Financial Intelligence

Peak Asset™ MANAGEMENT

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Financial Intelligence Newsletter for Q2 2024

By Jason Foster, JD, AEP®

Peak Asset Firm Update: New Additions

Hello! For those of you who I have not met yet, I'd like to informally introduce myself. My name is Jason Foster and I am the new Director of Wealth Strategies and Legacy Planning at Peak Asset Management. I have been a licensed attorney for over 20 years, with over 10 of those years assisting individuals and small businesses with tax planning, estate planning, and bankruptcy restructuring. I transitioned to the wealth management industry in 2015, with stops at Fidelity, JP Morgan Chase and Colorado Financial Management, prior to enjoying a "soft landing" here at Peak in December 2023. Since 2017, I have been providing comprehensive and holistic financial planning to high-net-worth clients with complex balance sheets and assets, assisting clients with retirement, tax, estate, asset protection and business succession planning. I look forward to expanding Peak's financial planning offering. In providing these various planning services, I work very closely with outside professionals, including both attorneys and CPAs, to streamline the process so decisions can be made with all professionals onboard. My main objective is to simplify the complex, and to help clients make informed decisions regarding their wealth. I also will be assisting clients with the management of their investments, asset allocation and portfolio decisions at Peak as a Lead Advisor, as well as helping Peak with marketing and compliance matters.

I also have the pleasure of introducing you to another key addition we've made at Peak in Grant Bugner, CFP®. Grant joined Peak in January 2024 following three years at another registered investment advisory firm, where he provided comprehensive financial planning and investment management advice. In addition to serving on the Advisory team, as a Certified Financial Planner™ he will be assisting the planning team at Peak in building out financial plans to help clients achieve their financial objectives and retire with confidence. He is also actively involved at Peak on our investment committee and marketing team. Prior to joining the wealth management industry, Grant spent 10 years in corporate finance, primarily with a Fortune 500 firm in Denver, specializing in risk management, debt optimization, and mergers and acquisitions due diligence.

We both take our fiduciary duty very seriously and look forward to serving your needs at Peak Asset Management.

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For my initial contribution to the Financial Intelligence Newsletter, I have included a piece on inflation and financial planning, as many of our clients have questions about how we account for inflation in our plans, what inflationary rates we utilize and why. I hope you find the article helpful.

Inflation and Financial Planning

Defining Inflation. Inflation is a general increase in the prices of goods and services and a concurrent fall in the purchasing value of money. As the costs of goods and services increase, the purchasing power of your money erodes away over time. Simply put, your money will buy less in the future than it will now. One of the key components

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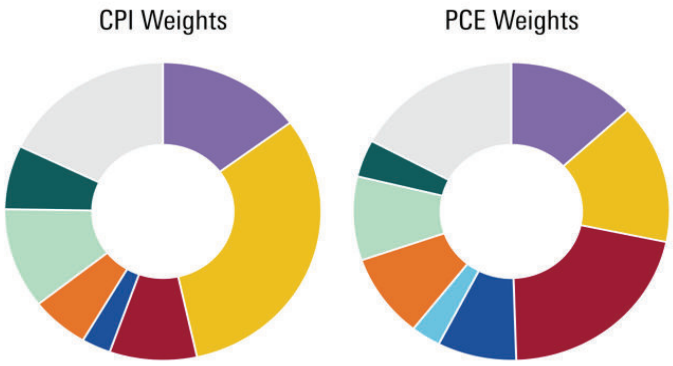
to our financial planning projections at Peak is utilizing a proper inflationary rate for these costs of goods and services in the future. Understanding how your expenses will increase over time is instructive when assessing your income flows, the types of resources available to fund any deficiencies, and the asset allocation needed in your portfolio to outpace inflation. At a basic level, the higher the estimated inflationary rate, the more pressure it can put on the income and assets available to combat this ongoing increase in expenditures.

