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From the CIO's Desk

The equity markets drifted lower in 3Q-2023 as uncertainty about rising interest rates continued. Bloomberg BusinessWeek is reporting that the bond markets have had their worst three-year period since 1787. You read that correctly. Any interest rate sensitive security has been taken to the woodshed.

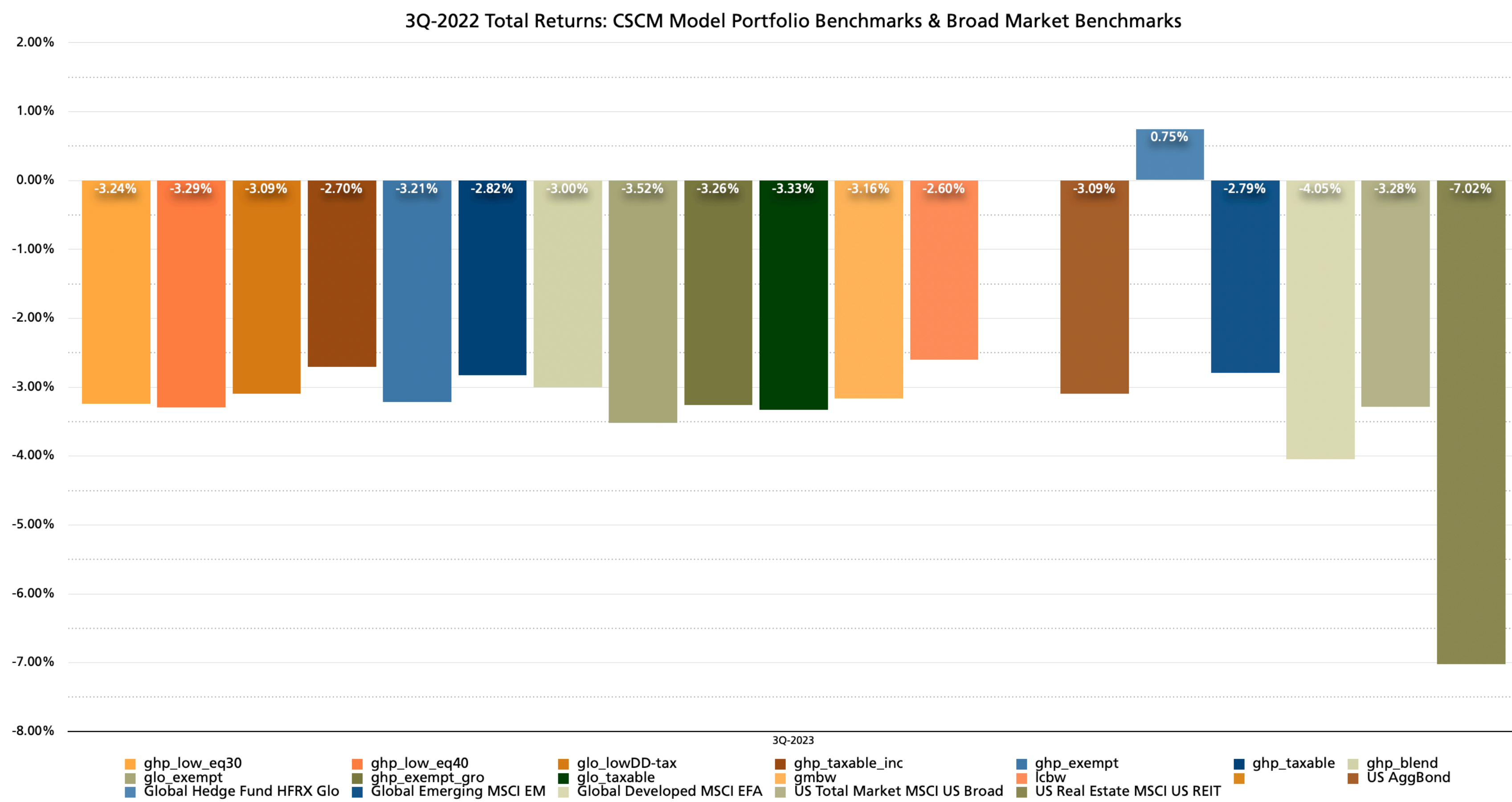
Inflation is showing signs of cooling and as such interest rates may soon stabilize. That would at least take downward pressure off of all securities.

