FIRST QUARTER 2024

Kreitler Financial Insights

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INSIDE INSIGHTS

Happy New Year .... pg. 1
Looking Forward to 2024 .... pg. 2
Human Behavior and Investing .... pg. 3
Using a Health Savings Account for future Long Term Care expenses .... pg. 4-6
Open House .... pg. 7
Best Tech of 2023 .... pg. 7
Q4 Market Review .... pg. 8-9

Happy New Year to our clients and friends. After a year full of volatility, the so-called Santa Claus rally delivered strong December returns for both stocks and bonds. For the year, the S&P 500 returned 26.3%, Dow 16.2%, and Bonds (US Agg) 5.5%.[1]

Markets overcame both uncertainty and pessimism on their way to these results. What did they overcome? High-interest rates. Persistent concerns about inflation. Continued war in Ukraine and a new war in Gaza. Political polarization. And yet the year ended with what the Wall Street Journal declared to be "The Blockbuster Year in Stocks No One Saw Coming" in its December 30, 2023, cover story.

So, what went right? Real Gross Domestic Product, a measure of economic growth after accounting for inflation's effects, was up 2.9%.[2] Inflation dropped from its 2022 high of 9.1% to 3.2% in October 2023 measured using the all-items Consumer Price Index. (CPI).[2] Markets also sniffed out the potential for higher growth driven by technology, and lower interest rates. The so-called "Magnificent Seven" large tech companies helped power the tech-heavy Nasdaq to a 44.6% return during the year.

What should investors take from this? Price matters; discipline matters. We believe investors will benefit by focusing on investment strategy, not forecasts, even while the mainstream world is promoting their short-term views. In 2022, markets had finished a very difficult year. The S&P 500 index was down 18.1% after rebounding a bit from bear market territory and bonds experienced their worst year in decades. Discipline prevailed and Investors who held firm in their allocations to long-term assets like stocks were rewarded in 2023.

1. YCHARTS
2. Kliesen, Kevin L. (2023). Slower GDP Growth and Falling Inflation in U.S. Economic Outlook for 2024. St. Louis Fed

Looking Forward to 2024

In Memorium

"If you're not willing to react with equanimity to a market decline of 50% two or three times a century, you're not fit to be a common shareholder and you deserve the mediocre result you're going to get compared to people who do have the temperament, who can be more philosophical about these market fluctuations."

-- Charlie Munger, January 1, 1924- November 28, 2023

But, says the skeptic, look at all that's going wrong! Wars in two theaters around the globe. Worries about interest rates and inflation continue.

Uncertainty is always present in investing, and frequently pessimism results in favorable prices for patient, disciplined investors. We find it helpful to zoom out to the macro view to provide context to the immediate news around us. We believe that it's a mistake to view the last several years as a 'normal' business cycle. Instead, the 2020 global pandemic created a massive disruption. Many of our clients have heard us use the analogy of the economic effects of Covid and the global response to it as being similar to throwing a stone into a quiet pool. First comes the initial big splash, followed by a series of ripples that expand out into the pool and diminish in size over time. The splash in 2020 was the initial fear, economic shutdowns, and the rapid 34% decline in the S&P 500. The ripples[1] that followed have been trillions of dollars in economic stimulus in the US (e.g. Paycheck Protection Program, CARES Act, etc.) and the Federal Reserve slashed interest rates and the yield on the 10-year Treasury fell to as low as 0.52%. Next, problems hampered supply chain problems just as consumers stuck at home turned to shopping, causing inflation in goods. As supply chain problems eased, consumers got out of their homes and inflation rippled to services from restaurants to concert tickets. Home prices jumped on the wave of money and cheap rates.

Today, inflation is cooling.[2] Remember Inflation falling doesn't mean prices falling; it means they increase more slowly than recently have.) The labor market shows signs of normalizing.

