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The Archvest Advantage Q4 2021 Newsletter

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Market Review

The year 2021 saw uncommonly high returns for stocks and some surprisingly negative returns as well. International stocks rose by 11.3%, the S&P 500 appreciated by 28.7%, and US growth stocks grew a blistering 32%. And then there were the losers - emerging market stocks were down by 2.5% while bonds declined 1.5%.

After a year like 2021 where some concentrated strategies performed so much better than diversified portfolios, it is natural to question the value of a diversified approach. With an appreciation of the broader context, however, the value of a diversified approach becomes clear.

The Defensive Value of a Diversified Portfolio

When any segment of the market significantly outperforms the others, such as US stocks did in 2021, diversified portfolios comprised of various asset classes will indeed underperform the stellar investment segment. But such outperformance is neither consistent nor predictable. Using the best asset class as what to compare diversified portfolio performance with is both misleading and myopic. This is because diversified portfolios are designed to endure the ebbs and flows of the market action by managing risk as well as earning returns.

There is a vast body of empirical and academic research that demonstrates that diversified portfolios perform the best over time when the criteria of performance is both return and risk management. Investors that hold their assets in non-diversified, concentrated portfolios composed of risky investments, such as stocks, see much greater volatility than do investors in diversified portfolios.

When the stock market is appreciating, most risky asset classes rise at the same time. And when the stock market declines, most risky asset classes decline at the same time. But not all investment classes are risky like stocks. Bonds, in particular, tend to have returns that are more stable than stocks and that relative to stocks do not move in lock-step ("correlation" is the finance term). For example, the S&P 500, real estate stocks and small cap stocks all tend to move in tandem in the same direction and to the same degree. Bonds, on the other hand, show no evidence of moving in tandem with stocks. Therefore, a portfolio composed of stocks and bonds has on average less volatility while both going up and going down than a portfolio composed only of stocks. At Archvest, we build diversified portfolios in order to manage both return and risk in accordance with clients' portfolio preferences.

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Why It's an Especially Good Time to be Defensive: Inflation

As the Federal Reserve has maintained extremely low interest rates for more than a decade, we have seen investors increasingly inclined to take more risks in the stock market rather than have their money earn far less in bonds or at the bank. However, with mounting inflationary pressure seen today, reflected in the 7% rise in the CPI in 2021, the Fed is changing policy and heading toward much higher interest rates in order to dampen inflation. Those higher interest rates will incentivize investors to put more of their money in the bank or bonds. Much of that money will come directly out of stocks and is thus expected to put downward pressure on stock prices. In earlier times, this was referred to as the Fed "taking the punchbowl away, just as the party was getting good". The "party" today is seen in US stock prices reflecting valuations relative to earnings that are twice as high as normal. The most widely respected valuation metric for the stock market is the CAPE ratio (the "Cyclically Adjusted Price-to-Earnings" ratio). Extensive research shows that high CAPE ratios are usually followed by much lower returns than average, including years of pronounced negative returns. Today, the CAPE ratio for the US is the second highest seen in over 100 years. The only time the CAPE ratio was higher was just before the Tech Bubble of 2000 burst and declined over 50% during the next couple of years. But not all CAPEs are created equal: the CAPE ratio is not nearly as high in foreign markets and that suggests those markets are less exposed to such low and negative returns in the years ahead. In this context, it can be appreciated that holding a diversified portfolio is especially important today as a part of a strategy to defend against outsized losses in a stock market downturn.

Investing Safely With I-Bonds

We recommend protecting yourself from inflation through I-bonds, which are inflation bonds issued by the U.S. Government. If you have some idle cash in your savings account and can afford to tie up the funds for a year, I-Bonds offer a relatively risk-free means of achieving the current annualized rate of 7%. This rate adjusts semi-annually in April and November with inflation each year, and interest is paid monthly. If inflation increases or decreases, the rate will adjust accordingly. The minimum purchase for these bonds is $25 and the maximum purchase is $10,000, and each bond must be held for at least one year, with a penalty of three months' worth of accrued interest if the bonds are redeemed before five years. Despite these restrictions, we believe that I-Bonds are a worthwhile investment because of the substantially higher income than a savings account. If you're interested in I-Bonds, please contact us and we can advise on the next steps.

Taxes- What You Need to Know

As President Biden's "Build Back Better Act" has not passed as earlier expected, there are two important tax-related elements to be aware of. Firstly, tax rates remain the same in 2022 under the Tax Cut and Jobs Act of 2017. Secondly, you are still allowed to convert IRA funds

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to Roth without limitations. We will continue to recommend this conversion strategy where appropriate.

As we kick off the 2021 tax season, please do keep an eye out for forms relevant to your taxable financial accounts, including any W-2s, 1099-Rs, 1099-SAs, and 1098s as applicable. Custodians have notified us that the first wave of consolidated 1099s will print during the week of February 14th and revision reports should be released during the first week of March. We are happy to send these reports directly to your tax professional upon request. Once your completed 2021 tax return is available, please forward a copy for our review and records.

Final Thoughts

As always, we greatly appreciate the confidence and trust you have placed in us to work alongside you as you financially prepare for your future. We invite you to follow us on Facebook, LinkedIn, and Twitter, as well as our RSS feed, where you can stay up to date on what we're reading and thinking.

THE Archvest Team