The upside of rising rates is that we now have a historically "normal" rate environment. Investors can earn significantly better current income now from Treasuries, money markets and bonds of all types. This will also improve expected returns from all portfolios that are balanced to any extent with these aforementioned income investments. The flipside of this coin is that borrowers have to pay more. Mortgages in particular are at rates last seen in the late 1990s.

Investors and advisors alike are suffering "market fatigue." Since 2019 markets have experienced both a rapid and scary selloff of 1Q-2020 (Covid) and the water torture of 2022 (Rate Hikes). Most portfolios are still well below their high-water marks of late 2021.

Once rates stabilize, all assets can then trade on their fundamentals, (earnings growth, valuation multiples, yield) and investors can collect better income while they wait for more normal market conditions to obtain once again and for portfolios to approach and breach previous High Water Marks.

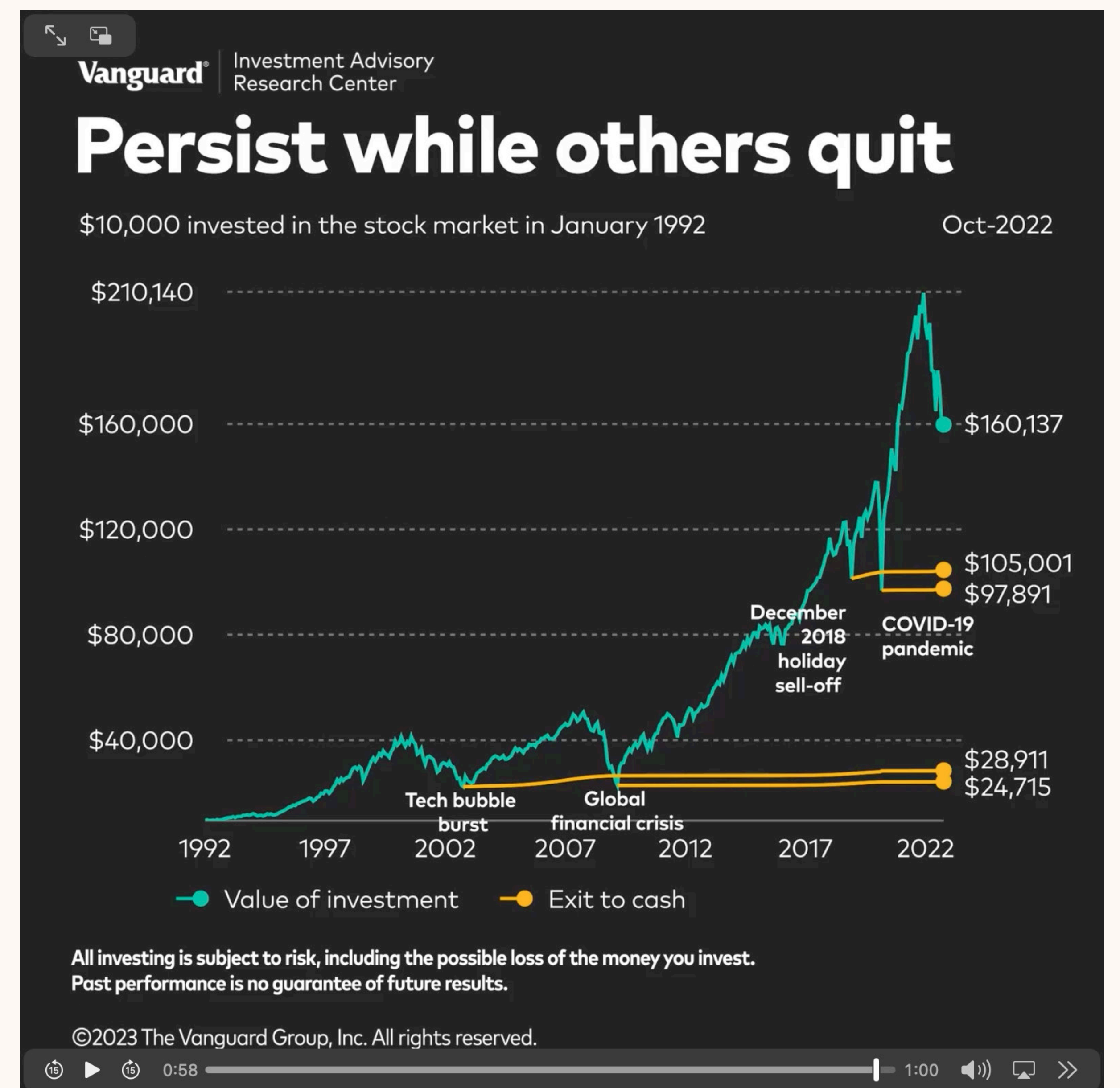
Thomas F. McKeon, CFA | October 13, 2023



