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The Ancora Advisory

An Investment Publication for Clients and Friends

Ancora consists of three primary business units; Family Wealth, Asset Management and Retirement Plans. With experienced portfolio managers, proprietary investment strategies and an entrepreneurial spirit, Ancora delivers tailored solutions so you can achieve more ... on your terms.

Market Volatility versus Economic Volatility

John Micklitsch, CFA, CAIA
Chief Investment Officer

Rightfully so, much is made of market volatility. Seeing the shift in value of hard-earned savings can make anyone feel uncomfortable, but a missing ingredient in the assessment of market volatility is often time. Time, along with other best practices such as diversification and quality, remains one of investors' greatest and most underappreciated assets. In addition to time, separating the economic juggernaut of capitalism from short-term market concerns is also an important factor in being a successful long-term investor. With data, we'll attempt to explain how a simple shift in evaluation time horizon can make you a less stressed and more effective market participant.

The value of our most productive assets, such as ownership in a business or a loan to a business, is associated with two primary inputs: the future cash flows that it can deliver and the level of interest rates. Businesses, in delivering cash flows, ride the long-term trend of the economy while interest rates are influenced by Federal Reserve policy and inflation levels. It would stand to reason, therefore, that the variability in the value of a collection of diversified business interests (your stock portfolio) would carry the same amount of volatility as the two primary inputs. Yet that is far from the case. The stock market is far more volatile than either the economy or interest rates. And not by a little.

From 1962 to 2021, the U.S. economy's average annualized nominal growth rate (real + inflation) was 6% and carried a standard deviation of 3%. During that same period, the ten-year Treasury yield averaged 5.8% and had a standard deviation of roughly 3% as well. Standard deviation is simply a measure of how much annual variance was evidenced relative to the average from the entire data set. Think of a data set with low standard deviation as being a tight set of dots around an average line and a high standard deviation as being a more spread-out set of dots around an average line.

Now, here's the shocker; over the same sixty-year period, the S&P 500 produced a 10.5% annualized return, but did so with a

standard deviation of 17%, almost *six times* the volatility of its two primary drivers. Why is that and what does it mean? How do we take something that is reasonably steady, such as economic growth and interest rate levels, and turn it into something that requires six times the stomach from a volatility standpoint? It happens, because collectively market participants have different objectives, time horizons and understanding of how businesses are valued, which results in wild, speculative and emotion-filled swings in public business values, despite long-term inputs that would suggest a smoother ride would be more appropriate. This delta is often attributed to "Mr. Market," a term coined by Ben Graham in 1949 to describe the market's periodic disconnect from longer-term fundamentals.

So, what can an investor do to not get dragged into the morass? For starters, to paraphrase Warren Buffett, just because somebody is offering you a low price for your business interests, doesn't mean you have to sell. Secondly, you can use Mr. Market's mood to your favor and allocate capital accordingly. Be cautious when he is euphoric and lean more towards buying when he is cranky. Lastly, you can shift your evaluation period for stocks from annual measurements to a rolling five-year evaluation period or even longer. During the previously referenced 60 years, the standard deviation of the average five-year annualized return dropped to 7% versus 17% when evaluated annually, while the average annual five-year return remained roughly 10%. By simply shifting your evaluation mindset to five years from one year, you can significantly reduce the emotional distractions and noise caused by Mr. Market and increase your odds of being a successful long-term investor. ◊

Why the Inflation Fight is Essential to Investors

David Sowerby, CFA
Managing Director, Portfolio Manager

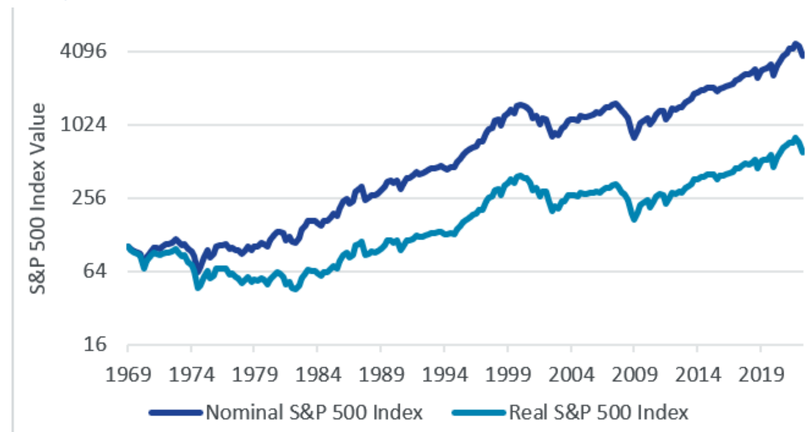
Midwestern summers are exceptional for their warm days and extended daylight and, encouragingly, this summer has also brought some relief to stock prices. Even when including some recent declines, the major indexes have gained ground since mid-June.

