RIVERVIEW QUARTERLY INSIGHTS

RIVERVIEW trust company

INFLATION? WHAT'S THAT?

One of the curses of being old (and there are many) is that all your cultural references become irrelevant; no one knows what you're referring to. Like gas lines. Or The Hustle. Or Fireball XL5. Or double-digit inflation.

Inflation has been so low for so long that most people can't conceive of 16% mortgages (which were a thing when I was in my 20s). A third of the people currently living in the rich world had not been born when average inflation last exceeded 5%, according to The Economist magazine. But while inflation had been hovering at a near-decade low, it has in the last month risen above 2%, a key level that could eventually cause the Federal Reserve to raise short-term interest rates if inflation were to persist above this level for some time. So the subject of high inflation becoming an economic reality in the coming years has become much more popular in the economic press.

To begin with, what is inflation exactly? Our old friend, Wikipedia, defines inflation as "a general rise in the price level in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value." In other words, it's the reason why comic books, which cost 10 cents when I was a kid, now cost around $10. "The common measure of inflation is the inflation rate, the annualized percentage change in a general price index, usually the consumer price index, over time."

Inflation is not entirely good or bad; again, according to Wikipedia, "[t}he negative effects of inflation include an increase in the opportunity cost of holding money [because it becomes worth less over time], uncertainty over future inflation which may discourage investment and savings, and if inflation were rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include reducing unemployment due to nominal wage rigidity, allowing the central bank greater freedom in

cont. on next page

carrying out monetary policy, encouraging loans and investment instead of money hoarding, and avoiding the inefficiencies associated with deflation."

The reason inflation is a concern now starts with the enormous economic stimulus packages from the federal government, together with very low short-term interest rates from the Fed. As a result, individuals and companies will find themselves flush with cash as the economy starts to recover. Vaccines become widely distributed, social restrictions become loosened, and people who have been going nuts from being stuck in the house open the spigots on a torrent of spending. Enough spending causes prices to rise, spurring inflation.

But even if some inflation happens, it might be temporary. As stated in a December 12 article in The Economist, a large spending spree "would result in a lot of money chasing goods and services that might not be in ample supply, resulting in a period of inflation that would tail off as the purchasing power of the money involved fell, bringing things back toward the status quo." In other words, "even if there is a spending boom, there will be plenty of economic slack around to accommodate it." Some economists predict that "the economy will get back to speed in fits and starts, some perhaps inflationary. But for most, high joblessness and contained inflation expectations make forecasting continued low inflation a no-brainer."

So what's the big deal? There's a lot of money around, prices go up a little, we go back to a normal (rather than ultra-low) inflation environment, but the jobless rate remains high enough that wages don't go up too high and therefore prices can't get too high. In testimony before the Senate Banking Committee, Jerome Powell, the Fed chairman, stated that "[i]n the near term, we do expect, as many forecasters do, that there will be some upward pressure on prices… Long-term we think that the inflation dynamics that we've seen around the world for a quarter of a century are essentially intact. We've got a world that's short of demand with very low inflation… and we think that those dynamics haven't gone away overnight and won't."

The argument for worrying about inflation seems to be worry itself. As The Economist stated, "[i]f 2020 has a lesson, it is that problems which many in the world had broadly stopped worrying about can rear up with sudden and terrible force." A later article in the March 27, 2021 edition of the same magazine breaks the "worst-case scenario" into three stages. The first stage, in which inflation rises mechanically as the economy and commodity prices pick up after the spring of 2020, is already happening. The second phase occurs as "spending by newly vaccinated consumers rebounds from the pandemic faster than production can keep up." This type of economic overheating is acknowledged even by advocates of continued stimulus. Further, it will become more likely if more deficit spending passes (for example, if President Biden's $3 trillion infrastructure bill passes). In the third stage, which is also the most controversial, "temporary inflation turns permanent as the public's inflation expectations rise and become self-fulfilling. Workers, anticipating a higher cost of living, demand higher pay; forward-thinking firms raise prices." This could result in a "return to the 5% plus inflation of the late 1960s, or perhaps even the 10%-plus rates of the 1970s."

Worse still is the prospect of "stagflation," which results from a combination of a slow economy, high unemployment and rising prices. The effects of stagflation in the United States in the 1970's and early 80's were so drastic that the Fed had to intentionally induce a recession by dramatically raising short-term interest rates to stop it. There is currently no indication that stagflation is a possibility at this time.