Endure and Prosper

The current challenge for all competent, ethical investment advisors is to get their clients to endure and stand by despite a protracted period of unsatisfactory returns. The Vanguard Group (now managing something close to $8 trillion) has created this brief animation of the returns of a broad benchmark of US Stocks from 1992 through October 2022. It shows how a hypothetical investment of $10,000 would grow if left alone and how much an investor would have if they cashed out at one of several panic points. As the animation shows, the most current value is down from the year-end 2021 peak. Still it is a 16-fold increase (to $160,137) from the original $10,000.

Click on the image to see the one-minute video on the Vanguard website.

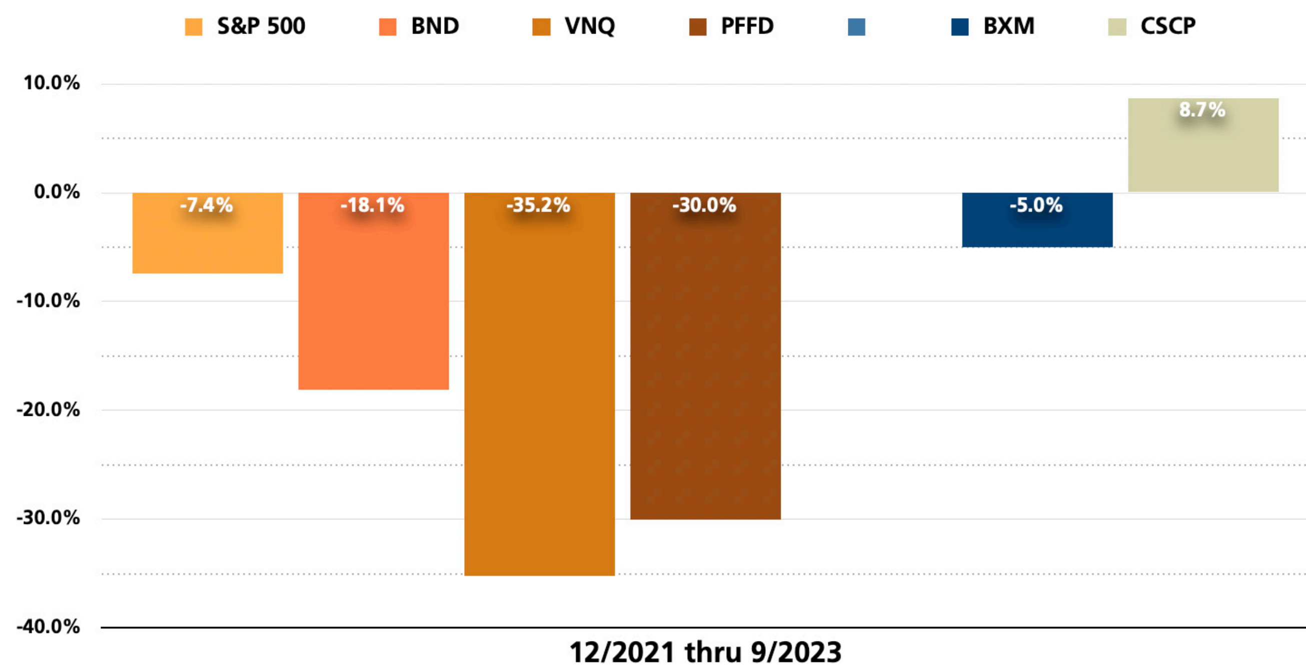


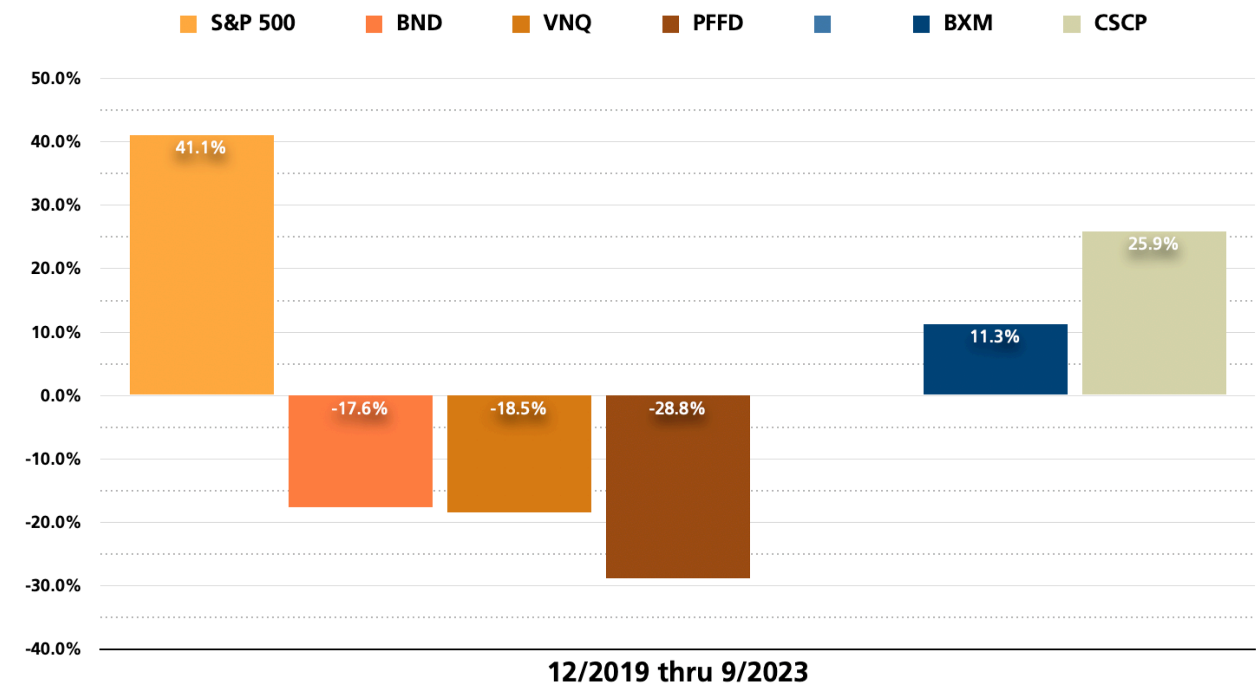
Review & Outlook 3Q-2023

The equity market rally of early 2023 sputtered and gave back some ground in 3Q-2023. Inflation and a higher new normal level for interest rates appear to be the proximate culprits.

Bonds and other interest rate sensitive investments like preferred stocks and REITs remained sharply depressed. Bloomberg BusinessWeek has reported that bonds have had their worst three year period since just after the Revolution. The US War of Independence that is, dating back to 1787. Not sure how anyone can cobble together enough data to make that statement, but there it is. It has been painful to own these investments for sure. The double whammy is that investors who were scared out of equities over the past few years ended up overweighted in bonds, often considered the “safe” asset class.

With inflation coming down sharply the Federal Reserve may see no further need to raise rates. With healthy yields to be had in the bond markets now, investors have more choices, balanced portfolios will perform better going forward and spendable income is meaningfully higher. Not too long ago, money market funds were paying a yield of a few miserable basis points. Investors can now collect more than 5% annual for this effectively risk-free investment. This is a return to a normal rate environment. The super low rates of recent years were the anomaly. The lingering pressure on stocks is due in part to investors re-allocating into money markets and their (now respectable) certain yield and away from the uncertainty of stocks and bonds. The FRED (Federal Reserve Economic Data) site reports that money market funds in aggregate have grown by almost $1 trillion in the past twelve months. For perspective, a trillion is one-thousand billion.





Sources of Market Fatigue

The two charts on this page show the four major asset classes we use in our Global Portfolios in varying proportions: S&P 500, BND (Total US Bond Market), VNQ (Real Estate Investment Trust Market) and PFFD (US Preferred Stock Market). We also include the CBOE BXM (Buy-Write Index) and the Clothier Springs Capital Partners (CSCP), our private partnership for investing in multi-family equity and debt. Data is for two separate time periods: 12/2021 through 9/2023 and 12/2019 through 9/2023.

