thoughts

FROM HANSON+DOREMUS SEPTEMBER 2023

Take care of what is difficult while it is still easy...

An article in *The Wall Street Journal* recently noted that people's financial literacy peaks around 53 or 54. At this age they are best able to make sound decisions around things like credit cards, interest rates, and whether a given fee is worth it or not.

This is good news, that people understand the importance of financial decisions and get better with age. But the discouraging fact is that at age 53 you don't have many more years before you hope to stop working and if you have not made good decisions up to that point you don't have much time to catch up.

OPTIMAL TIME

Age at which financial mistakes are minimized for each case study

Case study	Age
Eureka moment*	45.8 years
Auto loans	49.6
Credit card	50.3
Credit card late fee	51.9
Home equity lines	53.3
Credit card over limit fee	54.0
Credit card cash advance fee	54.8
Home equity loans	55.9
Mortgage	56.0
Small business credit card	61.8

Source: *The Wall Street Journal*

Financial literacy is not rocket science. It doesn't require a slide rule (old school) or sophisticated software (new school). It just requires common sense and a lot of discipline. A personal finance columnist at *The Wall Street Journal* once told me that covering the waterfront of personal finance takes only about 25 articles. After that the columnist, who obviously is intent on remaining employed, repackages previous articles, hoping his editor and the reader will think the advice is brand new!

The Wall Street Journal article noted that the 53-year-old at the peak of his financial literacy still tends to make one mistake. He fails to realize how long he will probably live, and therefore how much financial resources he needs in retirement. The average 50-year-old expects to live to 76, when in fact his statistical life expectancy is 86. Adding another 10 years to retirement adds an awful lot to expenses.

This is why it is super important to start early on building your nest egg. And one more thing I would add here that is crucial to achieving investment success; Warren Buffett likes to say that success in the market lies not with a high IQ but with a steady temperament. The average investor often buys after a market run up (performance chasing) and then sells after an extended decline (panic selling). Dalbar, the Boston based financial research firm has quantified this. Over the 30-year period ending December 2021, the S&P 500 returned an average of 10% per year, yet investors on average earned only 7.1%. Why the big difference? It is because investors don't have the patience and steady temperament to deal with the market's ups and downs. They buy at the top and sell at the bottom.

Financial literacy is important at all ages, but as noted, especially so when you are young. My very simple secrets to success for young people include, spend less than you earn, begin a regular savings plan, either for emergency needs or for retirement, and be very careful about borrowing. A mortgage for a house is fine, but carrying credit card debt month to month is a real no-no. And with your investments, choose a diversified portfolio of bonds and stocks in line with your needs and then practice your inner Warren Buffett – stick with your strategy through thick and thin. Get rich slowly. (Spoiler Alert, if you think I am blatantly repackaging true wisdom from past newsletter articles, you are absolutely right!)

- Eric Hanson

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HOW COMPETITION WORKS

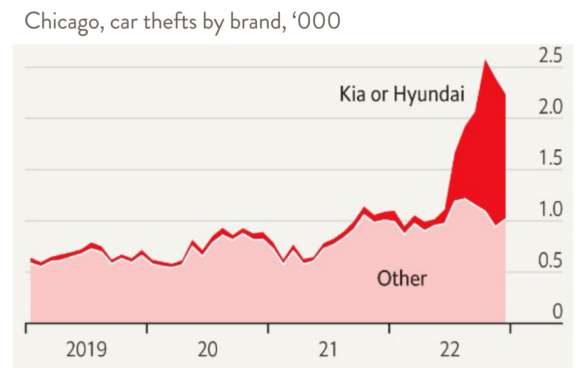
By Eric Hanson

"Disruptive innovation" at the auto mall...

Clayton Christensen, the Harvard Business School Professor who died much too young in 2020, was one of the most important business thinkers of his generation. One of his breakthrough observations was that of "disruptive innovation," the idea that existing producers of goods, after they become successful, are inclined to move up the value curve to higher-margin, more profitable goods and leave the lowest rung open to new competitors. These new competitors then cut their teeth on entry-level products, eventually becoming established in their own right. Think of the post-WWII car market. Detroit concentrated on bigger, more expensive cars, allowing the VW Beetle, Toyota, and Datsun (remember that name?) to enter the low end of the market. The new entrants eventually moved up to challenge the Big Three at every price point.