What is left to normalize? We have a few thoughts. There is a tension between the Federal Reserve's desire to tame high inflation and the government's continued record spending. The Federal Reserve has raised interest rates at one of the fastest paces in history and has been quietly reducing the amount of money in circulation via quantitative tightening. (For the curious, you can read The Mechanics of Fed Balance Sheet Normalization).[3] Government spending may need to slow, monetary policy may need to loosen, and interest which tends to accelerate both economic growth and inflation.

Our view is that the most likely path is toward a more benign environment for both stocks and bonds than the post-pandemic environment we've experienced. However, the path there will be uncertain and investors should expect volatility. A focus on long-term strategies and investor discipline is important, as always.

1. YCHARTS
2. Graphics for Economic News Releases. U.S. Bureau of Labor Statistics
3. Estenssoro, Amalia and Kliesen, Kevin L. (2023) The Mechanics of Fed Balance Sheet Normalization. St. Louis Fed.

Human Behavior and Investing

by Charlie Kreitler

I had the opportunity to join a meeting with Dr. Richard Thaler, the 2017 Nobel Prize winner in Economics, in December. Dr. Thaler won his Nobel for work in behavioral finance. What's behavioral finance? Effectively, economists originally based their work on the belief that all market participants act rationally in their self-interest. An example of this is typical spending behavior. When something becomes cheaper, it is rational for people to buy more.

Want a real-world example? Let's look at the annual shopping bonanza of Black Friday. Traditionally, this was the day that retailers hit profitability for the year, moving from "in the red" to "in the black". Lower prices encouraged shoppers to spend.

During Black Friday, American shoppers do what they do best—spend! In fact, a study by the Bureau of Labor & Statistics found that the holiday season accounts for around 19% of retailers' annual revenue.[1] Sales (lower prices) are a big driver of this. Responding to lower prices by buying more is rational behavior on the part of the consumer.

Irrational or harmful behavior exists too, which is what behavioral economics tries to understand and thereby encourage people to make better decisions. Let's take a look at an irrational spending example that relates to markets and investor behavior. When markets fall and stocks are cheaper to buy, many people panic and sell, thereby locking in losses that may result in permanent harm to their portfolios. Why do they do this, and what should we do to prevent it from happening to ourselves?

First, recognize that volatility is normal and must be expected. Of the major asset classes, stocks have delivered the best returns above inflation. To achieve the higher long-term returns that stocks and other long-term assets have historically delivered, investors must be willing to tolerate inevitable market swings without turning temporary declines into permanent losses by selling.
Second, invest with a disciplined strategy. A diversified portfolio may help manage the risk of a market drop affecting your ability to meet goals. This can help manage our emotions in a volatile market.

The price paid for an investment matters. Investors must lean against the emotional temptation to buy when markets are good (therefore expensive) and sell when markets are down (cheap). Holding cash and more conservative investments for known near-term expenses may help to ride through these inevitable periods of discomfort, but at the risk of the value of that money not keeping up with the cost of living.

1. Schaaf, Ian. (2023). How have the pandemic and online spending affected Black Friday shopping? Analyzing retail trade margins 2009–22. U.S. Bureau of Labor Statistics

Using a Health Savings Account for future Long Term Care expenses

Health Savings Accounts (or HSAs) are sometimes referred to as "triple tax free". Contributions to the account are made pre-tax. Income inside the account is tax-free. Finally, distributions from the account used are made tax free when used to pay for qualifying medical expenses. This combination can make them very attractive.

From my conversations over the years, most people use their HSA to pay for current medical expenses. The account is kept in cash and contributions are distributed the year they are made. Some people may benefit from a different approach and use their HSA to save for potentially larger health care expenses in the future such as long-term care needs. For those able to pay more out of pocket today, they may be able to accumulate an investment account that qualifies for tax-free distributions, potentially replacing the need for expensive long term care insurance.

Background

Company health insurance plans fall broadly into two categories, traditional or high deductible. Both have a premium, which may be shared by an employer or paid entirely by the insured. Traditional plans typically have a lower deductible. When you get medical care, you pay a copay that represents a portion of the total cost. You may have a deductible as well, which is a share of the cost that you will need to pay.