Anyone with a basic understanding of math might see those charts and know intuitively that it has been impossible for a globally allocated portfolio to make money over those time periods. And they would be right.

Of those four asset classes only the S&P 500 has had a positive return for one of the periods. The chart on the right is for a time period now approaching four years. While most portfolios reached new all-time highs at the end of 2021, most have also given some back as the Fed raised interest rates aggressively through 2022-2023 and all rate-sensitive assets declined sharply. Globally allocated and balanced portfolios suffered accordingly.

Reinvesting The Income

While the markets vacillate and digest the inflation news, we keep reinvesting all the income your portfolio collects. As well, investors making routine contributions to their portfolio are benefiting from continued purchases at depressed prices. In the fullness of time, these purchases will add meaningfully to your total return and eventual outcome.

The Fatigue is Real

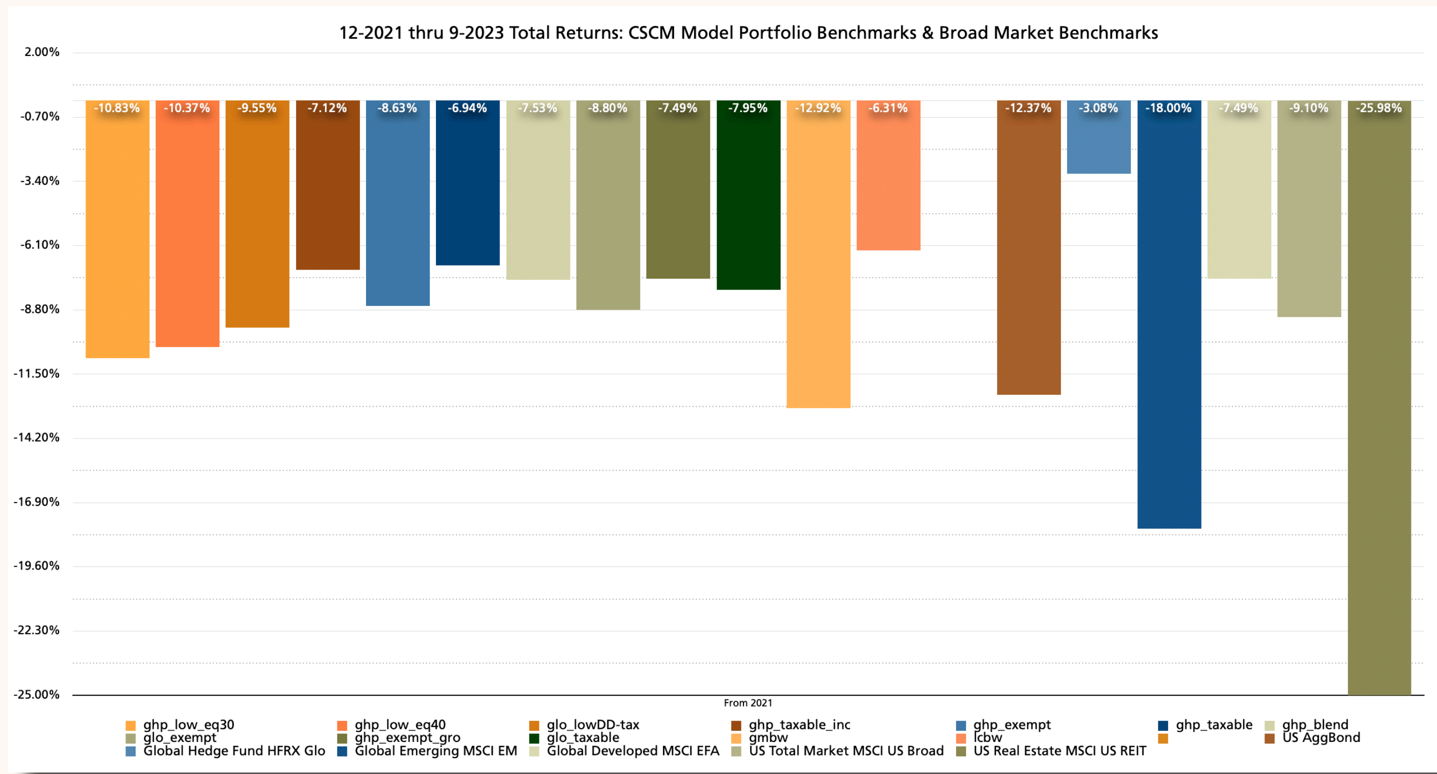
We all feel it. We all invest to see our investments grow over time and when we see little to no progress for an extended period of time, it is easy to become disheartened. It is human nature.