Real Rate of Return. This pressure can especially manifest itself with retirees who are exclusively utilizing fixed income to fund their retirement. When inflation rises, the returns on fixed-income investments like bonds may not keep up with inflation, which would result in a lower actual return on that investment. Economists refer to this after inflation return as the real rate of return for the investment, and it certainly is something we keep an eye on at Peak. For example, if your investments are earning 4% and inflation is running at 3%, your real return is only 1%. And this doesn't account for other costs, such as the potential tax considerations to access the money in a brokerage account, or ordinary income tax you'll pay when you take out a distribution from a tax deferred retirement account. Thus, an important part in constructing a retirement portfolio is balancing the need to outpace inflation and managing the risk that comes with combating inflation too aggressively.

Income Resources and Inflation. Selecting the right investments in retirement or brokerage accounts is only part of the solution. When building a comprehensive financial plan, clients will likely have access to other income resources during retirement. Although less prevalent now, some clients may have pensions or defined benefit plans they can rely upon. These can sometimes adjust for inflation, but even if it does account for inflation and increases every year, will it keep pace with the overall increase in costs and expenses? Most Peak clients are or will be entitled to receive social security benefits. Clients have the option of taking the payments as early as 62 or waiting to maximize the payout at age 70. The government will adjust these payments through a cost-of-living adjustment (COLA) for inflation every year, although this is often an imperfect correlation with the actual inflation rate, considering prescription drug prices and healthcare costs, an outsized expense for seniors, do not carry the same weight in the measurable increases in social security entitlements year over year. Other forms of retirement income, such as interest, dividends, and rental income all tend to move with inflation, although certainly not in lock step, and sometimes can vary considerably.

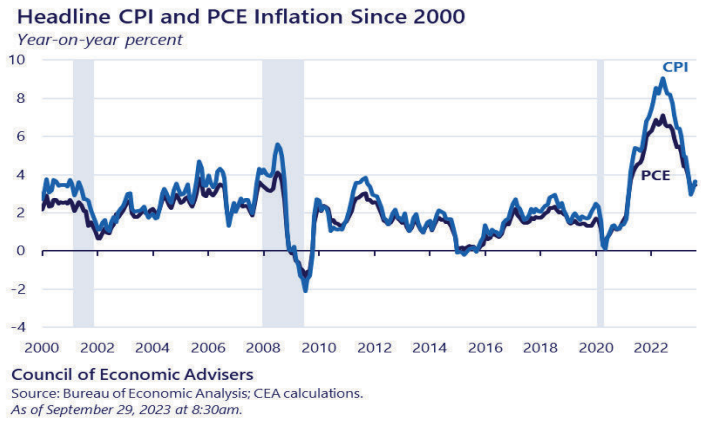
PCE and CPI Discussion. Before we dive into the inflationary rates we use in our financial plans, it makes sense to understand what the Federal Reserve looks at to set its own policies (including decisions on interest rates) when it comes to inflation. While the mainstream tends to consider the Consumer Price Index (CPI) a reasonable barometer when assessing how much we are paying for goods and services, the Fed has been utilizing the Personal Consumption Expenditures Price Index (PCE) in setting monetary policy since 2012. Although the building blocks that track consumer price changes of both the PCE and CPI are largely the same, there are some differences in the weights, especially with housing and healthcare, as illustrated below in these pie charts as provided by Morningstar:



Category	CPI	% PCE
Food	15	13
Housing	32	15
Healthcare	9	21
Financial	3	8
Nonprofits	0	3
Recreation	6	9
Transporation	11	9
Energy	7	4
Other	18	17

Other important distinctions include the fact that the PCE uses data from the gross domestic product report and from suppliers. The CPI uses data from household surveys only. Whereas the CPI only accounts for urban households, the PCE measures goods and services bought by all US households and non-profits. The PCE also includes expenditures on all goods and services purchased, including employer paid medical care, Medicare or Medicaid. The CPI excludes these specific purchases. The PCE is also viewed as more comprehensive than the CPI considering it includes a broader subset of durable and non-durable goods and services. The Fed favors these PCE distinctions and views it as the more accurate inflationary indicator. https://www.morningstar.com/markets/whats-difference-between-cpi-pce.