This Health Savings Account (HSA) accumulation strategy applies to high deductible plans. High deductible plans typically do not share in covering any medical expenses until after you have paid a specified amount out of pocket (the high deductible). This can frequently be several thousand dollars. To make this more affordable, many high deductible health plans are paired with a Health Savings Account (HSA).

With an HSA, you can make pre-tax contributions of up to $3,850 per person or $7,750 per family for 2023. For 2024 these figures will increase to $4,150 for individuals and $8,300 for families. Distributions from the HSA account are tax free if used for eligible healthcare expenses.

Using your Health Savings Account for future Long Term Care expenses

HSAs permit you to make a tax-free distribution to pay for medical expenses. While I have never seen data on this, I suspect most people make the distributions the same year they make the contribution. This makes sense because you pay for the medical bill using pre-tax dollars.

For those who have the means to pay medical expenses out of pocket and are willing to forgo the immediate tax-benefit on those expenses, another strategy is to accumulate and grow the tax-free HSA for later use. The money in the HSA is invested in a portfolio for long-term growth. (Note that if the HSA is used for current expenses, I generally suggest that it be kept in cash.)

The potential benefit of this strategy can be substantial. Let's look at an example.

continued on page 5

"Income inside the account is tax-free."

continued from page 4

Example

Jennifer, age 30, is starting a new job with an employer that offers a high deductible health plan paired with a Health Savings Account. Jennifer is healthy and doesn't visit the doctor often except for an annual physical. She reasons that she can afford the out-of-pocket expenses and can accumulate her annual contributions of $3,850 in the HSA. She plans to not touch the money until she retires at age 66, and she thinks he can achieve a 7% investment return.

If Jennifer's assumptions are correct, over the next 36 years she will save $138,600 pre-tax. Her 7% annual growth would make the account grow to $598,512 tax-free.

The HSA contribution limit is tied to inflation, so she may be able to increase contributions in future years. Also, if Jennifer gets married and has a family, their combined contribution increases to $7,750, allowing them to save even more.

Accumulating this account will give Jennifer options as she gets older and starts to consider how she will pay for potential long term care expenses. Knowing that she has a tax-free source of funds for health care may permit her to pay for expensive long-term care without insurance or other medical care.

Jennifer can take tax-free distributions for current health expenses whenever she needs them. If she is diligent about keeping records of her qualified medical expenses paid out of pocket, she may be able to make tax-free distributions for those expenses even years in the future. In the meantime, the account can remain invested and hopefully growing.

Potential Benefits

The potential benefits of having an HSA to fund future health expenses can be significant. Here are a few examples.

- Out of pocket medical expenses such as co-pays or procedures not covered by insurance. For many wealthy individuals, this may be the greatest benefit because you may be able to access care or services not generally covered by insurance. Generally, any expense the IRS would qualify as a deductible medical expense qualifies, but they also include some other expenses such as over the counter medications. It's best to consult the IRS list to see which expenses qualify.
- Long term care expenses including policy premiums. The amount of the premium you can pay from your HSA is based on a formula and increases with age.
- Bridging your health insurance premiums if you retire before Medicare eligibility begins at age 65. Private health insurance premiums aren't eligible HSA expenses, but there are two exemptions. Premiums for COBRA coverage after separating from a job, or paying for private insurance while you are collecting unemployment benefits are generally eligible expenses.

continued on page 6

Using a Health Savings Account for future Long Term Care expenses

continued from page 5

Considerations

This strategy works best the earlier you start it to allow more time for contributions to accumulate and potential compounded growth. It is most effective in HSA plans that allow you to invest the account balance in long-term investments such as stocks and bonds rather than only cash.