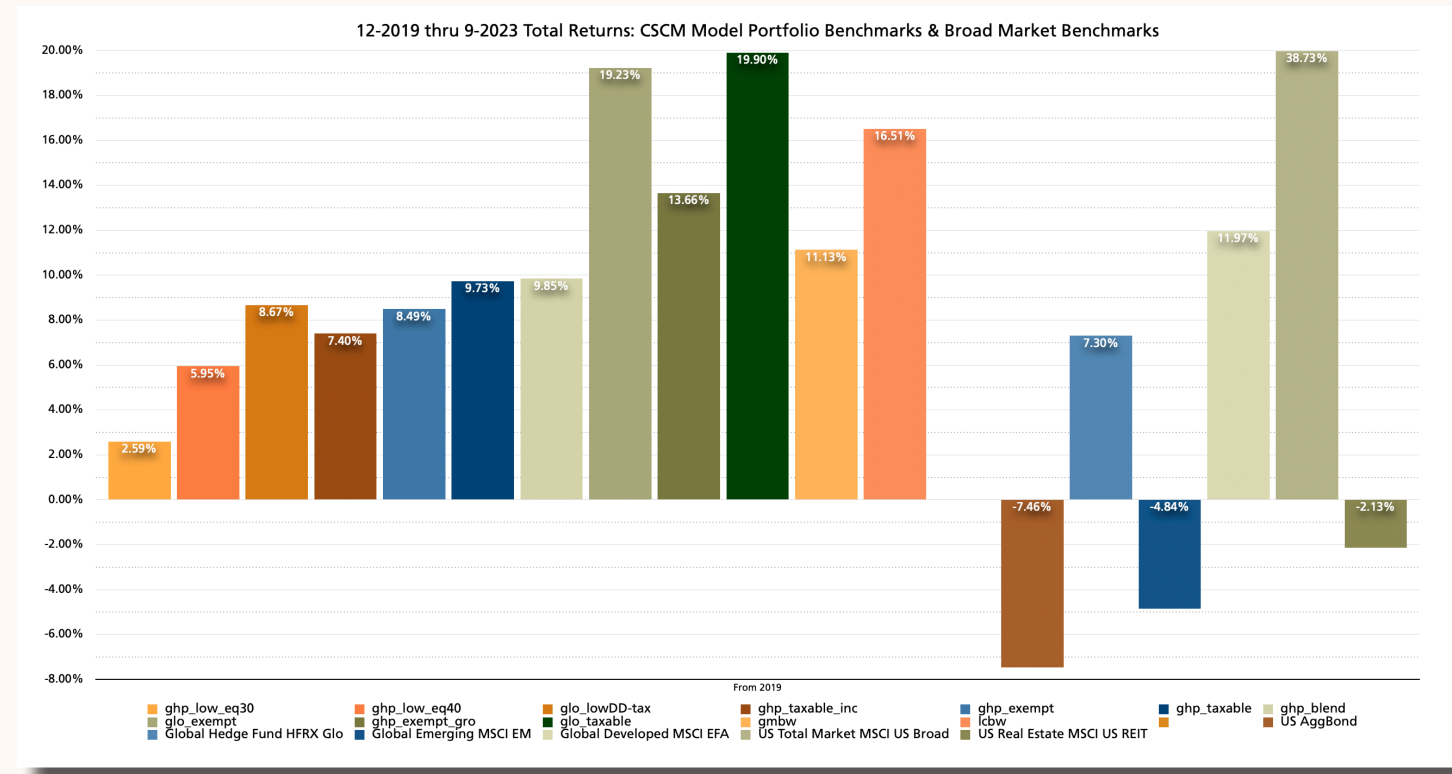
Returns Are Lumpy

A glance at a chart of equity market returns shows that while the overall trend is strongly upwards, the chart is far from a straight line. It shows periods of both sideways trends and down-market trends within the broad long-term uptrend. Veteran and successful investors have learned how to tune out of the endless daily noise, chatter and alarms that flows from the media in general and financial media in particular. Ultimately, equity prices follow corporate earnings. And while inflation triggered an aggressive response from the Federal Reserve, putting all financial assets under pressure, corporations are benefiting from robust price hikes driving higher earnings. Stock prices will eventually follow.