In August we marked 30 months of investing during the pandemic (since the prior peak in stock prices on February 19, 2020). In those 30 months, investors have faced two bear markets with a sizable gain sandwiched in between. During that time U.S. stocks, as measured by the S&P 500, have seen a cumulative gain of +22%, as of August 30, 2022. In contrast, an index of U.S. Treasuries declined by 7%. So much for the perceived safety of owning Treasuries in periods of weakness and higher volatility.

The biggest issue affecting markets now, and one which has had an arguably greater impact on the aforementioned bond market, is inflation. Never to be forgotten, inflation is a "tax," due to the purchasing power it erodes. Moreover, as Milton Friedman stressed, inflation is a monetary event caused by excessive growth in money supply. Not to dismiss the pain that the pandemic has had on society, but inflation is like a virus as well, capable of wiping out our asset gains and household income growth.

To illustrate inflation's corrosive impact, the following S&P 500 Index chart includes both nominal and real (inflation-adjusted) values. Specifically, the years from 1969 to 1981 witnessed a prolonged decline in real stock prices, dropping 50% as the U.S. experienced an era in which the inflation rate averaged 6.5% and peaked at over 10%, well above its long-term average of 3% inflation.

S&P 500 Index Nominal vs. Real Returns



Source: Bloomberg, Federal Reserve

In a brief speech at a recent Economic Policy Symposium, Federal Reserve Chairman Jerome Powell emphasized that the current 8% inflation rate is unacceptable and that the Federal Reserve would need to continue to pursue restrictive monetary

policy. This was the right message, though the current inflation rate has less to do with supply chain constraints or the war In Ukraine, in our opinion, and more to do with the era of low interest rates following the global financial crisis and more recently the rapid pickup in monetary stimulus that began in March 2020 and extended into this year. To be fair, the stimulus in the early days of the pandemic was the right policy, yet it simply went too far in providing that sugar buzz for the economy.

While in the very near term the capital markets have reacted negatively to Powell's speech, this is the necessary monetary policy if we are to avoid a repeat of 1969-1981. Regarding portfolio values, we expect they will achieve more favorable returns in the long run if inflation is lower rather than higher. Generally, an inflation rate of 4% or less has produced better stock returns. In contrast, a rate of inflation trending higher and above 4%, has produced negative real returns.

Part of the reason we remain more optimistic about the current fight with inflation is that many publicly traded U.S. companies took advantage of previously low interest rates to finance or refinance their debt at longer maturity, fixed-rate debt. As a result, higher interest rates should have a more limited impact on profitability and potential stock price returns than in past periods when interest rates were rising due to inflation. That is largely the same for U.S. households that refinanced their personal debt, such as mortgages, at lower rates and presently have stronger balance sheets, resulting in stronger consumer free-cash-flows than in previous inflationary periods.

In summary, midwestern seasonality is a given and stock prices witness their own version of short-term seasonal changes. Nevertheless, in our years of managing portfolios, we believe that the merits of a low inflation economy, combined with the ability of high-quality businesses to innovate and create long-term value for their shareholders, can weather any near-term seasonality. ◊

Hit the Fed's Curveball

Kevin Gale
Managing Director, Head of Fixed Income

The yield curve is a line that plots interest rates (yields) of U.S. Treasury securities ranging from one month in maturity out to 30 years. The slope of the yield curve can help investors determine the outlook for the economy. Under 'normal' economic conditions, the yield curve is upward sloping, meaning short-term interest rates are lower than long-term rates. When the Federal Reserve starts to raise interest rates and investors become concerned about the future economic outlook, the yield curve can invert, meaning short-term interest rates are higher than long-term interest rates. As a result of this, investors tend to favor purchasing short-term bonds, simply because of their higher yield than longer-term bonds.