VIRAL ACCELERATION

Chicago, car thefts by brand, '000



Source: *The Economist*; Chicago Police Dept.; USAFacts

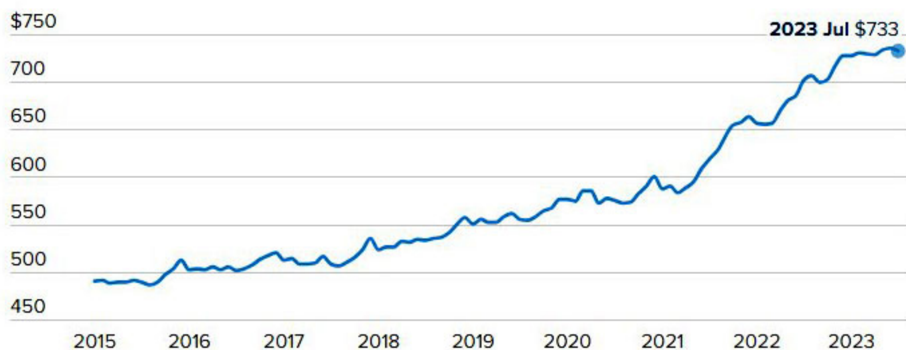
What got me thinking of this was a recent story from CNBC that noted there is only one new car model in the U.S., the Mitsubishi Mirage, that has an average transaction price under $20,000. The auto industry is pushing the consumer up to models with more bells and whistles, which in turn have a much higher, more profitable price tag. The consumer is not necessarily objecting to this since they are doing the buying, but the loan that has to be taken out to get into those cushy, heated seats that adjust 17 different ways is eye popping (*see chart below*). There are now 32 vehicles on the U.S. market that sell for an average price of more than $100k compared to 12 models five years ago. And these 32 models don't include the "super exotics" like Rolls Royce and Ferrari.

So, who might be the innovative disruptor of the car market in the future? A good first guess might be the Chinese who are eagerly eyeing the global car market. You can't be a big player in this market without being in the U.S. There are two problems here, however. The first is political. With U.S.-China relations where they are today, will Washington really allow Chinese cars to be sold in volume in our market? A big question mark. The second problem is that China has ceded the gas engine car market to Western manufacturers and the Japanese and Koreans. They are focusing all their attention on electric and hybrid vehicles.

It looks today as if China could send the U.S. a lot of cheaper EVs and hybrid cars, but will the mainstream U.S. buyer in the near term give up his love of the gasoline engine and embrace EVs? The Chinese have a lot of hurdles to clear before they can be successful in the U.S. In the 1950s and 60s, everyone said of the Japanese, "Sure these cars are inexpensive, but they are junk and will fall apart in a year." But this is what disruptive innovation is all about; facing what looks like insurmountable problems, getting your nose under the tent flap, building your brand, and moving up the value curve. Keep your eye on the Chinese and the low-end auto market.

Another interesting car-related article was in *The Economist* recently. It discussed car models most likely to be stolen in urban areas today. High-end models and dependable SUV workhorses from Toyota or Nissan are not the ones that are most often targeted. It is actually two Korean models, the Kia and Hyundai, that are most often stolen. So many in fact (*see chart above*) that Chicago and six other cities are suing the manufacturers. Past models of Kias and Hyundais do not come equipped with radio key fobs which immobilize the ignition and significantly reduce the chance of theft. Chicago argues that by not including these low-cost features, Kia and Hyundai have directly encouraged other crimes. As *The Economist* notes, if you are considering a drive-by shooting or a robbery, what better way to do it than in a vehicle that cannot be traced to you.

AVERAGE MONTHLY PAYMENT FOR A NEW CAR IN THE U.S.



Source: CNBC; Edmunds Chart: Ana Teresa Sola

U.S. HOUSING

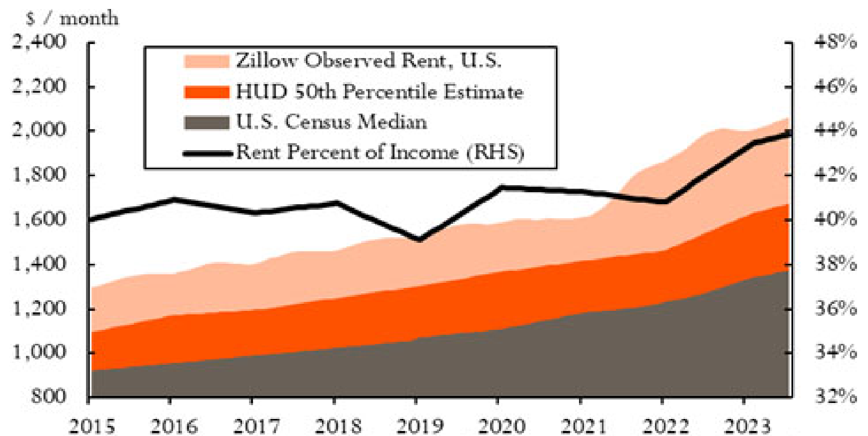
By Mark Andrews

Rental affordability has gone from bad to worse...

