Market Comments

June 27, 2023

Astrology: The Respectable Science

"The only function of economic forecasting is to make astrology look respectable"
John Kenneth Galbraith

"…just 10 stocks in the S&P 500 accounted for 88% of the S&P 500's return for the year-to-date period."

Executive Summary

- While YTD returns for the S&P 500 have been positive, the rally has been very narrowly focused.
- We are of the opinion that interest rates will be higher and for longer than the market is expecting
- Even with a reduction of rates in-line with market expectations, we do not believe that rates will be at a level to return to an environment where valuations do not matter
- Continued focus on valuation will remain of elevated importance relative to recent past

A key hallmark of our investment philosophy is that forecasting is only accurate in the rear-view mirror. Few investors saw the rally from the October 2022 lows for the S&P and most that did were not anticipating the concentration of returns in the S&P year to date in the face of economic concerns, continued high inflation, significant tightening by the Fed, and ongoing geopolitical concerns. Mega-cap tech and specifically companies tied to artificial intelligence have rallied hard this year, in reversal to what was seen in 2022. While those returns are great if you were smart or lucky enough to own nothing but those stocks, or at least were overweight those stocks, the more likely scenario is that you were also overweight those stocks in 2022 and had the exact opposite returns. An investor with such a portfolio is what we refer to as concentration risk where the return of their portfolio is tied to a small subset of a larger marketplace.

Market Performance Barometer (Through 5/31/2023)

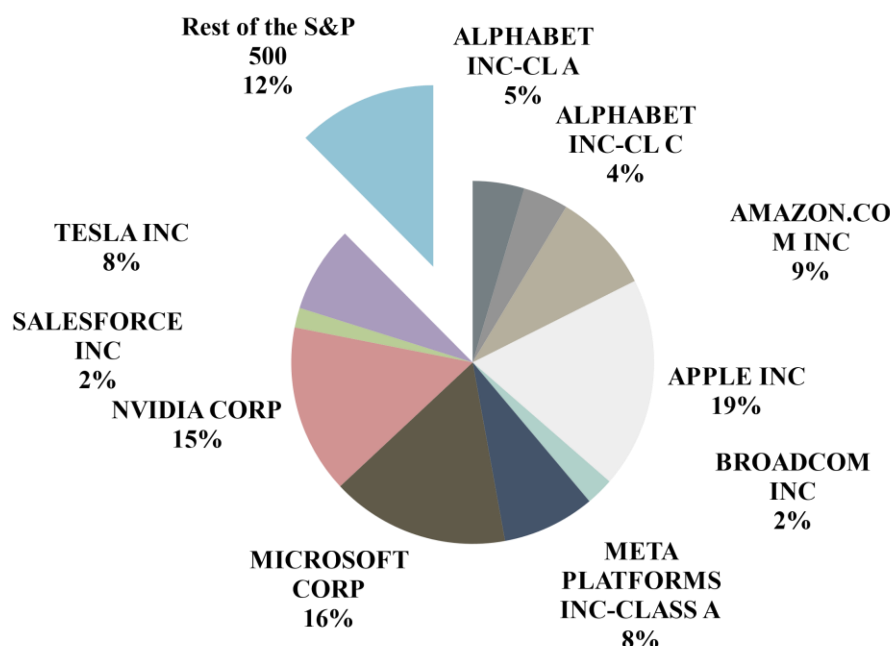
	Performance					Performance			
	1 Mo	QTD	YTD	1-Year		1 Mo	QTD	YTD	1-Year
Equities					**Fixed Income**				
S&P 500 Index	0.43%	2.00%	9.64%	2.89%	U.S. Aggregate	-1.09%	-0.49%	2.46%	-2.14%
Russell 1000 Value Index	-3.86%	-2.41%	-1.45%	-4.59%	Corporate	-1.45%	-0.69%	2.78%	-1.70%
Russell 1000 Growth Indx	4.56%	5.59%	20.75%	9.54%	Municipal Bond Index	-0.87%	-1.09%	1.65%	0.49%
MSCI EAFE	-4.12%	-1.33%	7.25%	3.72%	1-5 Year	-0.93%	-0.75%	1.40%	-2.55%
MSCI EM	-1.66%	-2.75%	1.15%	-8.12%	U.S. Treasury	-1.16%	-0.63%	2.35%	-2.26%
Top Sector Indexes (YTD)					Bottom Sector Indexes (YTD)				
S&P 500 INFO TECH INDEX	9.46%	9.96%	33.95%	19.33%	S&P 500 FINANCIALS INDEX	-4.32%	-1.28%	-6.77%	-8.60%
S&P 500 COMM SVC	6.21%	10.22%	32.81%	5.53%	S&P 500 UTILITIES INDEX	-5.87%	-4.11%	-7.22%	-9.96%
S&P 500 CONS DISCRET IDX	3.21%	2.24%	18.64%	-0.79%	S&P 500 ENERGY INDEX	-10.04%	-7.07%	-11.44%	-7.55%

Source: Bloomberg

As the chart below shows, just 10 stocks in the S&P 500 accounted for 88% of the S&P 500's return for the year-to-date period. It is worth pointing out that the 500 in the name S&P 500 refers to the number of stocks in the index or that the combined impact of the other approximately 490 stocks in the index only accounted for 12% of the return so far this year. Very few investors we

have encountered in our career have been comfortable with the level of volatility associated with having a long-term portfolio with this level of concentration. When we are confronted with concentration risk, we tend to think about two very common investor biases, familiarity bias and anchoring bias. Familiarity bias refers to when an investor only invests in "what they know" while anchoring bias refers to skewing decision making to an arbitrary benchmark.