Beware of the penalty for distributions not associated with medical expenses. In addition to taxing the value of the distribution as income, they are subjected to an additional 20% tax. The account is available now or in the future. If you have an immediate expense, you can tap your HSA. Remember that it's possible this could happen in a bad market, so be certain you have other funds available if you invest the HSA aggressively. You could also keep a portion of the HSA in cash to cover short-term needs.

Remember that an HSA is not a substitute for insurance. The money you have available to you is limited to the value of the account. While the hope is to grow the account for the future, in the near term you will not have as much available. In some instances, insurance coverage that could pay a larger benefit if needed may be desirable.

Keep good records of the medical expenses you pay. While you can take money out for current year expenses, having records of past expenses will allow you to make tax-free distributions in the future, even years later. Many health insurance companies will let you save a summary of expenses for the past year or more. I like to do this annually when organizing my income tax data.

HSA accounts can be inherited by a spouse. However, they're not tax efficient for other beneficiaries such as children. In this case, the entire HSA becomes taxable to the child in the year of death and there are no stretch provisions such as there are with an IRA. Because of this, it's often best to plan to deplete them for health expenses during your lifetime. Some people may choose to leave their HSA as a qualified charity to avoid this taxation.

Best Tech of 2023

TIME.COM

Naqi Neural Earbuds

Electrical signals made by clenching your jaw or lifting an eyebrow turn into commands; wearers hear a voice to help navigate the invisible user interface. The still-in-development device could be used to control wheelchairs or smart-home items. Segal sees pro gaming as another arena for the tech.

Meta SeamlessM4T

The company's software is capable of understanding nearly 100 languages from both speech or text, and can translate on the fly between them in real time in a variety of formats—speech-to-speech, text-to-text, speech-to-text, or text-to-speech.

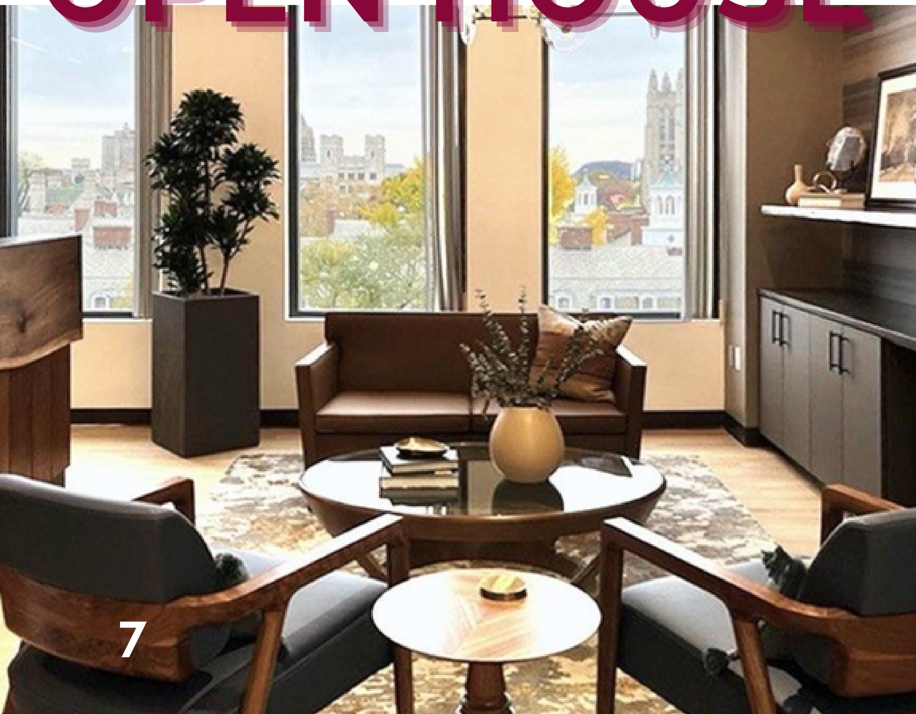
ArcBest Vaux

The ArcBest Vaux system uses a moving platform and rack that sits in delivery trucks and wheels all contents off the vehicles in a matter of seconds, rather than the dozens of individual trips a forklift would normally take to unload.