Last month we wrote about how unaffordable housing has become as the sharp rise in home prices and interest rates have outpaced income growth. But that was for those buying a home – what about for renters who don't have to take out a mortgage?

Renters have not experienced quite as dramatic a decline in housing affordability as buyers, but it's gone from bad to worse. *The chart on the right* shows country-wide median monthly rental figures from Zillow, the Department of Housing & Urban Development (HUD), and the Census. These things are hard to measure, and they show materially different median rent ($1,375 to $2,050 for 2023), but they all show an acceleration in prices in 2021-2023.

RENTAL PRICE AND AFFORDABILITY



Source: Census American Housing Survey (even years inflated at rental price component of PCE Index), BEA, HUD, Zillow (data begin 2015), author Calculations.

Comparing the HUD rent figure to renter household income, monthly payments accounted for around 40% of income until 2022 when they started rising to today's 44%. Keep in mind, the affordability threshold is 30% of income, so renting in the U.S. hasn't been affordable for a while. A lot of that has to do with renter household income being well below homeowner household income, with the Census estimate at 52-54%.

But we might have thought renters would be insulated from the dramatic housing price and mortgage swings given they don't buy and they don't borrow. So why has rental affordability deteriorated as well?

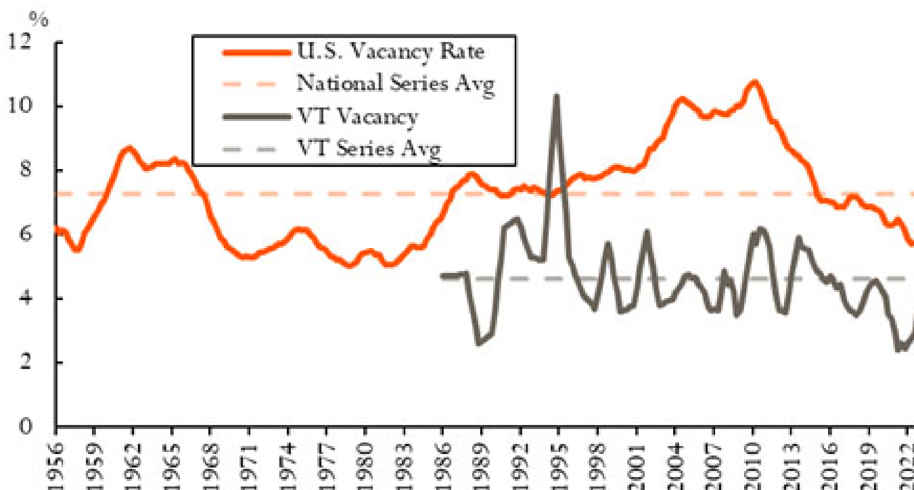
Perhaps the most obvious answer is that owners pass on increasing costs to their tenants. As monthly housing payments have increased as well as the cost of services associated with owning a home, owners need to charge more to keep up. Another factor is a familiar one from last month: lack of inventory. According to the Census, in 2022 rental vacancy rates reached 5.6%, the lowest level since 1984. While it has ticked up recently, it's still below the long-run average for the Census's data (*chart at bottom*).

Additionally, interest rates still play a role for renters. A typical housing progression is to rent until you buy your first home. Those first-time homebuyers are the ones most impacted by affordability because they generally need to take out larger (loan-to-value) mortgages. Facing the rising all-in cost of buying a home, renters have stayed put, keeping rental units off the market.

There's also a demand factor. The pandemic led to different patterns of household formation. Many of those who had moved in or remained with relatives or friends entered the search for housing all at once, releasing a flood of demand.

Closer to home, Vermont's Housing Finance Agency notes the problem is particularly acute in Vermont. They point to Census data which showed Vermont had lowest rental vacancy rate in the country in 2022 (it's since moved to 8th lowest). At the same time there has been more demand to live here, with population growth at -0.01% annualized for the ten years prior to the pandemic and at +1.22% since.

RENTAL VACANCIES IN THE U.S. AND VERMONT



Source: Census, FRED; VT data annual prior to 2005; 4-quarter moving average

INVESTING TRENDS

By Anne Doremus

If some is good, more must be better...

