



PERSONAL
INVESTMENT
MANAGEMENT, INC.

Quarterly News Release

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General Announcements

After over a year of decentralized operations, PIM intends to return to our office in September. We are beginning now to host clients in our office for planning and review meetings. We look forward to seeing you.

Market Commentary:

Brian C. Fahey, MA, CFA and Christopher J. Reedy, MBA, CFP®, CIMA®

The Fed

The US Federal Reserve (“the Fed”) is run by a seven-member Board of Governors. The Fed employs some of the best economists in the world and collects and analyzes an enormous amount of economic data. The research produced by the Fed matters a great deal; the Fed’s actions, comments and publications significantly impact global capital markets.

If it has occurred to you that references to the Fed in our recent communications have been more frequent than normal, you would be right, and we should be forgiven. From their open market operations to their research reports and press conferences, following the Fed has been of outsized importance through the economic collapse brought about by COVID-19 and the subsequent recovery.

The FOMC

The Federal Open Market Committee (FOMC) has 12 members: the seven members of the Board of Governors, the President of the Federal Reserve Bank of New York and the Presidents of four of the remaining 11 Federal Reserve Banks throughout the country. The FOMC meets 8 times a year but may meet with greater frequency in extraordinary circumstances. It is this group that assesses economic conditions and sets monetary policy.

The FOMC meeting in June was the most important since March of 2020. Prior to the June meeting the Fed had signaled that they would keep short-term rates at zero until there was substantial realized, not forecasted, progress in the labor market and inflation was averaging 2% over a longer timeframe. This historically accommodative policy position has served as a strong tailwind to capital markets.

The Dot Plot

One datapoint that the Fed uses to increase transparency in policy deliberations is something referred to as the “dot plot”. Introduced in the wake of the 2008 Financial Crisis, this represents each Fed Governor’s best guess on where short-term interest rates will be each quarter over the coming years. At the June meeting, two Governors moved their dots higher, suggesting an end to the ultra-accommodative policy and an increase in interest rates as early as next year.

The Reaction

The bond market took immediate notice. During the three-day period following the FOMC meeting, the interest rate sensitive Five-year Treasury sharply increased in yield (fell in price) and the inflation sensitive 30-year Treasury bond fell in yield (increased in price). The magnitude of the changes in yield of these two US Treasury securities was a six-sigma event, something that should only happen once every 4 million years. This tells us that investors were very surprised by the dot plot announcement and now believe that the Federal Reserve’s willingness to support the economy through low interest rates is fading.

Over the same three-day period, the S&P 500 declined by 3%, then quickly reversed course to record new all-time highs.

What happened in June in capital markets might not seem like much. Relatively few people understand or care much about the bond market on a day-to-day basis. The stock market wobbled for a few days and then rallied higher.

Our Views

The Fed has been incredibly successful in calming the credit market. High yield corporate borrowers have never paid a lower price to issue debt as they are today. The hundred-year record was broken this past quarter. Investment grade borrowers are 0.3% away from breaking their low-cost record. US banks recently passed their annual “stress tests” and COVID-inspired financial restrictions have now been lifted. The banking system is so flush with assets their biggest concern is finding a good home for client deposits, which is the exact opposite of the bad loan provisions they were issuing a year ago. The labor market is healing. The June jobs report surprised on the upside, with the economy adding 850,000 jobs.

The equity markets have been remarkably steady at the macro level over the past year. The S&P 500 has experienced 34 all-time high closes in 2021. The largest decline, year-to-date has been 4%, while the average year experiences at least 1 decline of 10% or greater.

Markets move through cycles, oscillating around a long-term trend. Like nearly everything during the pandemic, this cycle has moved remarkably fast. Years’ worth of financial market gains have been packed into 15 months. Household equity holdings are at an all-time high, eclipsing the record from the technology bubble of the late ‘90s.

At the same time equity valuations are in the 99th percentile of observations for just about every metric we follow. Of greatest concern is that the economic drivers that explain changes in the S&P 500 (interest rates, currency exchange rates, risk aversion and growth expectations measures, energy costs, liquidity, corporate credit, commodity prices, inflation) have recently lost their explanatory

power for the first time since the pandemic began. This suggests a market that is becoming detached from fundamentals and operating on investor sentiment and positioning.

It is into this environment that the Fed wants to take the training wheels off the economy. The Federal Reserve worries about economic stability and the labor market. Their primary concern is the flow of credit from lenders to borrowers (credit/debt markets) and the workforce participation rate, not the value of the S&P500. The first step to normalizing policy will likely be to reduce (or “taper”) the monthly purchases of US Treasury and Mortgage-Backed securities. These purchases support lower interest rates for all borrowers, most especially mortgages. This announcement may come before the end of the year. The Fed is correct in their desire to end their COVID-era monetary support, but that means a more challenging environment for equities for the rest of the year.