The point is, the economic impact of rampant inflation is so bad that it should be worried about, regardless of its likelihood. And the benefit of thinking and worrying about it is that it can clarify your concerns about your own portfolio.

So even though age makes your cultural references irrelevant, it does provide you with some perspective. Having lived through the 70s and early 80s, I know the devastating impact inflation can have on people's lives.

I also know that people who viewed their investments from a consistent, long-term lens made money during that time. The patient investor always takes what the market gives her, regardless of the economic environment. With that in mind, here are our inflationary observations:

- Rampant, runaway inflation (that is, inflation that is well above the 2% rate targeted by the Fed) is possible but unlikely. The only good thing about inflation is that, unlike a pandemic, you can see it coming from a mile away.

- Consider a slight tilt toward "value" stocks, as opposed to "growth" stocks (if you are a client of ours, you already have such a tilt in your portfolio). One common measure for valuing stocks is their "price-to-earnings" ratios; a high P/E ratio indicates that the price of the stock is higher relative to the revenue it generates, and therefore is an expensive stock (often indicating that it is a growth stock). For value stocks, the reverse is true. Growth stocks maintain their higher valuation with the assumption that interest rates will stay lower and that the company will grow significantly. Value stocks, on the other hand, are often cyclical and can do better in higher interest rate environments. As the mere threat of inflation has arisen, we are already seeing value stocks outperform growth stocks over the past 3 to 6 months. If the inflation rate rises, we would expect that trend to continue.

- Inflation makes your cash worth less. So if we get to the point that inflation is increasing significantly, you may consider putting some of your cash into short-term bonds or even CDs. This is a tricky call because if inflation gets really out of control the return on cash deposits may equal or even surpass short-term bonds or CDs within a fairly short period. The main point is to monitor cash returns, particularly when the short-term Fed rate exceeds 2%, on a regular basis.

- One place where people made money during inflationary periods over the long term was by buying individual bonds and holding them to maturity. A high-quality 30-year bond with an 8% yield (yes, there were such things) outlasted the period of inflation and generated a consistently superior return for its life. This is a particularly difficult technique to recommend because it involves market timing (something we never advocate). It's a technique that shouldn't even be considered until short-term rates exceed 7% or 8%. Even then, such a shift would require a thoughtful approach that would require you to hold such instruments for long periods of time.

As always, stay the course and be comforted by the fact that the noise of "financial news" does not now nor has it ever seriously impacted your investments. Rather, the headlines that you've lived through over the last five years (like the Trump election, the Biden election, BREXIT, and the pandemic) have not affected your long-term investment returns. Although they may have touched you personally, to your portfolio they (like the threat of inflation) have been ripples, not tsunamis.

SPOTLIGHT ON PLANNING

DECISIONS, DECISIONS: WEIGHING THE PROS AND CONS OF AN IRA ROLLOVER

If you lose a job, switch employers, or step into retirement, you might consider rolling your retirement plan savings into an IRA. But this isn't your only option; it could make more sense to keep the money in your previous employer's plan or move it to your new employer's plan (if allowed by the plan).

You could also cash out, but that's rarely a good idea. Withdrawals from tax-deferred retirement accounts are taxed as ordinary income, and you could be hit with a 10% tax penalty if you are younger than 59½, unless an exception applies.

Some employer plans permit in-service distributions, which allow employees to take a partial distribution from the plan and roll the money into an IRA. When deciding what to do with your retirement assets, be aware that IRAs are subject to different rules and restrictions than employer plans such as 401(k)s.

What IRAs Have to Offer

There are many reasons to consider an IRA rollover.

Investment choice. The universe of investment options in an IRA is typically much larger than the selection offered by most employer plans. An IRA can include individual securities and alternative investments as well.

Retirement income. Some employer plans may require you to take a lump-sum distribution when you reach the plan's retirement age, and your distribution options could be limited if you can leave your assets in the plan. With an IRA, it's likely that there will be more possibilities for generating income, and the timing and amount of distributions are generally your decision [until you must start taking required minimum distributions (RMDs) at age 72].

TOP REASONS FOR MOST RECENT IRA ROLLOVER

69% Didn't want to leave assets with former employer

65% Wanted to preserve tax treatment of savings

57% Wanted to consolidate assets

55% Wanted more investment options

44% Was required to remove the money from former employer's plan

Source: Investment Company Institute, 2021 (more than one reason allowed per respondent)

Account consolidation. Consolidating your investments into a single IRA may provide a clearer picture of your portfolio's asset allocation. This could make it easier to adjust your holdings as needed and calculate RMDs.