When first introduced, Exchange Traded Funds (ETFs) were considered a novel improvement to the existing passive mutual fund structure. In addition to tracking a stated market index, ETFs allowed investors to trade at market prices throughout the day. Up until then, standard mutual fund investors had to settle for trading at only end of day prices. This instantaneous pricing was particularly important for large, institutional investors executing sophisticated trading strategies. The subsequent steady inflow of money into ETFs created something of a flywheel effect with growing asset bases leading to steady declines in fund level management fees. Financial service firms, sensing opportunity, rushed to get in on the game. Between 1993 and 2009, the number of ETFs increased 10 times to over 1,000 funds and by 2020, more than 7,100 ETFs were being traded across the globe.

Now, after more than 30 years of steady growth, an interesting thing is happening. While the number of ETFs continues to increase on a *net* (openings vs. closings) basis, the pace of fund closures is accelerating. So far this year, a total of 929 ETFs have closed globally, a marked increase from last year's 373 YTD closures. More importantly, the amount of money flowing into ETFs is also falling. U.S. ETFs have attracted $275 billion so far this year, a level well below the $605 billion recorded in all of 2022 and the $942 billion logged in 2021 (*see charts below*).

At least three developments are contributing to this sea change. The first has to do with industry structure. Issuing ETFs is a scale business. Most big ETFs are essentially identical (one S&P 500 ETF is just like another), so investors are attracted to those with the lowest fees. Further, the cost to manage these funds are relatively fixed, so the more money you manage, the lower the fee you can charge. This reality has led to consolidation in the ETF business. Consider that while over 160 firms issue ETFs today, three firms – Blackrock, Vanguard, and State Street – hold almost 80% of the invested assets.

Second, for years ultra-low interest rates caused many investors to turn to riskier stocks to boost return. This "there is no other alternative or TINA" trade presented a favorable backdrop for financial firms interested in issuing the next, best stock ETF. Now, thanks to higher interest rates, investors can turn elsewhere to find attractive returns with much less risk.

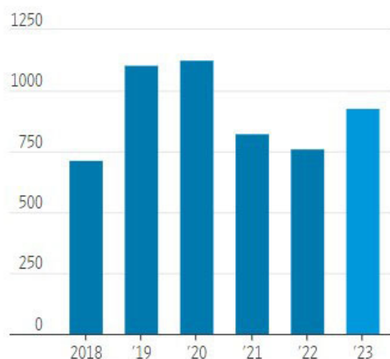
Finally, product proliferation can be blamed for the tempered enthusiasm for ETFs. The largest ETFs today track broad market indices like the S&P 500 or the MSCI EAFE. But as these products have matured over the years, ETF issuers have expanded into niche strategies. Today, for example, you can buy ETFs targeting just about every part of the investment market. More complex (read riskier) strategies employing leverage and hedging are also common. Thematic ETFs designed to track an optimistic investment narrative, such as Cybersecurity or Artificial Intelligence, too have proliferated. To get a sense of how far the "thematic ETF" concept has gone, consider that recent closures have included a fund that invests only in companies headquartered in Texas and one focusing on Dermatology and Wound Care.

The track record of thematic ETFs in particular deserves attention. Expressing an investment theme through individual stock selection can be difficult – often only a limited number of firms operate in the target market, or the companies also have other business lines. Fees too can be high when the ETF fails to attract sufficient funds. Finally, poor performance is common. Typically, by the time an investment theme is well known, and the fund launched, the prices of the constituent stocks already reflect the perceived good news.

ETFs tracking broad-based indices at a low cost represent a true product improvement. But investors should carefully examine the fees and underlying structure of funds in more niche areas of the ETF market. Often what seems like a good idea in the investment world is anything but.

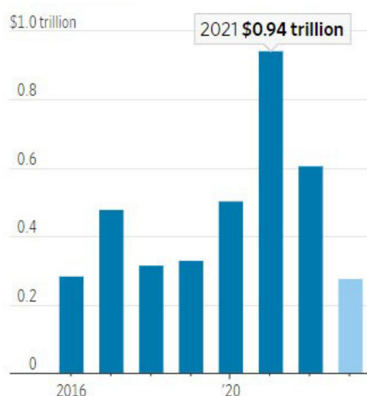
ETF CLOSURES ON PACE FOR RECORD

Global exchange-traded fund and product closures



Note: 2023 data is through Aug. 28
Source: *The Wall Street Journal*; ETFGI

U.S. ETF INFLOWS



Note: 2023 inflow is through Aug. 28
Source: *The Wall Street Journal;* FactSet

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