Investment Strategy

Between current equity valuations and our perception that the Fed intends to pull back from the policy accommodations that have supported the economy through the pandemic, we have turned slightly bearish in the short-term. However, while we struggle to see how domestic equity markets could advance much further, we are not planning major adjustments to client portfolios. Our rationale: 1) corporate earnings may be strong enough to support current prices and beyond, driven by consumer spending and business investment throughout the remainder of the year, 2) aside from high valuations, there appear to be no structural economic flaws throughout the economy; balance sheets of US firms and consumers are very favorable, 3) the labor market is strengthening, supporting the notion that consumer spending may support equity prices, 4) the macro-economic data mentioned above may adjust to levels that explain the price of the S&P 500 over the coming months; such a change would not be abnormal, 5) foreign economies are slowly emerging from the pandemic and may present greater opportunities for equity growth than domestic markets, 6) we are not market-timers; even if a correction is looming, nobody knows exactly when it will occur or how long it will last.

In summary, we design and manage investment portfolios that are intended to be resilient through short to intermediate-term market fluctuations. While rich equity valuations and probable Fed actions may create a tough environment for stocks, an improving labor market and healthy consumer spending may be enough to support the transition to economic normalcy without too much drama.

Editorial

Christopher J. Reedy, MBA, CFP®, CIMA®

Introduction

It is interesting, the things we remember. One of my favorite movies is “Dave”, a 1993 film in which “Dave”, played by the actor Kevin Kline, is used as a body-double for the President of the United States, who has had a stroke and is in a coma. Feeling somewhat empowered to effect positive change, Dave calls a budget meeting, during which the following dialogue takes place.

Dave: “Commerce Department”

Commerce Dept: “Yes, Mr. President”

Dave: “You’re spending \$47 million on an ad campaign to boost consumer confidence in the American auto industry.”

Commerce Dept: “Yes Sir, ah, well, you see its designed to bolster individual confidence in a previous domestic automobile purchase.”

Dave: “So, we’re spending \$47 million so that somebody can feel better about a car they’ve already bought?”

PIM’s communications are designed to be informative, even at the risk of sometimes providing detail that is too technical or possibly uninteresting. We resist, enthusiastically, anything that might give the impression that we are a marketing organization that happens to manage investment assets. Yet, the narrative that follows, I admit, may have the effect of reinforcing the decision that you, our valued clients, have made to allow us to serve you.

Two articles came to me recently, one from a long-time PIM client, and one in my regular reading. Both struck a nerve and are worth discussing.

Article 1: Wall Street Journal / Jason Zweig

The first was published on June 11th in the Wall Street Journal. The article is titled: You Can’t Invest Without Trading. You Can Trade Without Investing. The author begins this way:

I’ve had it. The Wall Street Journal is wrong, and has remained wrong for decades, about one of the most basic distinctions in finance. And I can’t stand it anymore.

If you buy a stock purely because it’s gone up a lot, without doing any research on it whatsoever, you are not – as the Journal and its editors bizarrely insist on calling you – an “investor.” If you buy a cryptocurrency because, hey, that sounds like fun, you aren’t an investor either.

Whenever you buy any financial asset because you have a hunch or just for kicks, or because somebody famous is hyping the heck out of it, or everybody else seems to be buying it too, you aren’t investing.

You’re definitely a trader: someone who has just bought an asset. And you may be a speculator: someone who thinks other people will pay more for it than you did.

More from the article:

An investor relies on internal sources of return: earnings, income, growth in the value of assets. A speculator counts on external sources of return: primarily whether somebody else will pay more, regardless of fundamental value.

Last piece from the article:

Nevertheless, the journal and its editors have long called almost everybody who buys just about anything an “investor.” On July 12, 1962, the Journal published a letter to the editor from Benjamin Graham, author of the classic books “Security Analysis” and “The Intelligent Investor.” That June, complained Graham, the Journal had run an article headlined “Many Small Investors Bet on Further Drops, Sell Odd Lots Short.”

He wrote: “By what definition of ‘investment’ can one give the name ‘investors’ to small people who make bets on the stock market by selling odd lots short?”

“If these people are investors,” asked Graham, “how should one define ‘speculation’ and ‘speculators’? Isn’t it possible that the current failure to distinguish between investment and speculation may do grave harm not only to individuals but to the whole financial community – as it did in the late 1920s?”

I don’t need to restate, for clarification, the point Graham made in 1962 or the point Jason Zweig is making now. Given the emergence of speculative investing on a more public scale than we have seen in recent years (or maybe ever), which has produced millionaires in some cases, and in a relatively short time, it seems valuable to pause and acknowledge that we are investors. We, meaning PIM and all of our valued clients. We are not traders, and we are not speculators. Regardless of the Journal’s resistance to distinguishing between the three terms, Graham and Zweig are right.