Different exceptions. There are circumstances when IRA owners may be able to withdraw money penalty-free prior to age 59½, options that are not available to employer plan participants. First-time homebuyers (including those who haven't owned a home in the previous two years) may be able to withdraw up to $10,000 (lifetime limit) toward the purchase of a home. IRA funds can also be withdrawn to pay qualified higher-education expenses for yourself, a spouse, children, or grandchildren. IRA funds can even be used to pay for health insurance premiums if you are unemployed.

When to Think Twice

For some people, there may be advantages to leaving the money in an employer plan.

Specific investment options. Your employer's plan may offer investments that are not available in an IRA, and/or the costs for the investments offered in the plan may be lower than those offered in an IRA.

Stronger creditor protection. Most qualified employer plans receive virtually unlimited protection from creditors under federal law. Your creditors cannot attach your plan funds to satisfy any of your debts and obligations, regardless of whether you've declared bankruptcy. On the other hand, IRAs are generally protected under federal law (up to $1,362,800) only if you declare bankruptcy. Any additional protection will depend on your state's laws.

The opportunity to borrow from yourself. Many employer plans offer loan provisions, but you cannot borrow money from an IRA. The maximum amount that employer plan participants may borrow is 50% of their vested account balance or $50,000, whichever is less.

Penalty exception for separation from service. Distributions from your employer plan won't be subject to the 10% tax penalty if you retire during the year you reach age 55 or later (age 50 for qualified public safety employees). There is no such exception for IRAs.

Postponement of RMDs. If you work past age 72, are still participating in your employer plan, and are not a 5% owner, you can delay your first RMD from that plan until April 1 following the year in which you retire.

MARKET SNAPSHOT

MARKET SUMMARY – Short- and Long-Term Index Returns

Index Returns as of March 31, 2021

Stocks had another strong quarter of performance to begin 2021. However, bonds performed negatively due to rising global yields. Yields generally rose more in the US than in other parts of the world; hence, the US bond market suffered its worst quarterly performance since the early 1980s.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
1Q 2021	6.35%	4.04%	2.29%	6.22%	-3.37%	-1.90%
1 Year	62.53%	45.86%	58.39%	36.05%	0.71%	1.45%
5 Years	16.64%	8.92%	12.07%	3.52%	3.10%	3.28%
10 Years	13.79%	5.21%	3.65%	6.23%	3.44%	4.22%

