FRIDAY, MARCH 17, 2023

Hello and welcome to the Dividend Cafe. I am recording in Newport Beach and have all kinds of things to talk about today because we're going to go back to what we'd done, oh, it was about a month ago where we just took a lot of the questions that had built up from different readers and go through 'em one by one, all different topics. So you're getting another multi topic Dividend Cafe. I of course could have chosen to write this week's Friday Dividend Cafe about the Silicon Valley Bank collapse and these various instabilities coming out in the banking system changes in policy at the Fed and FDIC. But we did that earlier in the week, and if you missed it on Monday, we did a special edition Dividend Cafe. I should point out that chances are, if we're ever doing a special edition Dividend Cafe, it's usually not because everything is going so well. There's usually something kind of bad or questionable or vulnerable distressful that leads to what we perceive to be a desire from our clients to have us interject with immediate, thoughtful commentary. And I hope that's what the prior Dividend Cafe this week was thoughtful commentary on what is a truly bizarre situation. But in the meantime, it does seem that there's been a lot more questions that have built up lately, and I try to answer one every day in the Ask David section of DC Today. But when I start seeing it get this far behind, I think Dividend Cafe is a nice way to catch up all at once.

And one of the first questions that came in this week had to do with my prior weeks' concept of an ongoing flat market, a sort of flattish directionless market. And the question was what we think about inflation in the flat markets, and when you look at the historical reality of inflation relative to market pricing, doesn't it actually net of inflation refer to something even worse? So that question about inflation and flat markets I think is a perfectly legitimate one, but I just want to point out that the way in which one charts how a market is done has to be consistent. You can't say, here's how stocks have done net of inflation, and here's how bonds have done without factoring inflation. And in reality, when you show a chart of the stock market, you're showing what people would've put dollars into and then what dollars it'd be worth at the end. And we're not used to talking about that. Netting out the inflation. The chart sort of has to speak for itself. And in order to maintain the integrity of the data, you have to be consistent. Use nominal rates of return for stocks just like you're using nominal rates of return for cash and for bonds. And so look, if you have a stock market, I'm making up a number that's up 6% and there's 3% inflation, and you have a bond market that's up 2% and there's 3% inflation, the difference between the two is uniform when you're factoring in the inflation, what the only thing that makes the difference is the nominal rate of return. And so I think it's a perfectly appropriate way to talk about these things as long as you maintain consistency.

Now another question related to the subject of inflation and flat markets would be whether or not we could see increase in trading and people trying to trade up and down around a directional market. Would that add to portfolio volatility? Would it add to portfolio volume? Historically, I don't think there's any reason anything it adds to volume per se. Flattish markets tend to take certain actors out, and then of course you may see more activity for those trying to trade. But again, nothing about there being more people trying to time the market up and down indicates that there's more people doing it well. And whenever there's a period of people doing something that isn't going well, it there's heavier volume in what they're doing until there isn't. And when they get kind of rip off their own face, then they tend to quit trading. Let me know if I need to repeat that or not. So I don't expect it to be particularly germane. And I do think that there would be some who try to trade their way through a directional market and will deeply regret it.

All right. The next question has to do with the tax tail and the index dog and someone saying, I am sold on the idea that indexing is going to struggle. And for all the arguments you've made going forward that were not assured the same price to earnings ratio, the same valuation expansion that we've been getting. And yet I'm sitting on a bunch of indexes and I have big capital gains. So you advise me just to kind of sit on those indexes, try to get a little of the yield or the dividend out of the index but am I kind of stuck because of the tax ramifications? And I just want to be very clear that I never believe in the tax tail wagging the investment dog. I always believe in being tax sensitive but not tax obsessed. And no, there is absolutely no way that I would recommend someone maintain a suboptimal or subpar portfolio, let alone for an extended period of time merely because of taxes. And in fact, certain things when they have the ability to go down, could very well solve the tax problem for you in the worst possible way. And I think you know what I mean. But this option about, well, let's just try to get the dividends we can out of the index. I just want to point out the current yield in the S&P 500 is 1.6%, 1.7%. So for the most part, people hoping to be income minded don't even have the option of getting that out of an index. And I think there are ways to soften the tax impact, but we have to look at each individual situation, the liquidity, the income need, the total size of portfolio. But no, as a general philosophical response, I do not think that when show taxes drive the investment decision, it should be a factor but not the factor.