Inflation: Bad AND Good

Inflation protection has forever been a primary rationale for investing in stocks. As some level of inflation is effectively a permanent state of the economy, owning assets that benefit from rising prices is perhaps the best way to earn returns, grow your capital and have your purchasing power out pace inflation.





Risk and Return

The charts above on both pages show the returns from our model portfolio benchmarks (on the left) and for the primary asset classes we use to invest client portfolios, in various proportions based on return objectives and risk tolerances.

You should be able to discern that return and risk move from left to right, low risk-return to higher risk-return, on both charts, more clearly in the chart on the right.

Interestingly, lower risk-return portfolios—which generally have lower equity exposure and greater bond exposure—have endured the worst bond market in several centuries and been punished accordingly, for the 12-31-2021 through 9-30-2023 period.

The chart above is for the 21 months since the equity market high at the end of 2021. It has been an unproductive time for all markets as the Federal Reserve raised rates aggressively, ostensibly to combat inflation. Real estate in particular has had a rough go of it. With all that is going on in the world today, this past 21 months of no gains in our portfolios seems like eons.

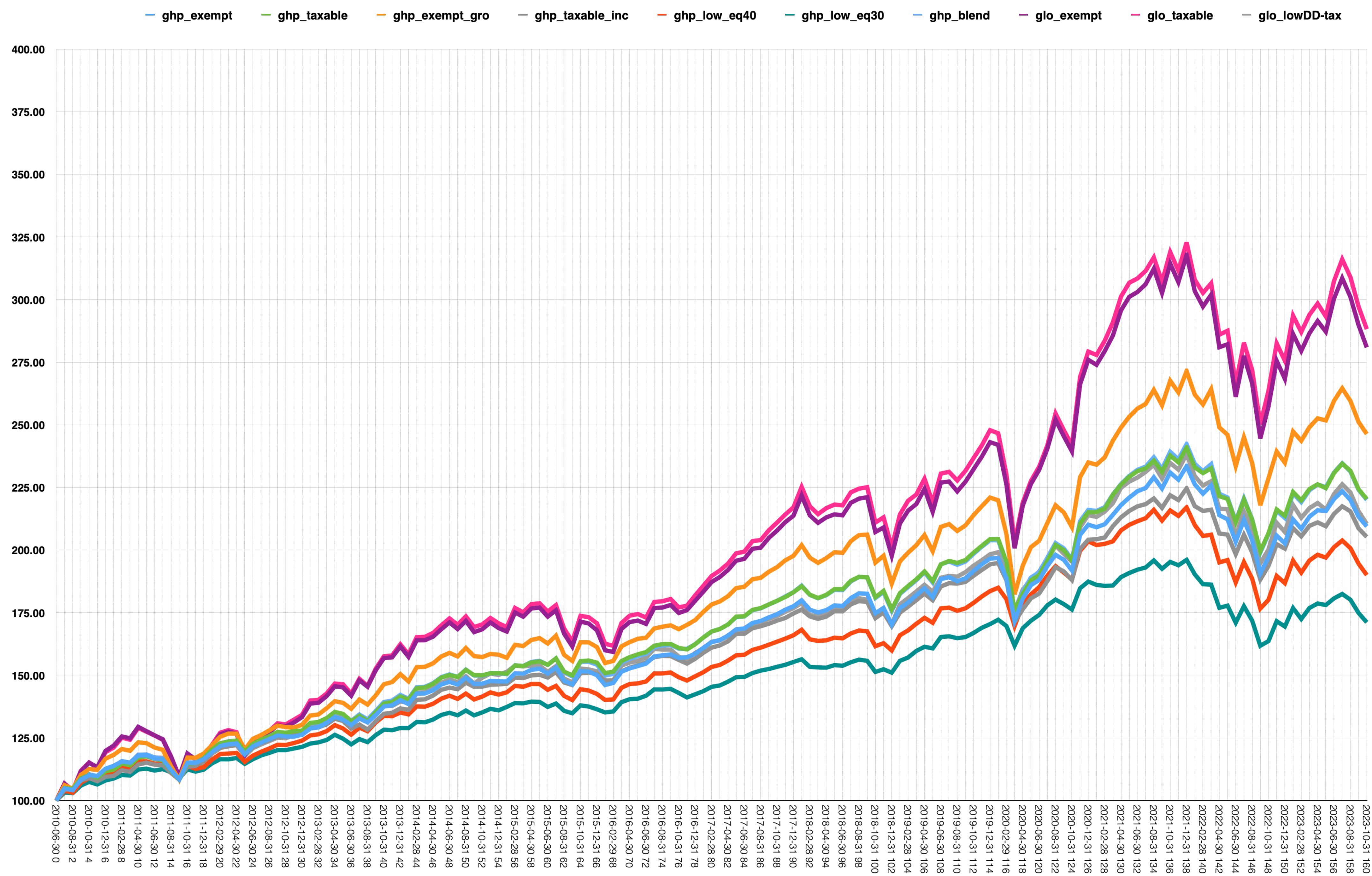
The chart upper right shows the same model portfolios and asset classes for the period commencing on 12-31-2019 (pre-Covid) through 9-30-2023. This period included both the harrowing market sell-off in 1Q-2020 and the water torture market decline of 2022. It also includes the 75% equity market rally from 3-31-2020 through 12-31-2021, which came on the heels of the 1Q-2020 selloff.