Regardless of the Federal Reserve's preference, over long periods of time, both indexes tend to track each other, although the CPI tends to trend slightly higher. Here is a chart from the Council of Economic Advisors in 2023 illustrating this point:

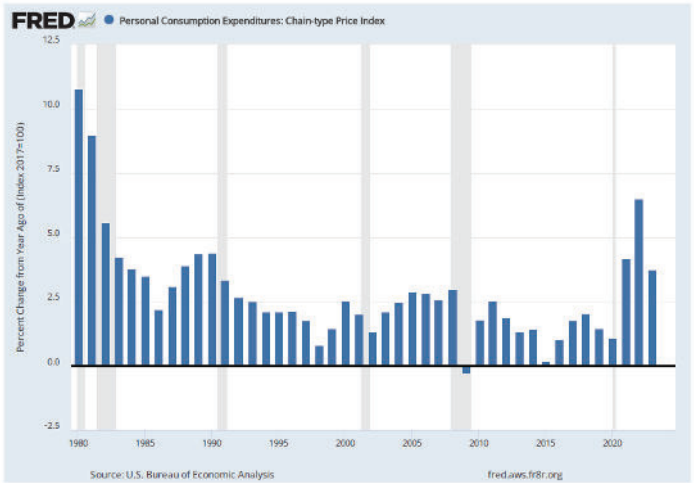


There can be meaningful differences during shorter stretches, however. For example, in the summer of 2022, the CPI inflation was almost 2 full percentage points higher than the PCE inflation. Much of this can be attributable to the weight given to housing and healthcare within the CPI. Other differences, such as the PCE formula adjusting monthly (versus yearly for the CPI), can also result in a slightly different overall inflationary rate, which is another reason the Fed prefers the PCE: its weights are updated more frequently and can better account for consumer substitution per the referenced Morningstar article.

Current Inflationary Rates for CPI and PCE. According to recent Fed data, annual CPI inflation clocked in at 3.5% in March and 3.4% in April. This shows considerable moderation from the recent peak of 8.6% in May 2022 and then 9.1% in June 2022, although it's still higher than where the Fed would like it to be. The PCE measured inflation at 2.7% in March and 2.7% again in April. In June 2022, PCE reached a 40-year high of 7%. Although the recent April reading for the PCE is higher than the Fed's 2% goal, inflation clearly has trended downward since the June 2022 highs.

If we are just taking into consideration the PCE index, for the current year, Morningstar projects that the PCE will average 2.3% for 2024, with a 2.1% drop by the fourth quarter. https://www.morningstar.com/economy/why-we-expect-inflation-fall-2024. J.P. Morgan forecasts core PCE prices to be 2.4% for 2024, down from 3.4% in 2023. Either projection would be closer to the Fed's long-term goal of 2%. https://www.jpmorgan.com/insights/outlook/economic-outlook/economic-trends. While I will not comment on whether I believe we can bring inflation down to these projected rates, either of these PCE rates for 2024 would put us below our current long-term inflationary rate we use for financial planning purposes in eMoney as discussed below.

Inflationary Rates Used in Our Planning Reports. Currently, we are growing basic living expenses at 2.54% per year within our eMoney financial plans. This is based on a 30-year average of the CPI (the typically higher of the two indices) that ended in September 2023. As of December 31, 2023, the 30-year average for CPI adjusted downward to 2.51%, but we have kept the 2.54% rate for the time being. This is currently lower than both the CPI and PCE for April 2024 as indicated above, but like our approach to investing, it makes sense to take a longer-term view on inflationary rates as we attach them to your base expenditures within our eMoney plans. We also prefer to separate out certain expenses, such as long-term care and post-secondary



educational expenses, to inflate them at different rates for reasons I will explain in further detail below.