Somebody asked a thoughtful question, speaking of the Silicon Valley Bank episode about moral hazard and these deposit or bailouts, and whether or not I was worried that by giving extended coverage above and beyond the FDIC limits to those who have cash deposits in some of these troubled banks of over $250,000, that we were going to increase the moral hazard going forward. And I think that that's inevitable that you certainly do. Now, to try to be objective and nuanced here, I don't think they did anything that encourages greater risk taking and foolishness at the banks in the sense of the banks have to think about their own capital, which has been blown up here, their own equity value, which has been blown up their own riches, wealth and compensations, stock value, stock options, net worth, which has been blown up. And even those who lend in the bank, the unsecured bond holders, the creditors have to think about the value of their debt, which is pretty much in this case been totally wiped out. And so yes, there are concerns about the moral hazard of depositors getting a benefit above and beyond what they were supposed to have gotten relative to the law, but it's not quite the same as the bank itself being bailed out. And I certainly think the objective in doing so here, even though I think there's other things that could have been done, and most importantly I don't think it ever, ever, ever should have got to this position. But in fairness there, we're trying to stave off contagion thinking as bad as the moral hazard may be, and breaking the rules to extend FDIC coverage may be for uninsured depositors, what would be even worse is if people created a self-fulfilling prophecy of contagion by, because they're worried about banks, they would draw funds, which creates a reason to worry about banks. And I just cannot tire of saying this is the reality of fractional reserve banking. We've made a decision as a society to have fractional reserve banking. That decision is going nowhere, by the way, I promise you that. And yet, as a function of math, the risk is always there that a bank can go upside down and it's net worth if those who have deposit on demand access exercise it, and it forces the bank to dip into its equity cushion, which proves to be inadequate or is impaired at the time because of things like bond market to market losses.

Very, very thoughtful Client asked a question about my views of what is appropriate for someone to invest in alternatives. They had read an article that suggested that the minimum net worth to invest in alternatives ought to be 10 million. And that there needs to be various criteria around risk tolerance, time liquidity and so forth. And I mostly agree with a lot of it. I think the 10 million figure is somewhat arbitrary. I think some people have a tolerance for the benefit of illiquidity with private markets, private equity, certain hedge funds, real estate, they could tolerate it at a lower number than 10 million and some people would even need a higher number. So each case is going to be different, but I believe that the liquidity or illiquidity, if you will, tolerance is by far the most important consideration. And things like risk tolerance as far as one's ability to tolerate the permanent erosion of capital, we look at an alternatives not as taking existential risk, but rather diversifying risk to non-correlated spaces that generally are going to have more manager execution idiosyncratic risk as opposed to the notion of getting really bad short term performance. But yeah, I think that each case is going to be different and illiquidity is probably the most important criteria in how one approaches this.

Someone asked if I thought the Fed would be out and out dishonest and say that they were going to raise rates just so it would have a certain impact in the market, but then know that they weren't really going to do it in the end. And my answer's kind of nuanced here because on one hand, there's no question that central banks, including our own Fed heavily use a policy tool that we call forward guidance. But do I think that amounts out and out lying and do I think it's really problematic? It's just a gray area. I don't think that they're lying for the most part when they say they're going to raise or they're not going to raise. I think that the time that they say it, they basically mean it. But it is true that by merely posturing, you're going to do something in the world of leveraged banking. You may get the response you want before you ever have to do anything. A great example is when they said we're going to buy up to like a hundred billion of high yield junk bond ETFs and whatnot during COVID, and I think that they spent 2 billion, it may have gotten up to 4 billion, but I mean they spent a tiny fraction of what they said, and there was no question that the reason they didn't have to really execute on everything they said they were going to do is because the market did it for 'em. High yield rallied, spreads collapsed. And they kind of brought a little bit of improvement to financial conditions just by merely threatening that they were able to do something. And so I think that is a policy tool they use, and I think that it's very possible that they can use it effectively. But at some point, if you're doing it all the time saying you're going to do something and never doing it, you have to worry then on the other side of the ledger about credibility.

