The Chance Financial Quarterly

This is the second issue of my newsletter and covers the first quarter of 2023. Feel free to pass this on to others, and they can request a free subscription.

Making Sense of the Market and Economy

The first quarter of 2023 was a pretty good one, all things considered. There were some bumps and a few bruises, but the market performed quite well, and you should notice it in your statements. Unless, of course, in a moment of fiscal insanity, you decided to invest all of your money in a bank that failed. More on that in a moment.

The S&P 500, which represents roughly the 500 largest stocks, returned about 7.5%. If we kept that up for a year that would be around 30%, enough to make us forget what a crappy year I had to write about last quarter. At a broader level, the Nasdaq index, which is about 3,000 stocks, returned about 17% in the first quarter. That means that smaller, i.e., riskier, stocks more than doubled the performance of larger, safer stocks. That's what risk is all about. When things go sour, Nasdaq is likely to way underperform.

In my view, the market seems to be at about the level it should be at. I base that on the fact that the ratio of the stock price to the earnings per share of the S&P 500 is around its long run average. I know the market is often short-term irrational but long-term rational. Even at my age, I view my investments from a long-term perspective. And you should too.

But surely something isn't rosy. And that would be inflation. Last summer it was running at an annual rate of 9%, which can only be described as cataclysmic. Now its only 5%, which still sucks. Inflation is a vicious tax imposed by government mismanagement of the economy. It is vicious because it hurts those who can least tolerate it. It is like raising taxes where the less income you have, the higher your tax rate. In simple terms, it discriminates horribly against the poor. And guess who it benefits? Those who borrow a lot, who get to pay back with cheaper dollars. That means banks and the government. If you think government cares about the poor, inflation is proof that they don't.

In response to this high rate of inflation, you have probably heard that the Fed is jacking up interest rates. Yes. They raised rates seven times in 2022 and twice in the last three months. These rate increases discourage borrowing, which is supposed to cool off what it perceives as an overheated economy. But, the economy is not really overheated. Unemployment is around 3.6% and GDP grew only 2.6% last quarter. (We'll get the Q1-2023 figure near the end of April.)

(In a future issue, I will explain what it means when we hear that the Fed is raising or lowering interest rates.)

But the Fed is getting it wrong, which is common. What is happening is an acute shortage of labor that, along with ridiculous levels of the minimum wage and continuing post-pandemic welfare that discourages work, are disincentivizing people to work and causing those that do work to cost a lot more than they should. How many of you have gone to a restaurant lately and

complained of slow service and an obvious shortage of workers? Show of hands. Yeah, as I expected almost all of you.

This problem could be fixed in a heartbeat. But no PhD economist from Harvard or wherever has the creativity to see the solution. Which is … (drum roll): Lower the minimum working age from 16 to 15. In fact, I would go to 14. There is no reason why 14 and 15 year olds cannot flip burgers, seat people, and wait and clean tables.

Instead, the Fed thinks that punishing us all with high interest rates is a good idea. That is the conventional thinking that comes from the economic theories taught at America's most prestigious universities. They could throw those out and put more teenagers to work, and inflation would come down with far less pain than we get from higher interest rates.

What about immigration? Wouldn't that help? Sure. We could take more immigrants. Legal, of course, but then, they'd need to learn English pretty quickly.

One of the positive effects of this Fed action is higher interest rates on savings. Money market funds are paying around 4.5%. Now, more than ever, you cannot afford to keep a lot of money sitting around in checking accounts. Use money market funds, and especially those that allow you to write checks. In the last ten years or so, that didn't matter as rates were very low, but it sure does now.

(Side note: It also doesn't help that the government pumped too much money into the economy during the pandemic. This massive growth in the money supply has also contributed to inflation. But if we'd fix the labor shortage, this problem would take care of itself.)

So, what about the safety of the banking system? We saw major banks fail in the first quarter. Silicon Valley Bank (SVB) failed, and its depositors were bailed out. SVB was a darling of the tech industry. It had many rich depositors who were covered for FDIC insurance up to $250,000 an account. But the administration decided there were too many friends with balances above that level to leave high and dry, so it took your tax money and bailed out the billionaires. Signature Bank of New York (SBNY) also failed, in spite of, or because of, having former chair of the House Financial Services Committee, Barney Frank, on its board of directors, as well as First Republic (FRC). SBNY went completely under and FRC's stock took over a 90% loss. Silvergate Bank also failed. The government fixed all of these banks with bailouts and arranged mergers, though shareholders lost a lot of money, as they should.

