EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

September 30, 2023

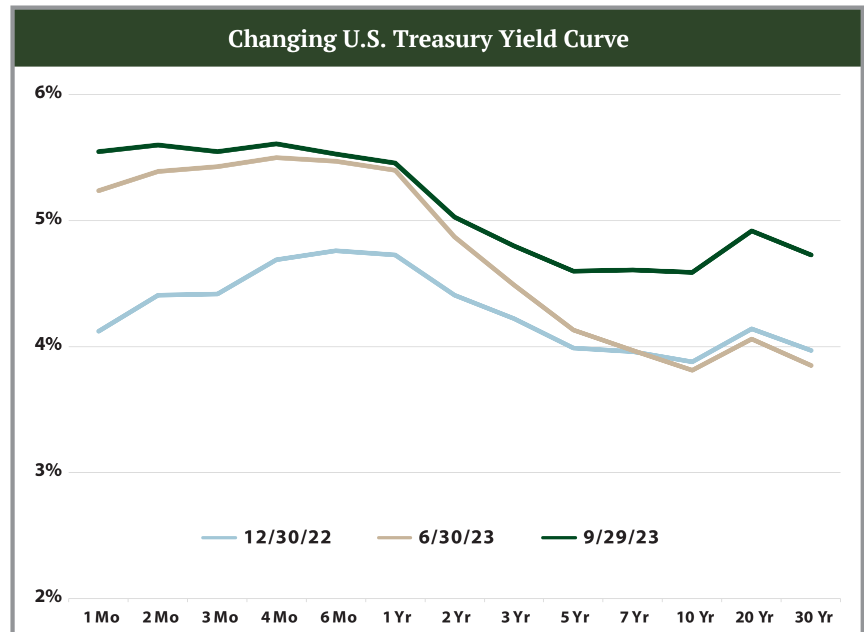
HIGHLIGHTS

- As the year has progressed, the Fed has communicated that rates will be higher for longer, and during the 3rd quarter the message started to sink in for investors.
- We noticed that financial planning follows a seasonal rhythm where similar topics arise at the same time each year. Therefore, we have decided to concentrate our planning efforts according to a predetermined calendar.
- Sequence of returns risk highlights the potential vulnerability of a retiree's financial situation to the timing of market returns. To mitigate this risk, retirees should carefully plan their investment strategies and withdrawal approaches and be prepared for potential market volatility during retirement years.

Higher for Longer: Interest Rates Moving Toward Normal

After a strong first half, the equity market was down about 3% in the 3rd quarter but is still up 13% for the year (using the S&P 500 as the benchmark). The market was strong during the 1st half despite the Federal Reserve (Fed) raising its target Fed Funds rate from 4.25% (lower bound) to 5% by the end of the 2nd quarter. The Fed then raised rates again in July before a pause at the September meeting, leaving the lower bound target at 5.25% as of quarter end.

Higher interest rates represent a headwind for economic growth, as well as the stock market, as the cost of borrowing money increases. For example, if a company is looking to borrow $100 million to build a new factory, the final decision is altered significantly if it now must pay 6.0% vs. the 1.6% it may have paid two years ago. The factory now must add more value to the company to justify the investment and, as a result, the bank will be more cautious about loaning money. This higher cost flows into the value of stocks because future cash flows are worth less. If an investor can earn 5% in cash, risking that cash in an investment will require a higher potential return. The investor will pay less for a stock with the same level of earnings, lowering the price to earnings ratio and ultimately the overall stock market.