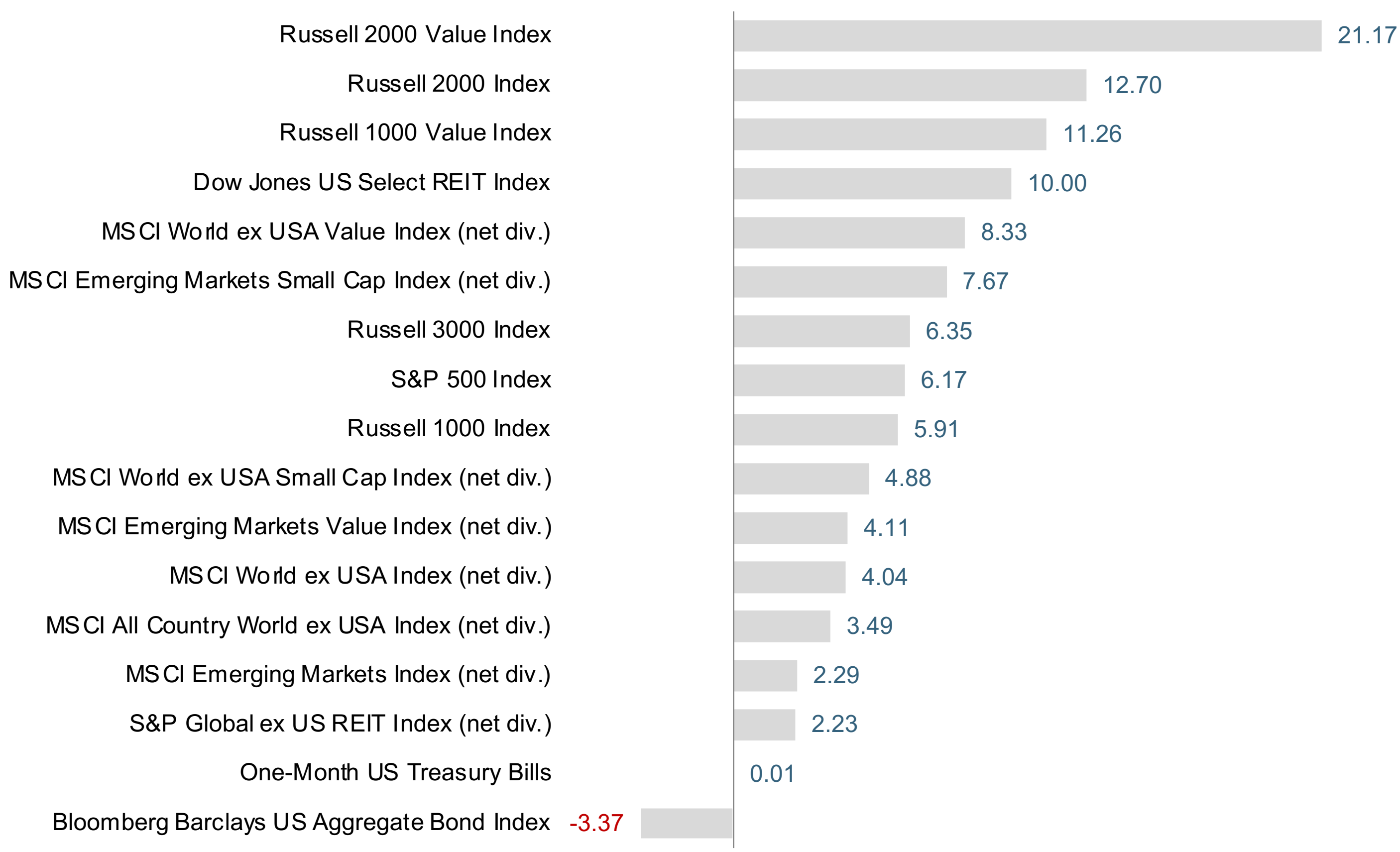
See important disclosure information

GLOBAL MARKETS - First Quarter 2021 Index Returns (%)

Equity markets around the globe posted positive returns in the first quarter. Looking at broad market indices, US and non-US developed markets outperformed emerging markets.

Value outperformed growth across regions. Small caps outperformed large caps across regions as well.

REIT indices outperformed equity market indices in the US and underperformed in non-US developed markets.