You and I of course could have $300,000 in a bank account and be covered for $250,000 and be forced to eat a $50,000 loss. But rich tech people get preferential treatment. Are you surprised? And SVB bank was very poorly managed. We have undergraduate banking students who could have led that bank and not even come close to failing, while continuing to party and celebrate LSU sports victories. A little common sense and a few basic risk management principles would have avoided the whole s**t storm.

And interestingly, with SBNY, a bank deeply involved in the crypto industry, investors saw this coming. Its stock had been sliding for 14 months before it fell off the cliff. By comparison, the performance of XLF, an exchange traded fund that tracks the banking industry, did relatively well. During this first quarter with these three bank failures, it fell from just 34 to 32. Not bad for an industry that looked like it might collapse.

So, all in all, we weathered this mini-bank crisis just fine, except that future generations bore the cost of bailing out reckless billionaires. But that's what we get from our politicians.

A Teaching Moment: What's This Gonna Cost Me?

Why is it we say that a lot? Why is it that when we look at a restaurant menu online and notice that the prices aren't there, we react negatively? In just about everything we buy, we care about what we pay. I bet even Bill Gates doesn't like paying too much for something.

And yet, we rarely, if ever question the cost of our investments. And if we did, we sometimes get the run-around. These financial experts have a way of explaining things that can make you feel you're getting a great deal when you're not. I know there are a few of you financial advisors reading this, but I happen to know that you folks are the exception. You're honest and transparent with your clients. There just aren't enough of you.

The financial industry has the most fantastic business model of any industry in history. It can manage $10 million as cheaply as $1 million. But it charges a percentage, so it makes more when it's managing a larger account, though the cost is about the same. On the plus side, that's an incentive for financial advisors to make the account grow. But, seriously, suppose the account grows just because the market grew. A rising tide lifts all boats. So why should anyone but the account owner reap the benefits, at least to the extent the financial advisor does?

In this short note, I want to explain how you pay for your investments. If you use a financial advisor or planner, you typically pay that person a fee. Many such advisors charge 1%. The good ones charge a lot less, but those are the exceptions. Now, 1% doesn't sound like much. It's what I call the 1% illusion. If your coffee went up 1%, you wouldn't think twice, though perhaps you should if you drink a lot and every day. But a slice of your money amounting to 1% is actually a lot over a long period of time.

But the main problem in my mind is that you pay it continuously. Almost every other service we buy is paid when we need the service. You don't pay your hairstylist, auto mechanic, or doctor continuously. Hey, even lawyers don't bleed you continuously. Imagine this. Suppose you had $300,000 in investments and a fee of 1%. That's $3,000 a year in costs. The financial advisor looks over your portfolio and gives you some occasional advice. Now, you couldn't get surgery for $3,000, but I suspect you could get at least 10 visits to your primary care physician. And imagine over the years that your account accumulates to $600,000, which is still not a lot of money to retire on. But your advisor is now getting $6,000 and doing the same thing. And all this is just for one year. It will happen every year.

Financial advisors are so much more expensive than doctors. Why? Because you don't know what you're paying them. If you knew and were happy with them, then great. But I suspect 9 out of 10 people could not quote a ballpark annual dollar figure for what they pay their financial advisor.

In addition, your investments are generally made in mutual funds. They charge a certain percentage of your account value. This is called the expense ratio. If your expense ratio is more than about 0.3%, which still sounds pretty low, you're probably paying too much. You're buying the wrong funds, paying for portfolio managers who are actively trading, trying to improve your performance, when study after study shows that they cannot do it consistently.

And speaking of your mutual funds, you can actually get a lot of questions answered from them, rather than using a financial advisor. They are not allowed to tell you how to invest, but they can answer questions about such things as required minimum distributions, transferring money, changing beneficiaries, and so forth.

Homework assignment, if you have a financial advisor, find out how much you're paying. Multiply that percentage by the balance in your account and ask yourself if it's worth it. And check your mutual fund expense ratio. If it's more than around 0.3%, you can get it down. Low cost, broadly diversified index funds can be gotten at less than 0.1%. Imagine cutting at least two-thirds of your costs and getting the same, if not better, performance over the long run. You will definitely have a lot more money years later, because those seemingly low costs accumulate rapidly over time.

Take care of your money, and it will take care of you.

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Don Chance, PhD, CFA holds the James C. Flores Endowed Chair of Financial Services and is Professor of Finance at Louisiana State University. Any views expressed herein are his own and may not represent those of his employer. He likes to think of himself as an all-around nice guy who believes that the more knowledge he shares with others, the better investors people will become and the more likely they can avoid being ripped off by the Wall Streeters, who know many ways to take your money and make you think you came out ahead.