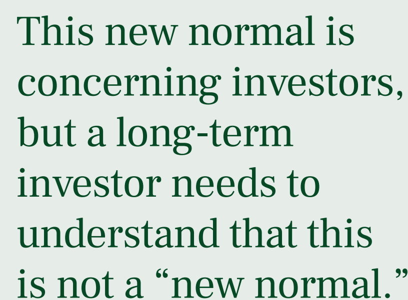
So why was the market up in the first half of the year as interest rates climbed? Investors believed the Fed would be cutting rates by year end and the worst was behind us. As a result, long-term rates remained relatively low. The 10-year US Treasury was yielding approximately 3.9% at the end of 2022 while the 3-month US Treasury was at 4.4%. By the end of the 2nd quarter, the 3-month increased to 5.4% while the 10-year fell to 3.8%. This meant the higher rates had less impact on the economy - long-term borrowing rates were still low and future cash flows were not as discounted.

Higher for Longer: Interest Rates Moving Toward Normal continued

As the year has progressed, the Fed has communicated that rates will be higher for longer, and during the 3rd quarter the message started to sink in for investors. After the most recent Fed meeting in September, the consensus of the Federal Open Market Committee, i.e., those setting the Fed's target interest rate, was that the target would be over 5% at the end of 2024. This is vastly different than the earlier assumption that it would be under 5% by the end of 2023. Long-term rates also started to increase. The 10-year US Treasury increased to 4.6% by the end of the 3rd quarter. Corporate rates also increased. The 5-year A rated bond went from yielding 4.7% during the 1st half of the year to 5.3% at the end of the quarter.

The results of the "higher for longer" estimates are increased borrowing costs and greater discounting of future cash flows which means lower valuations. Other concerns have continued to dampen market enthusiasm. Russia's war with Ukraine continues and energy prices remain high. The price of oil increased 29% during the 3rd quarter. While the government avoided a shut-down at the end of September, a deal was only reached through November. And our government's borrowing will become more difficult with higher interest rates. If the government is spending more to pay off the interest on its Treasuries, that crowds out other spending.

This new normal is concerning investors, but a long-term investor needs to understand that this is not a "new normal." This is the way interest rates used to behave. From 1990 to 2000 the Fed rate ranged from 3% to 8.5% (lower bound). The rate was cut to 1% in June 2003 and stayed there for a year before gradually increasing to 5.25% by late 2006. The housing crisis led to a 0% rate starting at the end of 2008. This is when our low-rate environment started. We were climbing out of it until the COVID-19 pandemic resulted in historic fiscal and monetary actions. The current rates are returning us to a more normal environment, not creating a new environment.



What matters in this environment is what has always mattered – investing in strong companies which can generate cash flow through an economic cycle and are valued at a reasonable price. Our process will continue to drive towards finding companies that fit this profile and continues to be a superior wealth building strategy.

Using a Planning Calendar to Organize the Financial Year

Over the past few years, we have created more processes to help clients with their financial planning. We noticed that financial planning follows a seasonal rhythm where similar topics arise at the same time each year. Therefore, we have decided to concentrate our planning efforts according to a predetermined calendar.

The timing of many of these events is triggered by the tax code. For example, taxes are due April 15th for the prior year unless the taxpayer is on extension and then final returns are due by October 15th. Similarly, quarterly estimated taxes need to be paid at the same time every quarter. Therefore, finishing tax planning well before the end of the year is necessary to avoid missing deadlines. Preparing for the annual filing is best done in February and March after the banks, brokers and investment partnerships have provided their 1099s and K1s.

Using a Planning Calendar to Organize the Financial Year continued

Gifting to both family and charities becomes most relevant leading into the holidays. The holidays concentrate thoughts on loved ones and our communities that deserve support. Therefore, we recommend updating gifting goals in November each year.

Some of the financial planning tasks do not have hard deadlines or obvious times of year when it makes sense to address those tasks. For instance, there is no ideal time to review investment options in retirement or 529 plans. We schedule this activity in May since clients usually have more time once the tax deadline has passed. Regardless, these investment reviews and other tasks on our calendar are very important to one's financial health and deserve attention.

It is important to address each of these topics with plenty of time to spare so that you are not rushed by deadlines. Time pressure often causes errors that could be avoided with better planning.