Contribution to S&P 500 YTD Through 6/23/23



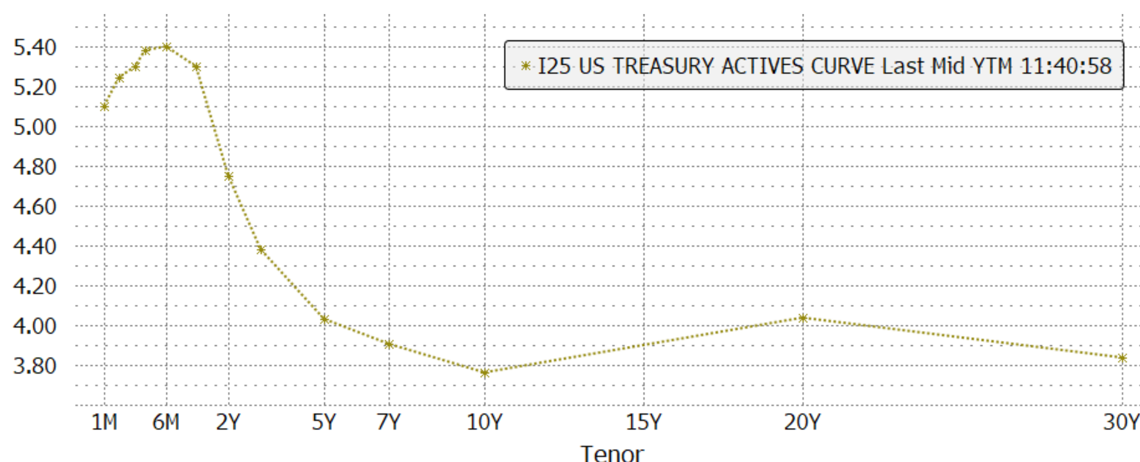
Source: Bloomberg

"Yes, short-term fixed income is very attractive right now, but we do not see it as a straight and easy replacement for all fixed allocations.."

Over the past several months, we have been inundated with requests to move more fixed income into short-term positions, and the topic warrants a conversation. Yes, short-term fixed income is very attractive right now, but we do not see it as a straight and easy replacement for all fixed allocations. To better explain why, we need to take a look at why we manage assets in the space at all. Short-term fixed income securities provide stability, liquidity, and lower interest rate sensitivity, which makes them suitable for investors with short-term cash needs or a very conservative risk profile. You know exactly what you're getting with a one-year bond paying a 5% yield; however, we don't always think about the opportunity cost of that position. Short-term fixed income positions also introduce an important but often ignored risk: reinvestment risk. Reinvestment risk is the risk that you will have to reinvest proceeds at a lower rate when put into a new investment.

Bonds have a known maturity date, or the date that you will receive your principal back from the issuer of the bond. As one can very clearly see from the below yield curve, the top of the curve is the 6-month. So only someone who doesn't like maximizing return would buy anything other than the 6-month. Right? If your investment horizon is less than a year, you might be correct. But let's say this allocation is part of a long-term allocation. If rates will remain at these levels across all tenors in perpetuity, rolling 6 month bills will work out well for you. But, there is a higher

probability in our opinion that the curve will normalize and the inversion will reverse where you are once again compensated more for holding longer-term maturities. The most likely scenario will be that the short end of the curve will come down, meaning that rolling those 6-month maturities will be lower and lower. Said another way, you would have been better off with a different allocation.



"…we are firmly of the opinion long-term investors are better off giving up some near term yield in order to increase the probability of maximizing the return over their investment horizon."

Enter intermediate fixed income securities. In this space, we typically find higher yields, a potential for appreciation, and a broader range of credit exposures. These characteristics will appeal more to investors with a longer time horizon and a higher tolerance for volatility. Even though the yield curve is currently inverted, and short-term is paying out slightly more than the intermediates, we see opportunity in the space as rate increases putter out and inflation slows down. Additionally, it does not always pay out when we concentrate positions and merely chase yields; we continue to keep an eye on the horizon to position our bond allocations to have the best opportunity beyond the short-term.

While we do believe there is a high probability that this will occur, the exact timing of this is less clear; we may need to consult our astrologers to help us get that piece of the equation right. Instead of banking everything on the stars and trying to time the exact switch over from short-term to intermediate-term, we are firmly of the opinion long-term investors are better off giving up some near term yield in order to increase the probability of maximizing the return over their investment horizon.

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