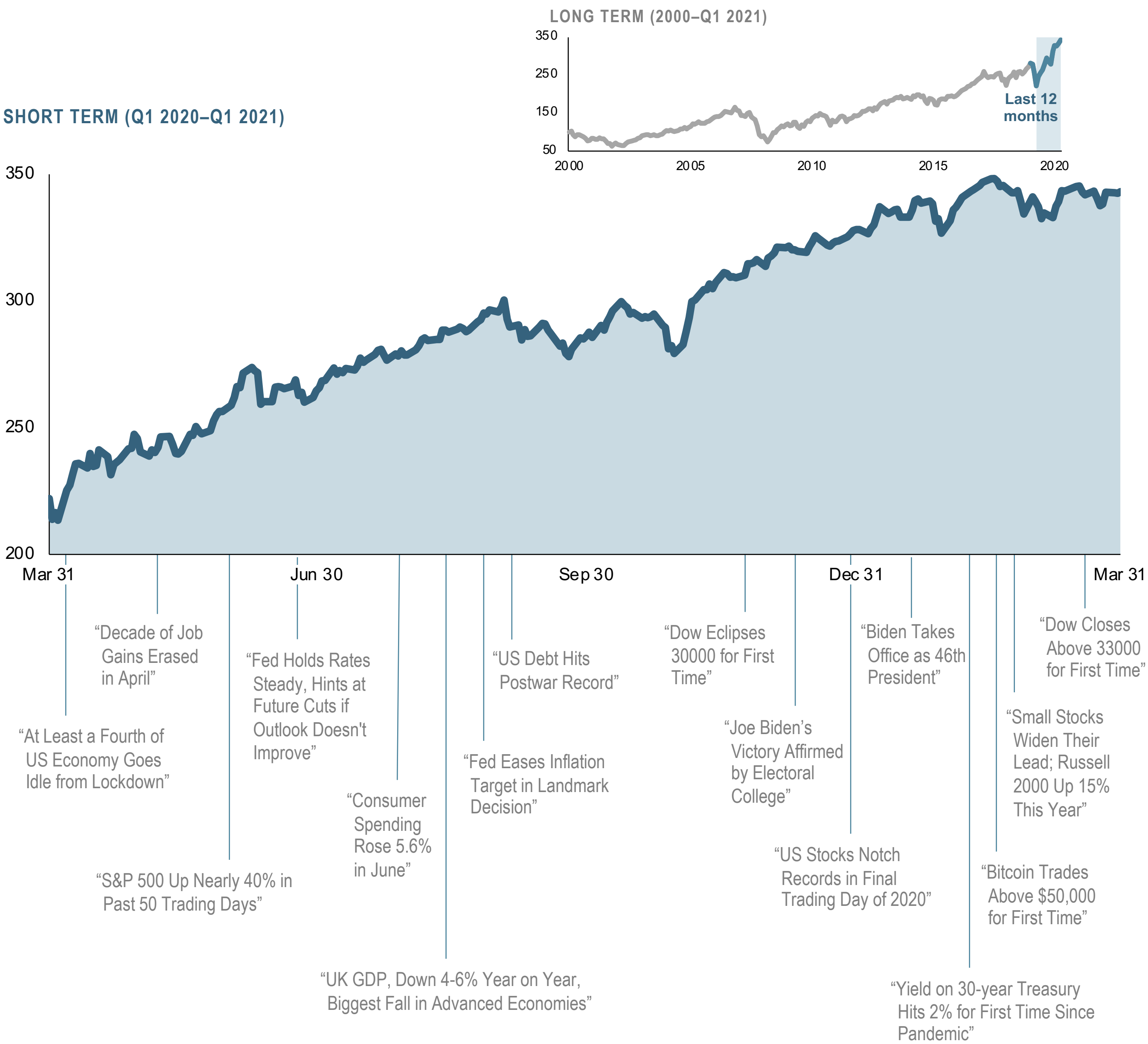


See important disclosure information

WORLD STOCK MARKET PERFORMANCE

MSCI All Country World Index with selected headlines from past 12 months

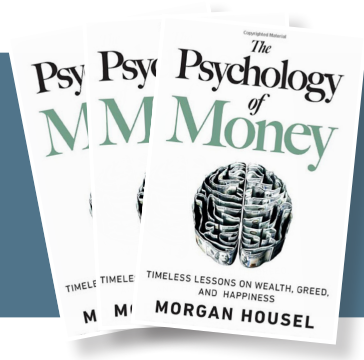
These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



Graph Source: MSCI ACWI Index [net div.]. It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

See Important Disclosure Information.

BOOK REVIEW



THE PSYCHOLOGY OF MONEY

Morgan Housel

In the introduction to this terrific book, Morgan Housel compares the story of the wealthy technology executive who patented a key component in Wi-Fi routers to that of a janitor. The technology executive was a genius with an incredibly immature relationship to money: he once had a valet go to a jewelry store and buy a few thousand $1 dollar gold coins so that he and his friends could skip them across the ocean like rocks. He eventually went broke. The janitor, who also fixed cars at a gas station, died at age 92 with a net worth of $8 million, $6 million of which he left to charity. Housel asks the question, "in what other industry does someone with no college degree, no training, no background, no formal experience, and no connections massively outperform someone with the best education, the best training, and the best connections?" The answer, of course, is in no other area except investing. This is true, Housel concludes, because "financial success is not a hard science. It's a soft skill, where how you behave is more important than what you know." And all this happens before page 5.

It's become such a cliché that it's almost not worth saying, but The Psychology of Money is a must-read. It is the best book we've seen on investing in at least 10 years. Broken up into 20 chapters of discrete observations about money, it is very easy to read and remarkably insightful. The book starts by making the point that "No One's Crazy," that your personal experiences with money make up "maybe 0.00000001% of what's happened in the world, but maybe 80% of how you think the world works." People from different generations and backgrounds have learned very different lessons about money; what we've all experienced is far more compelling than what we've learned secondhand. I can read about the Great Depression, but I don't carry its scars. Further, the entire subject of investing is, for most people, incredibly new. Before World War II, "most Americans worked until they died. That was the expectation and the reality." No one had to save for retirement, because it wasn't a big thing. The 401(k) account did not exist until 1978 and the Roth IRA was not "born until 1998. If it were a person it would be barely old enough to drink." Therefore, "[i]t should surprise no one that many of us are bad at saving and investing for retirement. We are not crazy. We're all just newbies."