Following is a graphic of our financial planning calendar. Please reach out regarding those issues that are relevant to you and your family.

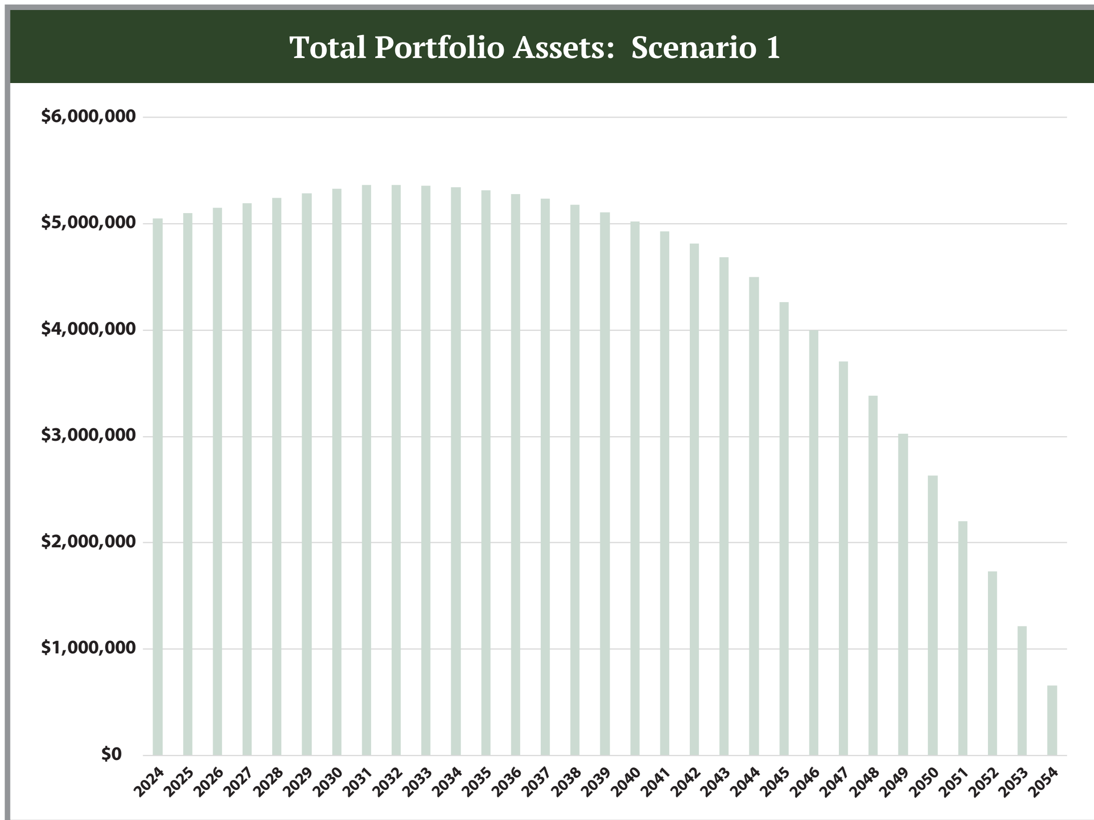
Eagle Ridge Financial Calendar	
January	Calculate Required Minimum Distributions (RMDs) for IRAs Automate Investment Contributions and Distributions Review Annual Contributions to Retirement Accounts (using updated limits for the new year)
February	Assess Monthly Cash Flows/Budgeting
March	Confirm Prior Year Contributions to Retirement Accounts Deliver Tax Materials (as requested)
April	Help with IRS Tax Filing Deadline
May	Review Investment Options for External Accounts e.g. 401(k), Employer Sponsored Plans, 529 Plans etc.
June	Review Savings Options for Funding Education
July	Update Estate Planning Documents and Beneficiaries (as appropriate)
August	Help Clients Enroll in Employee Benefits and Review Medicare Coverage Assess Life, Disability and Long-Term Care Insurance Coverage
September	Review Estimated Tax Liabilities
October	Ensure all Required Minimum Distributions (RMDs) from IRAs are Complete Perform Roth Conversion Analyses Evaluate Capital Gains, Harvest Tax Losses (as appropriate)
November	Review Annual Exclusion Gifting Advise and Assist with Annual Charitable Gifting
December	Assess Asset Allocation for Risk Exposure Check all Contributions to Retirement Accounts Have Been Made
Quarterly	Provide Portfolio Review Reports to Clients Distribute Investment Commentary Update Capital Market Assumptions (used for Cashflow Projections)