Article Two: The New Yorker / Robinhood / Sheelah Kolhatkar

On May 17th, The New Yorker published an article written by Sheelah Kolhatkar. The article is titled Robinhood’s Big Gamble. This was presented to me via email by a PIM client with whom I have worked for many years. He is a forever intellectually curious person and thought I might enjoy the read. As with many articles published by The New Yorker, this was rather lengthy at 18 pages. The article describes the history of the founders of Robinhood and the development of the company over time. When I set it down following my first read, I was troubled.

In the summer of 2020, a young man in Naperville, Illinois (my former home) used the Robinhood app to place a put spread options strategy. When you own a put, it gives you the right to sell the underlying security at a certain price (you may “put” the security to your counterparty). When you sell a put, you receive income and are vulnerable, if the underlying security falls in value, to having the security “put” to you. Buying and selling puts on the same security at the same time is designed to hedge overall risk.

The young man received an email from Robinhood at around midnight on June 11th, informing him that his account had been restricted. He checked his account to find that he owed more than \$700,000. Stunned, he sent a series of emails to the company asking for clarification. He received email replies, many of which were auto generated and the last of which, at 3:26am, informed him that he must deposit a little over \$178k within a week.

He left home on his bicycle, rode to a train station, and stepped in front of an oncoming train. His suicide note stated, in part: "How was a 20-year-old with no income able to get assigned almost a million dollars' worth of leverage?"

That's the abbreviated version. The full article provides considerable additional detail. Now, what to make of it?

It would be easy to rail against Robinhood for sending alarming emails in the middle of the night. It would be easy to rail against Robinhood for intentionally building a business in such an important industry that provides no human customer service (thus, the autoreply emails). It would be easy to rail against Robinhood for allowing a young man with little experience the ability to attempt complex options strategies. It would be easy to rail against Robinhood for all of these and a great many more things.

But it would also be imprudent. The information I have comes only from the cited article and is therefore incomplete. Maybe there is more to the story. I rather doubt it, but maybe. What is clear is that this young man was, by virtue of the particular options strategy he placed, attempting to be reasonable, perhaps even conservative. What is also clear is that he didn't understand the strategy completely. He didn't understand that while one side of the trade went against him, the other side, which he could have exercised himself the next day, might have nearly or entirely offset what he owed on his short put. His repeated attempts to seek clarification from Robinhood seem to indicate that he had a notion about this but was unsure. The specific information he received from Robinhood may have been incomplete, perhaps even inaccurate.

On July 1st, an article appeared on CNN.com, which conveys, in-part, the following:

Robinhood has settled a wrongful death lawsuit filed by the family of a 20-year-old trader who died by suicide after seeing a negative account balance of \$730,000.

Kearns' death was cited by Wall Street's self-regulator in a record-setting penalty imposed on Robinhood on Wednesday for harming investors.

FINRA ordered Robinhood to pay about \$70 million in fines and restitution to harmed customers, the largest penalty ever handed down by the regulator. Robinhood neither admitted nor denied the charges.

The Dunning-Kruger Effect

There is a certificate on my office wall attesting to my limited, brief academic work in behavioral finance. Certificates are nice, though it takes relatively little these days to earn one. I am not, by any stretch of the imagination, an expert in this field. But I do recall something about the Dunning-Kruger Effect. Generally, this is the tendency of the incompetent to have an inaccurately high opinion of themselves, and conversely, the tendency of the competent to be more conservative in their self-assessments. The former overestimate themselves. The latter overestimate others. My fear is that a

little good luck speculating in the markets can cause an inexperienced person to overestimate their skill level and take bigger and bigger risks over time. Indeed, there may be dozens, or hundreds, or thousands of people who bought GameStop, or AMC, or Bitcoin, experienced gains early, then substantial losses shortly thereafter. The person who bought GameStop on January 27th when it traded at \$347 per share certainly did so with supreme confidence. I wonder how they felt on February 19th when the stock closed at \$40 per share?

Conclusions and Closing Comments

Here are my takeaways: 1) Do not engage in investment strategies that you do not understand – or if you do (as a speculator), limit your exposure to what you can afford to lose (which necessitates that you fully understand your own exposure), 2) Be honest with yourself about who you are, what you know and don't know, 3) Understand the difference between speculating, trading and investing, 4) Do not do business with a financial services firm that has no obligation to act in your best interests, 5) Do not do business with a financial services firm that offers no qualified live customer service.

Obviously, the typical client of Personal Investment Management is at little or no risk of the dangers described in this commentary, but you probably know of someone who is. At minimum, having a better understanding of these issues may help you feel a measure of comfort with the car you already bought.

Enjoy Summer

Notwithstanding recent record high temperatures, it is quite lovely to see the blue sky and feel the warmth of the sun. Far better yet, we are all beginning to come together with friends and loved ones, with little apprehension, for the first time in a long time. From our families to yours, sincere best wishes for a wonderful summer.