Somebody asked if I thought Social Security, the third, I'm going to call it the third rail of politics, Social Security ideas has become that third rail. Somebody asked if I thought that we might just convert it from a pension plan, a defined benefit plan to a defined contribution or a 401K type plan where it's privatized and then the taxpayer is going to build up a certain base of capital versus right now where it's a fixed rate that they're assembling and people are going to get a certain benefit out mathematically, much like a pension fund. I don't believe that they will make that change. I certainly do think they should, but I just want to remind people that what this reader was asking for is something that George Bush Jr. Tried to do himself after he was reelected in 2004. And so in early '05, he brought up private accounts, Social Security, and he was just murdered for it. I mean, hammered the pressing that this would take away the protection of Social Security, it would take away the safety, all very untrue, but nevertheless really baked into the narrative. And then of course, Republicans being falsely maligned and attacked for plans to shore up Social Security, they responded in classic form by doing nothing whatsoever. And so when the Republican Party was willing to walk away from any kind of effort to reform that aspect of Social Security, and when the Left was so willing to kind of demonize the idea of reforming, it definitely changed my view on the feasibility anytime soon of such a change.

Alright, getting near the end here. The second to final question had to do a Modern Monetary Theory. And whether I not or not, I thought based on my view of Japanification and a low, slow, no economic growth, as we have wildly excessive fiscal and monetary policy, did I believe that Congress is willing to allow this fiscal insanity to go because they're just buying time to eventually go to a MMT, a Modern Monetary Theory? And my answer is no. I don't believe that. I don't think that there are five people in Congress that would understand what MMT is, and I don't think that they are headed in that direction necessarily. I think that they don't need to be when they get to play around the edges of a quasi MMT by letting a Fed run up its balance sheet and buy other assets they're not really supposed to be buying. I think they've gotten their cake and eating it too. But fundamentally, what MMT seeks to do, I think could become very problematic.

The final question I want to address is how to go about selecting a wealth advisor. Somebody had asked what I thought the right criteria would be to either look to replace your advisor or select a new one. And I just want to say that it's obvious I'm talking my own book to some degree. I would like to think that the things I'm going to say apply to what I believe about our firm and our group of advisors and personnel at the Bahnsen Group. But of course, that's the reason that I believe these things, that we are those things is because I believe them to be the ideal and the optimal situation. And I'm going to start with just the most unhelpful part of my answer is I do think that one has to go to some degree off of a gut feel. Do you feel a connection? Do you feel a trust with the person or people sitting across from you? And that trust is paramount in an advisor client relationship. Now, in terms of how that trust gets established, we believe it comes from trustworthiness that a client should trust the advisor when the advisor is worthy of their trust. And you're worthy of the trust by sometimes saying things that people don't want to hear by telling the unvarnished truth in all circumstances and by working tirelessly. And I think that's where a lot of trust gets deteriorated in our industry is that you have a very significant amount of advisors that don't work tirelessly, therefore don't earn trust, and then there's a lot of vulnerability in that relationship. But there's a couple other components I'd throw out there. I believe that most ought look for an advisor who is a legal fiduciary, who has a lot of transparency and alignment in the way that they're compensated. And I think that those who are kind of really just sort of paid salesmen for other products, for financial products, I think that's a different model. And even if it's a really honest and high character paid salesman, it doesn't produce the alignment that I think a fiduciary relationship entails. And this is a very core principle at our firm. More and more I think people want a firm, need a firm that has a good breadth and depth of services. I think if you want a really elegant, sophisticated portfolio, you don't want to go to a firm that only does planning. If you want really high quality planning and cashflow modeling and resources around retirement taxes, estate charitable giving, you don't want a firm that only cares about the portfolio management. So some sort of synthesizing of these different services that represent real wealth solutions is important. But all that aside, the fiduciary standard, the depth and breadth of services, nothing can trump the trust and trustworthiness at the core of the relationship. And that's always been our standard. And it's about as specific as I could be here in answering this.

So we went through a lot of different topics. I hope you got a lot out of it. Maybe some of these questions were pertinent to you, some were not. But I will go ahead and leave it there. And if you have any additional questions, send 'em our way. We're obsessed with answering everything on your mind. Do you see today, Dividend Cafe? We could write you back privately. We're pretty faithful in my correspondence. And in the meantime, enjoy your March Madness weekend and enjoy sharing this Dividend Cafe with anyone you wish. Rate us, subscribe to us, say good things about us at your podcast at YouTube. Feel free to post this Dividend Cafe at your social media. Whatever you want to do. It helps spread the word and with your questions, we promise to get back to you right away. Thanks for listening to watching and reading the Dividend Cafe.