Managing Cash Flows in Retirement

Managing assets in retirement can be a far more challenging task than earlier in life when an investor's primary focus is on saving and asset accumulation. For many retirees, the shift to decumulating an investment portfolio comprised of multiple accounts with varying tax rules, can be a daunting task with new challenges. One of these challenges, called 'the sequence of returns' is the risk of negative market returns occurring late in working years and/or early in retirement, which can result in significant financial setbacks for retirees. If a retiree experiences poor investment returns early in retirement, especially during the first few years, it can significantly erode the value of their portfolio.

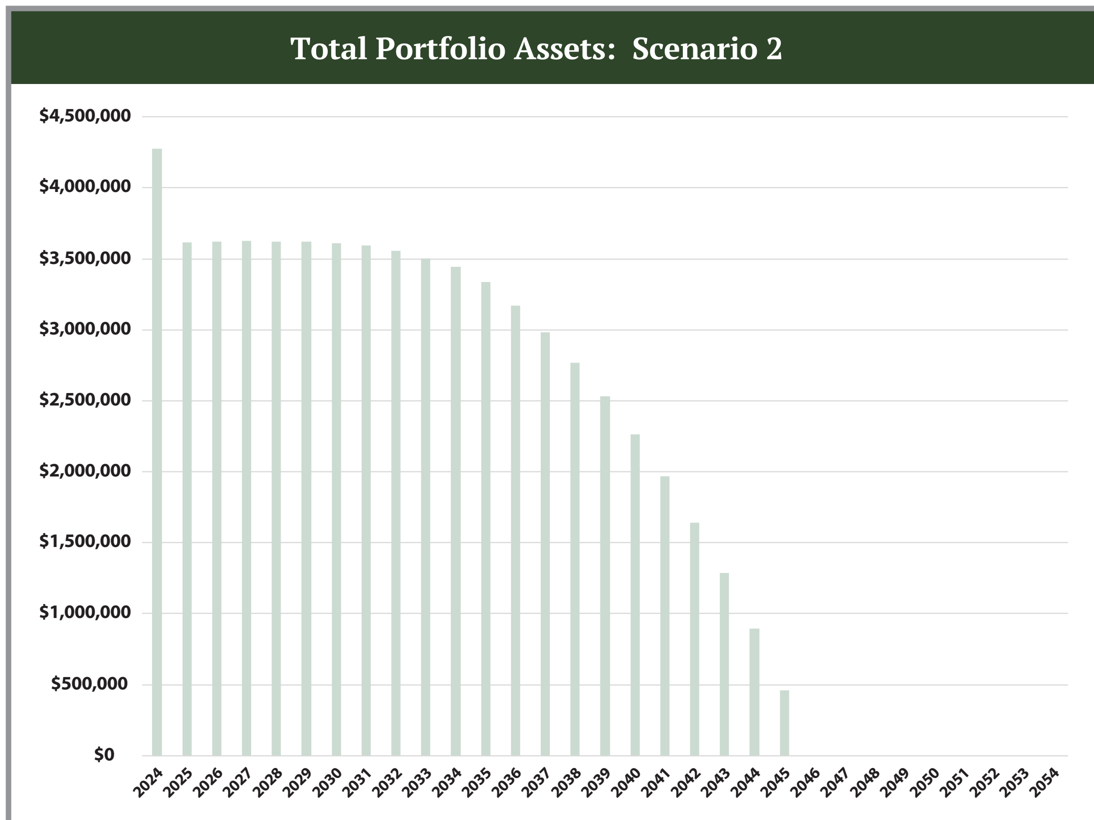
Consider the following scenario:

