenance house plant. Once purchased and placed in the perfect spot in your home, you just need to provide it a bit of care to keep it from wilting. Once you have a solid estate and wealth transfer plan in place, it needs to be updated when your life changes. Which specific instances call for an edit? Glad you asked.

New Additions to the Family

When you have a new baby, everything changes, including your estate plan. First, you need to name guardians in your will, or get a will in place if you haven't already. And don't forget to include your bundle of cuteness as a beneficiary (via an adult guardian). If you have more kids, including adoption and/or stepchildren, repeat as necessary. As your kids transform into full-fledged adults with spending power, it's also important to periodically assess their place in your estate plans to make sure everything is equally distributed or split however you see fit. The main goal here is to prevent family rifts after you're gone.

Splitting Up

Marriage may have prompted you to put a plan in place to direct where your money should go in the event of your death. It likely involved creating or updating your will and other estate documents, as well as revisiting the beneficiary designations on existing health and insurance benefits. Splitting up means that it's time to take another look at where all those things stand. Some people completely (and happily) erase exes from their will, but you may still choose (or be forced) to leave funds to your former spouse. Maybe it's part of a court settlement, or for childcare, or because things ended amicably and you simply want to. Figure out what (if anything) you'd like to bequeath and make the change to prevent any future drama. You'll need to update a handful of other things after a divorce: beneficiaries for life insurance and retirement accounts, emergency contacts, shared passwords, power of attorney, health care proxy.

The Departed

Sadly, you may outlive some of the people named in your documents. If your health care proxy, power of attorney, or executor dies, you need to name new ones or elevate your alternates to primary position and name new alternates. If a beneficiary dies, reallocate inheritances to other living heirs or charities close to your heart. Similarly, if the appointed guardian of your children or special needs adult passes, it's vital to designate a new one.

New Laws and Landscapes

This is when it's prudent to call in the pros – your wealth advisor, accountant and attorney – because federal and state laws can change at any time and throw your current plan into chaos. If you move to another state, definitely read up on its codes and fill out any documents required for that state. For example, the advance directive from your old state might not hold up in the new one.

Money, Money, Money...MONEY!

A big salary increase or a sudden windfall from something like an inheritance or a great day at the track means a big bank account bump. Having assets you want to protect means a call to your wealth advisor and estate attorney. The same applies when you purchase pricey assets like homes or vehicles, or if you find yourself on the winning side of any lucrative business ventures. It's also important to realize that a bigger estate might lead to more people fighting over it, so nip any possible disputes in the bud and look into creating a trust and setting up specific and ironclad asset allocation to your heirs in your will. Once it's in writing you can rest easy knowing your wishes will be followed.

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