Further, nothing is as good or as bad as it seems. Luck plays a bigger role in business and investing success than anyone wants to admit. The line between "inspiringly bold" and "foolishly reckless" is often "only visible with hindsight." Therefore, we should focus less on specific individuals and case studies (how did so-and-so get rich?), and more on broad patterns of success and failure. And perhaps the biggest pattern of success comes from the magic of compounding. This point is summarized brilliantly by the observation that "$81.5 billion of Warren Buffett's $84.5 billion net worth came after his 65th birthday. Our minds are not built to handle such absurdities." Absurd, yes, but hugely important.

Along with compounding, "long tails" (that is, where a small number of events account for the majority of outcomes) have "tremendous influence in finance." Housel observes that "most public companies are duds, a few do well, and a handful become extraordinary winners that account for the majority of the stock market's returns." Since 1980, "40% of all Russell 3000 stock components lost at least 70% of their value and never recovered over this period. Effectively all of the index's overall returns came from 7% of component companies that outperformed by at least two standard deviations." These outsized returns from small numbers of events do not indicate that you should as an investor try to identify what those events are and when they will occur. Rather, your success "as an investor will be determined by how you respond to punctuated moments of terror, not the years spent on cruise control" waiting for something to happen. In other words, a "good definition of an investing genius is the man or woman who can do the average thing when all those around them are going crazy."

Our minds, however, often keep us from allowing compounding and long tails to work that magic. Too often our personal views of money get in the way of growing wealth. Money gives you the gift of time. "The highest form of wealth is the ability to wake up every morning and say,' I can do whatever I want today.'" But social comparison (the pervasive thought that we will never have enough as long as we keep comparing ourselves to others) creates problems: "the hardest financial skill is getting the goalpost to stop moving," to decide when enough wealth is enough. Rather than keeping up with the neighbors, money should be able to give you "greater control over what you can do and when you can do it." This is money's greatest intrinsic value. The author reinforces this point by quoting from interviews with a thousand elderly Americans, setting out the most important lessons they learned during their lifetimes:

> No one – not a single person out of a thousand – said that to be happy you should try to work as hard as you can to make money to buy the things you want.
>
> No one – not a single person – said it's important to be at least as wealthy as the people around you, and if you have more than they do it's real success.
>
> No one – not a single person – said you should choose your work based on your desired future earning power.

If all that is true, then staying wealthy is at least as important as getting wealthy. The book suggests holding three perspectives for doing so:

1. More than I want big returns, I want to be financially unbreakable. And if I'm unbreakable I actually think I'll get the biggest returns, because I'll be able to stick around long enough for compounding to work wonders.

2. Planning is important, but the most important part of every plan is to plan on the plan not going according to plan.

3. A barbelled personality – optimistic about the future, but paranoid about what will prevent you from getting to the future – is vital.

Following these perspectives leads to some boring but critical conclusions. First, save more. The author defines wealth as "just the accumulated leftovers after you spend what you take in. And since you can build wealth without a high income, but have no chance of building wealth without a high savings rate, it's clear which one matters more." Second, hold enough cash to weather any temporary downturns in market values. Third, stay committed to your strategy even during its lean years. "The historical odds of making money in US markets are 50/50 over one-day periods, 68% in one-year periods, 88% in 10-year periods, and (so far) 100% in 20-year periods." These techniques will prevent you from keeping up with the neighbors, but they will also help to keep you "financially unbreakable."

Another way of looking at these factors is "room for error." Forecasting the timing of significant events is impossible; having a margin of safety renders such forecasting unnecessary. Having enough room for error "lets you endure a range of potential outcomes, and endurance lets you stick around long enough to let the odds of benefiting from low-probability outcome fall in your favor. The biggest gains occur infrequently, either because they don't happen often or because they take time to compound. So the person with enough room for error in part of their strategy (cash) to let them endure hardship in another (stocks) has an edge over the person who gets wiped out, game over, insert more tokens, when they are wrong."

This brief summary has looked at just a few of the high points of this book. It makes several other critical points, all of which lead to the same conclusion: understanding our own psychology and not falling prey to its traps is far more important to building and maintaining wealth than maintaining some hypothetical, mathematically-optimal (and never actually achievable) investment strategy.

If you never gain anything else from our newsletters, it will have been worth it if we have convinced you to read *The Psychology of Money*. It's that good.

IMPORTANT DISCLOSURE INFORMATION

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]).

RIVERVIEW trust company™

WASHINGTON
900 Washington Street, Suite 900
Vancouver, Washington 98660
360.693.7442 | riverviewtrust.com

OREGON
5400 Meadows Road, Suite 325
Lake Oswego, Oregon 97035
503.558.6454