Historically, the inversion of the Treasury yield curve, as defined by the difference in yield between the 2- year Treasury note yield and the 10-year Treasury note yield, has lasted from very short time periods of one month or less, to longer time periods of nearly two years. On average, when the Treasury yield curve inverts, it lasts about 7 months before it resumes its traditional upwards slope (long-term yields become higher than short-term yields). The inability to exactly time these movements in yields and the associated reinvestment risk of shorter dated maturities, make it important for investors to consider if solely purchasing short-term bonds in a portfolio is the best approach for their fixed income needs.

As shown in the following chart, the yield curve has inverted numerous times since the mid-1970s. In general, on a historical basis, if you had purchased a two-year treasury note when the yield curve initially inverted, you would find yourself reinvesting upon maturity two years later at a lower yield, even if you buy a longer-dated security. This reinforces our view that a laddered bond portfolio is often the most diversified approach to bond investing over time.

U.S. Treasury Yields

Source: Bloomberg

In addition, historically, a diversified intermediate-term bond portfolio has outperformed a short-term bond portfolio over time, even during periods of inverted yield curves. The following table shows the total return of a diversified short-term bond index versus a diversified intermediate-term bond index over a two-year period from the time the yield curve first inverted. Only once since the late 1970s did the short-term bond index outperform.

Bond Market Cumulative Total Return

	Jan '06 - Jan '08	Jun. '06 - Jun. '08	Feb. '00 - Feb. '02	Aug. '89 - Aug. '91	Jan. '89 - Dec. '90	Jan. '82 - Dec. '83	Aug. '78 - Jul. '80
Bloomberg 1-3 Yr Govt./Credit Index	13.10%	12.65%	18.02%	21.15%	20.73%	32.07%	17.90%
Bloomberg Intermediate Govt./Credit Index	14.17%	13.89%	21.16%	21.90%	21.81%	36.08%	14.15%

Source: Bloomberg

Predicting where interest rates will be two years from now, much less ten years from now, is one of the most difficult tasks in investing. Over time, we believe maintaining a well-diversified intermediate duration, laddered bond portfolio provides investors with an excellent source of diversification from interest rate risk, which is one of the key risks to manage in fixed income investing. ◊

When It Pays to Be a Contrarian

Michael Santelli, CFA
Director, Portfolio Manager

The markets so far in 2022 have been very choppy. After a 12-year bull run from the March 2009 bottom of the global financial crisis (notwithstanding a sharp but very brief pandemic-induced bear market in early 2020), we are now facing some significant headwinds. The main event in this episode of market volatility is the battle between the Federal Reserve and inflation. The Fed has been raising interest rates and threatens to continue doing so until inflation is subdued. It has also embarked on "quantitative tightening", i.e., a reduction in the size of its bloated balance sheet from past liquidity binges. The Fed's previous quantitative easing policy, which occurred following the global financial crisis, was nectar to the markets. Now it is reversing course and tightening conditions, what is an investor to do?

First, it is important to be able to make it through any short-term period without forced selling. Consider whether you are comfortable with the amount of liquidity at your disposal to fund any near-term spending needs. If not, it could still be the right time to make any necessary changes to become more comfortable.

Second, keep an eye on the long-term. After your short-term liquidity needs are comfortably met, it makes sense to remain invested in an appropriately diversified portfolio that is designed to meet your long-term goals. Here it is important to note the obvious: we are all thirteen years older than we were in 2009. Has your risk tolerance changed? How close are you to retirement now? Is it appropriate to change your asset allocation target? All valid questions. We are always prepared to discuss these questions with our clients and include both our investment and planning teams in the analysis.

Third, as we build portfolios, we look for opportunities that offer attractive risk-adjusted returns. Oftentimes these opportunities are found in “unpopular” areas. Who wants value stocks when disruptive growth stocks are posting huge returns? Who wants energy stocks when seemingly everyone is at war with fossil fuels?

There is a time for almost everything in a diversified portfolio, especially if a period of underperformance has left an asset class or sector attractively priced on a relative basis. For example, after a multi-year period of underperformance, value stocks have held up much better than growth stocks during the 2021-2022 period. Energy stocks, which were being thrown out of portfolios by many institutional asset owners just a few years ago, posted a 24.5% return (measured by the S&P Global 1200 Energy sector year-to-date through June 30, 2022), while the S&P 500 posted a -20% return over the same period. It was less than 3 years ago, in April 2020, that crude oil traded at *negative* $37/barrel as investors wondered when people would travel at pre-pandemic levels again. This year, crude has spent much of the year above $100/barrel and energy companies are booking record profits.

