ARCHVEST® WEALTH ADVISORS

P: 925-215-5600
F: 925-272-0215

1390 Willow Pass Road, Suite 930
Concord, CA 94520

The Archvest Advantage Semi-Annual Newsletter

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Market Review

In 2023 thus far, the stock market has been on an upward trajectory, with the S&P 500 increasing by 16.9%, the NASDAQ increasing by an impressive 39.4% (marking its best start to the year in 40 years), and the Dow closing with a 4.9% increase. These highly correlated indices tend to move in sync, so the significant discrepancy among them is notable.

The market rally has been predominantly narrow, primarily driven by the weight of the eight largest tech companies in the US: Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla, and Nvidia. Together, these companies now account for 30% of the S&P 500's market capitalization, up from approximately 22% at the beginning of the year. Given that the S&P index is market cap-weighted, appreciation in these particular companies results in higher weighting of them within the index. It is worth noting that historically, narrow market rallies have not typically translated into broad market rallies. In fact, as recently highlighted in The Wall Street Journal, the Cboe Volatility Index (VIX), often referred to as Wall Street's fear gauge, has fallen below 14 to near the lowest levels since February 2020. This index tracks the price of options used to hedge against stock-market downturns. It appears that investors are increasingly attracted to higher volatility stocks. Moreover, there are significant bullish bets on call options related to the artificial intelligence frenzy, particularly in companies like AMD, Intel, and Nvidia. All these factors indicate that this market rally might be on borrowed time.

The Cash Trap

With the Federal Reserve (Fed) raising short-term interest rates, cash and short-term (ST) bonds may appear relatively appealing, as they are yielding an annualized rate of over 5%. However, it is important to consider the risks associated with such investments, namely real returns and reinvestment risk.

The current yield, also known as the nominal return, on cash and ST bonds is over 5%. However, the nominal return must be adjusted for inflation before calculating the real return in order to accurately assess the investment’s value. The goal of investing, after all, is to achieve a real return rate greater than zero, as this ensures that investments will outperform inflation. As cash and ST bonds are essentially risk-free, they only offer a risk-free rate of return, and when adjusting this risk-free rate for inflation, the real return is almost always negative or zero. In the past 12 months, with an inflation rate of 5.7%, the adjusted real return of cash and ST bonds has been negative. Despite the attractive 5% yield, cash and ST bonds cannot provide a positive real rate of return.

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Another risk associated with cash and ST bonds is reinvestment risk. If you purchase a 3-month Treasury bond with an annualized rate of 5.1%, you will only earn 1.25% over the 3-month period. At the bond's maturity, you would then receive the principal amount back, at which point the prevailing interest rates could be higher or lower. Cash and ST bonds can still serve a purpose in a portfolio if you have a specific short-term goal in mind, such as making a large purchase in the next year or two. Rolling cash into ST bonds or holding funds in a money market account can be sound and prudent moves when trying to minimize the impact of inflation on your purchasing power. However, it is important to note that the objective of these tactics is not to achieve a positive real return rate.

In summary, while the yield on cash and ST bonds may appear attractive at 5%, we do not consider these asset classes to be viable long-term options. Instead, we view cash and ST bonds as alternatives to cash which are designed to mitigate the impact of inflation. Adjusted for inflation, we would expect the real return of cash and ST bonds to be slightly negative or zero at best. Therefore, in order to achieve a positive real rate of return, it is best to explore higher-risk and longer-maturity bonds as part of a well-diversified portfolio.

I Bonds: Keep or Cash Out?

With the rise in interest rates and increased inflation during 2022, I Bonds became a popular topic of discussion. I Bonds are a type of savings bond issued by the U.S. government which earns interest that keeps up with inflation over time. Last year, investors were offered an attractive annualized rate of over 9.5% with the purchase of $10,000 in I Bonds. However, as inflation has decreased, the underlying I Bonds have renewed at progressively lower rates. Although I Bonds' long-term rate is unaffected by the Federal Reserve Board's aggressive actions and has remained stagnant, inflation has been the primary driver of the I Bond rate, and as inflation has declined, so have returns on I Bonds. In the latest window, I Bonds purchased between May 1st and October 31st—the annualized rate stands at 4.30%, which is lower than that of most money market funds, which offer daily liquidity. It appears that the attractiveness of I Bonds is diminishing. So, how does one exit from an I Bond investment, and when is the opportune time? We must consider the rules set by the Treasury.

Firstly, you must hold an I Bond for at least 12 months after the initial purchase. Secondly, if you choose to redeem any I Bond you have held for less than 5 years, you will incur a penalty equivalent to 3 months of interest. Given these stipulations, we believe that, rather than forfeiting the 6.89% annualized rate earned from November 2022 to April 2023, it is best to exit from an I Bond when the rate drops further, such as to the current rate of 4.30%. We will need to monitor the rate changes in November, but if rates decrease further, it may be prudent to withdraw your funds in January or February of 2024.

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Digital Legacy

In today's digital world, smartphones have become an essential part of our lives, allowing us to store countless memories and other valuable data all in one easy-to-access place. However, have you considered what would happen to your data, and how that data would be accessed, if something were to happen to you or your loved ones?

If you store your login information in an accessible place, your beneficiary might try to use that information to access your accounts. It would be unwise to rely on this approach, however, as, once a phone carrier is notified of the owner's passing, the account is locked, and data becomes inaccessible. To address this issue, Apple and Google have developed no-cost solutions.

For iPhone devices, Apple has integrated "Legacy Contact" into iOS. To set up this solution, navigate to Settings → Select your profile → Select Password and Security → Scroll down to Legacy Contact. From there, you can choose a beneficiary who will receive a security token as a backup. You can save or send this token to your trusted contact during the setup process. Your named beneficiary can submit the security token and a death certificate to Apple, gaining access to your photos, messages, notes, files, downloaded apps, and device backups through a separate login for a period of 3 years.

For Android devices, while Google does not have a built-in feature in the operating system, you can set up an Inactive Account Manager. This allows you to name a beneficiary who will be notified if your Google account remains inactive for a specified period. The beneficiary will not be notified during the setup process. After the specified period of inactivity, your beneficiary will be notified, and you can grant them access to your Google account through this process.

Living in the digital age, our devices have become indispensable tools in our lives. It is important to have a backup plan in place in the event of unforeseen circumstances so that your beneficiary can access your data if needed.

TD Transition to Schwab

For those of you who have TD Ameritrade accounts, Schwab recently sent an email regarding the transition to Schwab. Approximately 3 years ago, the Department of Justice approved the acquisition of TD Ameritrade by Schwab. This milestone paved the way for moving thousands of advisors and their clients to the Schwab Institutional platform. We are now in the final stages of this process, and your TD accounts will be fully accessible on the Schwab platform after Labor Day (September 4, 2023). Schwab has assured us that there will be no interruptions in accessing your accounts. Schwab recommends TD account holders to make sure that they can access their accounts on TD's portal: https://www.advisorclient.com as these login credentials will port over to the Schwab's website.

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If you would like to learn more about the transition timeline, please visit:
https://welcome.schwab.com/alliance

Thank You

As always, please contact us with any questions or concerns and we will be happy to meet with you and review or refresh your overall plan. Follow us on Facebook, LinkedIn, and Twitter, as well as our RSS feed, to stay up to date on what we're reading and thinking. Thank you so much for the opportunity to work alongside you.

THE Archvest Team