Graphene Radiator

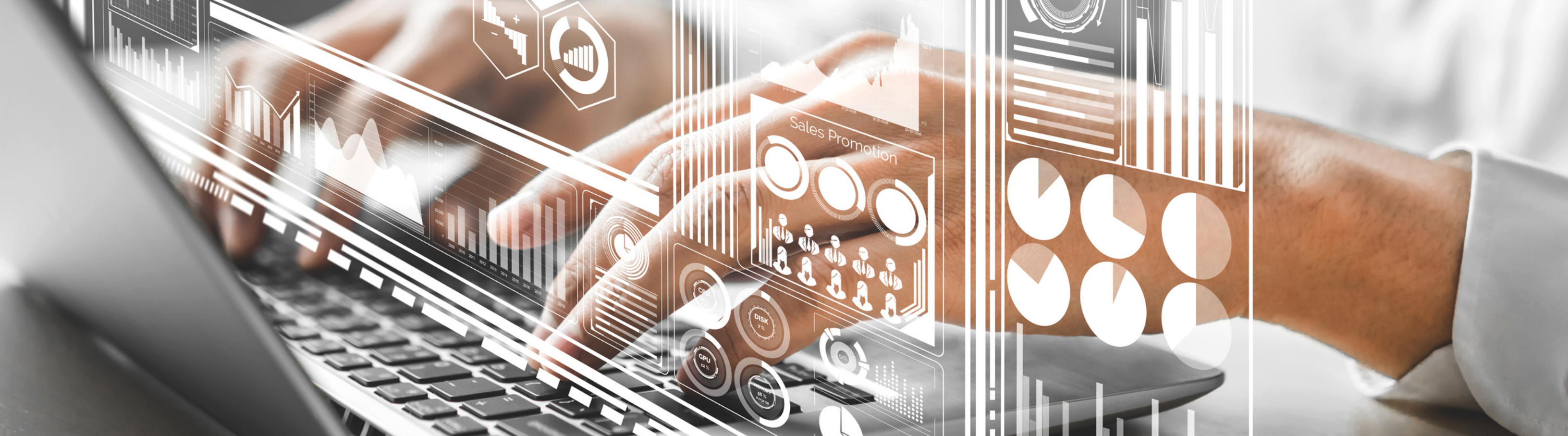
The Graphene Radiator is a virtual fireplace (featuring computer-generated holographic flames) that folds flat and can heat up to 167˚ F using just 200 watts of power—30% more efficient than electric coil heaters. With backing from Samsung, Graphene Square plans to produce 40,000 devices annually starting next year.

OPEN HOUSE



Thank you for attending our December Open House! We truly appreciate your presence and the opportunity to connect with you. Your participation and insights contributed greatly to the success of the event, and we look forward to seeing you at future gatherings!

Photo by Svigals + Partners.



Q4 Market Review

Better than expected consumer spending, enthusiasm around artificial intelligence, and easing inflation have fueled the U.S. equity rally in 2023, with the S&P 500 Index posting a 26.3% return for the year (YCHATRTS). Strong equity performance in 2023 was not only in the U.S. The foreign stock market as measured by MSCI EAFE Index, and MSCI Emerging Market Index returned 18.9% and 10.3%, respectively (YCHARTS).

Bond volatility was the story in 2023. The yield on the 10-year Treasury climbed by approximately 170 bps from early April to late October, then yields lowered by more than 100 bps in about two months. The decline in bond yields drove positive bond performance to end the year, and the U.S. Aggregate bond index returned 5.5% for the year ending December 31st (YCHARTS).
Higher interest rates make the cost of real estate financing more expensive and result in declining property valuations. In 2023, the real estate market continued to absorb these declining valuation adjustments. Private real estate as measured by the NCREIF National Index, returned -5.1% for the year as of December 31st reporting (Envestnet Tamarac).