A married couple retires with $5 million in investable assets, with 50% in tax qualified retirement accounts and 50% in taxable brokerage accounts. The couple begins with an initial annual withdrawal rate of 4.5% or $225,000 to cover their expenses. The following portfolio model illustrates their investment portfolio earning an average rate of return of 6% over a 30-year retirement with distributions increasing at a 2.5% inflation factor.



Managing Cash Flows in Retirement continued

The couple's entire 30-year retirement is fully funded in scenario 1. Now consider if the couple's investment portfolio experiences -10% returns consecutively in the first two years of retirement. If all other variables are kept constant, their portfolio balance model illustrates the following:



Keep in mind, these two projections are modeling the same average rate of return of 6% across the 30 years of retirement. But because the couple in scenario 2 are forced to sell assets at lower prices to cover expenses, they are leaving fewer assets to benefit from potential market recoveries in later years. The long-term performance is identical, but the timing of the poor investment results costs the couple 10 years of retirement funding.

There are many steps that investors can take to mitigate the sequence of returns risk. First, do not underestimate the impact of taxes on a portfolio supporting retirement distributions. Distributions from traditional IRAs, 401(k)s, and other pre-tax employer sponsored retirement plans are subject to ordinary income tax rates. Large distributions from these account types, especially during years of poor market performance, can increase tax liabilities and thus accelerate account depletion. Investors who are approaching retirement should direct more savings toward taxable investment accounts, and Roth IRAs or Roth 401(k)s (if available). These accounts can provide valuable tax diversification for a retiree drawing income from their investments.

Managing Cash Flows in Retirement continued

Improved longevity has increased the number of years Americans are retired on average, and therefore extended the number of years their portfolios need to provide support. A potential retirement of 25-35 years requires a thorough review of the retiree's overall investment allocation to ensure it is properly diversified. While retirees may consider lowering exposure to volatility with a more conservative stock-bond mix, most still have a need for their portfolio to generate growth and income for the future. Historically, a balanced stock and bond portfolio has helped investors outpace inflation. Additionally, there should be a portion of assets with minimal exposure to market fluctuations, including cash and cash equivalent investments, reserved as a first source of funds for expenses.

Eagle Ridge helps clients who are concerned with funding retirement create a financial plan that evaluates potential sources of retirement income like social security, pensions, and deferred compensation available to fund cash flow needs. This is a crucial step that helps determine the initial withdrawal rate from investment accounts needed to supplement a client's lifestyle. Additionally, Eagle Ridge models retirement projections utilizing Monte Carlo simulations. These are statistical probability analyses, which instead of utilizing a straight-line return assumption (from scenario 1), simulate many retirement trials with various asset class returns and inflation rates in each year. The resulting distribution of outcomes illustrates the probability of success – which in this case is a fully funded retirement.

In summary, sequence of returns risk highlights the potential vulnerability of a retiree's financial situation to the timing of market returns. To mitigate this risk, retirees should carefully plan their investment strategies and withdrawal approaches and be prepared for potential market volatility during retirement years. Eagle Ridge's financial planners help clients navigate these challenges and implement dynamic and tax efficient withdrawal strategies for managing their retirement income.

About Eagle Ridge

Eagle Ridge Investment Management is an independently owned, SEC-registered investment advisory firm. Our goal is to provide superior investment performance and a high level of service to a select group of clients, unencumbered by the need to sell products or meet corporate goals. We strive to help our clients meet their needs and compound their wealth through a disciplined investment process.

For more information, please contact Mike Oliver at **m.oliver@eagleridgeinvestment.com** or **203-227-4515**.