As a comparable to the CPI rate referenced above, it is worth reviewing the PCE Index over a similar time frame:

For the majority of years going back to 1990, the average annual PCE was at or below 2.5%. Although per Trading Economics the PCE Index from 1960 to 2024 is higher at 3.3%, we also want to acknowledge the Fed's determination to get the inflationary rate down to 2%, and the fact that monetary policy over the last 30 years has been dedicated to this objective. Thus, for the time being, we believe our 2.54% rate for basic living expenses adequately addresses long-term inflation within our eMoney plans.

Long Term Care and College Related Expenses. We realize different components of the CPI and PCE offer different inflationary stories as well. Due to the consistently high

inflationary increases over the years related to long-term care costs and post-secondary education expenses, we have decided to separate out these two categories in our modeling and reports in eMoney from a base financial plan. This allows us to layer in these types of expenditures, so clients can assess how they might affect a basic plan, assuming long-term care is needed, or college planning is desired. We use a 5% inflationary rate to support long-term care needs, although this might currently be low, at least for the state of Colorado. According to Health Care Benefit Services, dating back to 1990, the average inflationary rate for long term care is 6.2% in the state of Colorado. https://medicarehbs.com/long-term-care/cost-of-long-term-care-services. The national average increase per year is in the 3 to 5% range. https://www.ltcipartners.com/blog/these-two-trends-signal-much-higher-long-term-care-costs-in-the-future-regardless-of-inflation. Although long-term care can cover a broad range of services, we assume in our modeling long-term care will require the use of an assisted living facility. We also realize the costs can vary greatly depending on the type of facility preferred and care needed.

We use a 6% inflationary rate for post-secondary expenses, which includes all college and university related expenditures: tuition, room and board, books and materials and related expenses. Our planning software also tracks existing tuition rates and college expenses throughout the country, which allows us to start with accurate information and inflate from there. The average annual inflation rate for college tuition and fees is around 5% over the past 10 years, although this can vary greatly depending on whether a student is considering public or private school, and whether room and board is required. https://www.savingforcollege.com/tutorial101/the-real-cost-of-higher-education.

Stress Testing a Plan. It is important to note that the inflationary rates we use are long-term assumptions. Thus, we regularly build out scenarios that illustrate what happens to the overall financial plan if assumed inflationary rates are too low. Within the planning presentation, we can artificially increase expenditures, and/or the inflationary rate applicable to these base living expenses, long-term care and college costs. This allows us to "stress test" the overall plan so we can assess how increasing expenditures over time affects the resources and liquidity available to pay for these expenses.

Also keep in mind we attach a growth rate to your investments. This is not a growth rate we are anticipating or guaranteeing, but typically is a conservative rate of return for investments that you will be using to fund your retirement. Utilizing an aggressive inflationary rate (CPI versus PCE), and a conservative growth rate, results in a lower real rate of return. But if deploying this strategy results in a successful financial plan, and the real rate of return ends up being higher than our conservative planning projections, the overall plan should be in good shape.

Summary. Our goal is to simplify the complex, and determining the appropriate inflationary rate to deploy within your financial plan is complicated. In providing comprehensive financial planning we pay close attention to how these inflationary rates, growth rates on investments and withdrawal rates (what you need to take from your portfolio to balance the cash flow going out in the budget) interact within the reports generated by our planning software. As the data and information changes, so do our plans. If we sense inflation will run higher for longer, we will adjust our models accordingly so that our projections will tend to run on the conservative side. Thus, financial planning is never a static event, but an ever-evolving process that takes many variables into account in an attempt to make accurate projections. We suggest revisiting a financial plan on a regular basis to see how these variables, and changes to these variables, affect your financial plan. These meetings are designed to be instructive regarding where you currently stand, assist you in making informed decisions, and help guide you through the retirement journey. Let me know if you have questions or are interested in hearing more about our financial planning process. JRF

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