The U.S. economy saw impressive resiliency last year, and that fueled positive performance in many sectors of the market for 2023. However, a recession is still possible, and markets can still turn negative. As such, we continue to focus on diversification and discipline in the management of portfolios.

Market Chart December 31, 2023

Asset Class	Index	Year to Date Total Returns
US Stocks	S&P 500 Total Return	26.3%
	Russell 2000	16.9%
Foreign Stocks	MSCI Emerging Markets	10.3%
	MSCI EAFE	18.9%
US Bonds	Bloomberg US Aggregate	5.5%
Private Real Estate	NCREIF-National Index**	-5.1%
	*Source YCharts Returns as of December 31, 2023	
	**Source Envestnet Tamarac as of December 31, 2023	

Investors cannot invest directly in an index. Indices may change over time. Indices are not an investment and have no performance history. Past index performance is no indication of future results for the index or any investments.

NCREIF National Index returns are reported on a lag by the index.

continued on page 9

Q4 Market Review

continued from page 8

Cash on the Sidelines?

Disciplined investors adjust strategies as the world changes to capture the market's long-term returns. For people uncomfortable with the current environment who sat in cash and may have missed 2023's good market returns and today's relatively higher long-term rates, it's time to think about investing that cash into longer-term portfolio investments.

When 10-year interest rates in 2020 low of 0.52%, buyers of those bonds were locked into low returns for a decade. In that environment, holding cash and short-term bonds was a reasonable strategy. In our portfolios generally, we reduced bond duration by adding short-term bonds and holding higher levels of cash than usual in money market funds. This was a tradeoff between the interest rate you would receive and the risk that bond prices might fall if rates rise.

Quick Bond Primer

The return investors get on a bond is the interest paid plus the repayment of the entire bond at the end of the term. When interest rates change, the price of existing bonds adjusts so the return on a bond is the same as the new bonds with the new rates. When interest rates rise, bond prices fall. When interest rates fall, bond prices rise. Longer-term bonds are more affected by this than shorter-term bonds.

The interest rate environment has changed significantly. First, investors are getting paid to own bonds again. At the end of 2023, the 10-year paying 3.88%. Held for 10 years, an investor in the 2023 bond would receive $3,880 in interest. Compare that to the investor with $10,000 in that 2020 bond at 0.52%, who was locking in $520 interest over the 10-year period.

Second, longer-term bonds may be more attractive again. If interest rates decline, bond prices increase. Cash only adjusts to pay the new lower interest rate. Also, if markets move to a 'normal' interest rate environment, long-term bond yields tend to be higher cash yields.
Finally, we should consider more than just bonds and interest rates. With its long-term return of approximately 10%, the US stock market has delivered better returns than both cash and bonds for Investors with longer time horizons and we believe are an important part of diversified investment portfolios.

If you or someone you know would benefit from a conversation about this, we would be pleased to discuss it.

At Kreitler Financial, we help change people's lives by helping them dream a future they can't yet imagine, then outline the path to make it a reality.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Kreitler Financial, LLC ("Kreitler Financial"), or any non-investment related content, made reference to directly or indirectly in this article will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this content serves as the receipt of, or as a substitute for, personalized investment advice from Kreitler Financial. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Kreitler Financial is neither a law firm, nor a certified public accounting firm, and no portion of the article content should be construed as legal or accounting advice. A copy of Kreitler Financial's current written disclosure Brochure discussing our advisory services and fees is available upon request. Please Note: If you are a Kreitler Financial client, please remember to contact Kreitler Financial, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. Kreitler Financial shall continue to rely on the accuracy of information that you have provided.

POSSIBILISTS & PATHFINDERS

There is no assurance that any investment strategy will be successful or that your objectives will be met. Investing involves risk and investors may incur a profit or a loss. Asset allocation and diversification do not ensure a profit or protect against a loss. Past performance is not indicative of future results. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment decision.

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