Sometimes it pays to be a contrarian. ◊

Charitable Giving Tax Strategies for 2022

Howard Essner, JD
Managing Director, Family Wealth Advisor

We last wrote about this subject in 2018 following the passage of the 2017 Tax Cuts and Jobs Act. That law changed the way many tax filers itemize deductions by increasing the standard deduction and limiting the deduction for state and local taxes to $10,000. As a result, fewer filers itemize deductions and consequently receive no tax benefit for charitable contributions (noting that the “above-the line” $300/$600 charitable deduction enacted as part of the COVID-19 incentives is no longer available in 2022).

Many Americans give to charitable organizations without consideration for the tax benefit, but if you are going to give, you should look for ways to find some tax benefits even if you no longer itemize. In 2018, we gave you some ideas to consider. These ideas are still valid, and we thought it a good idea to share some of them with you again.

Use Appreciated Securities
The tried-and-true approach of using appreciated long-term securities to fund your gifts remains valid, even if you do not itemize. By using appreciated stock, you avoid the capital gain tax on the sale, even if you do not get a deduction. This strategy can also save state income taxes in states that use the federal taxable income as the starting point for state income tax (like Ohio).

Use Your IRA
If you are older than 70½ and have a traditional IRA, you should consider using the IRA to make direct contributions to your charity. We have written about this strategy more than once. If the IRA custodian pays the charity directly, the distribution does not appear on your federal tax return as income and therefore is not taxed, putting you in the same (or better) position than if you took the distribution, paid tax on it, made the contribution and then deducted the contribution. There also can be state income tax (especially in Ohio) and other federal tax benefits to this approach, and it is still a great idea to consider, even if you do itemize deductions.

Bunch Your Contributions and Use a Donor Advised Fund

You may want to consider bunching multiple years' worth of contributions into a single year. For example, if you normally give $5,000 to charities in a year, you could consider donating $15,000, $25,000 or even $50,000 in a single year, maximizing the deduction in that year, and then using the standard deduction in the other years. If you can, consider this approach in a year with high taxable income and/or when you have other deductible expenses, such as large medical expenses.

You can bunch contributions by giving a large amount to your favorite charity (letting them know, of course, about your strategy). Or, perhaps a better approach is to "pre-fund" your donations through a Donor Advised Fund (DAF). When you fund a DAF, you give money to a public charity, which then agrees to hold the money to fund future donations to other charities as "advised" by you. The charitable donation deduction is triggered in the year you fund the DAF, not when the funds are distributed to the ultimate charitable beneficiary. As a result, you can get a large, itemized deduction in the year that you fund the DAF, and then use the standard deduction after that. You can use appreciated securities to fund the DAF (with some restrictions), thereby increasing the tax value. Many charities sponsor DAF programs, including the charitable arms of Fidelity and Schwab, two of the custodians we use here at Ancora. There are some administrative fees associated with DAFs, which you should consider when determining whether to fund a DAF and how much you should give.

We also note that this bunching strategy can be beneficial even if you make charitable contributions and itemize deductions each year. Here's an example. Let's look at a married couple who pays more than $10,000 in state and local taxes, pays mortgage interest of $6,000 and makes $15,000 in charitable contributions. They have no other itemized deductions, so they have $31,000 in total deductions. In 2022, the standard deduction for this couple is $25,900. As you can see, the $15,000 in charitable contributions created $5,100 in increased deductions. In essence, $9,900 of the contributions were "wasted" (from a tax perspective).

Let's look at what happens if the couple gives $30,000 to a DAF in a single year and nothing in the next year, all else equal. In the first year, the couple deducts $46,000 of itemized deductions and in the second year, the couple uses the standard deduction of $25,900, for a total of $71,900 of deduction over the two years, $9,900 more than would have been deducted over two years using the couple's normal strategy. Pre-funding multiple years of contributions magnifies this effect.

As is always the case with taxes, each situation is different and you should consult with your attorney and/or tax advisor before adopting any strategy discussed in this article. ◊

As always, don't hesitate to contact your Ancora advisor or relationship team if you have any questions or would like to learn more about these topics. Visit our website at www.ancora.net to read past newsletters and find other news and insights from the investment professionals at Ancora.

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