The model portfolio benchmarks above are all positive, from a modest 2.59% to a respectable 19.90%. Remember, this period encompassed two equity market declines and the worst market for bonds in 200 years. Still, the returns are all positive for the benchmarks even though not all of the underlying asset classes were positive for the period. That shows how important asset allocation is.

Conversely, the 75% equity market rally that started in late March of 2020 through year-end 2021 shows how sharp and extended an equity market rally can be once broad-based sentiment turns from bearish to bullish.

Perspective

The whole point here is to offer some perspective and to give readers the historical ammunition to endure this protracted sideways market, so they can eventually reap the rewards. We remain fully invested in your chosen allocation. When the markets move to new highs, you will too.



Charting Return and Risk

The chart above is a more than thirteen year graph of our suite of custom benchmarks. The aim is simple: to have a suite of model portfolios with a range of risk and return profiles. The lowest (dark green) line is our GHP Low Equity 30 model. Limiting equity exposure to 30% is intended to limit volatility. The highest (magenta) line is our GLO Taxable (Global Long Only) model for taxable accounts. Typical equity exposure there is 70%.

The contours of the graphs are similar because we use the same market indexes, in different proportions, to build the models and benchmarks. We vary the weights of the risky assets inversely to the weights of the normally less risk assets. Bonds are generally thought of as less risky although the past few years has been very difficult for interest rate sensitive assets like bonds. The highest return of these models over the period shown is just under 200%. The lowest return is just under 75%.

Several Observations

- *None of the benchmarks have re-attained their previous high of 13/31/2021, as of October 31, 2023.*
- *Over this time span, the benchmarks have all endured eight or so significant down periods.*
- *Investors willing to endure more regular portfolio volatility in the short-term are rewarded in the long-term with higher returns.*

These benchmarks are not intended to be a bogey or target that we are trying to "outperform." Rather, they are intended to show that a different mix of the same asset classes will result in a range of outcomes and that return and risk are inextricably linked.

We do this because clients are human beings and have various goals and objectives driven by their unique circumstances, life situations and psyches.

The More Things Change

Admittedly, the news flow has been a little unsettling lately: inflation, politics, regional conflicts, the list goes on. Still, the capital markets are not broken. There are things to avoid and pay attention to but ultimately most of us get up every day, go to work and try to improve our positions. Companies grow, profits grow, inflation at some level is a permanent aspect of our lives and in time, market prices will reflect growing profits. Eventually, the equity markets will breach old highs and move to new highs. *The More They Stay the Same.*

Case In Point

The photo above is a prime example of the kind of market-manipulating noise that endlessly streams from the financial media. Federal Reserve Chairman Powell—the man responsible for the aggressive rate hikes of the past year—has effectively said this according to the above item:

The Fed MAY raise rates, IF the economy stays surprisingly strong AND IF a tight labor market stops easing.

A lot of if's and maybe's in there but the way it is presented and featured makes it seem like a foregone conclusion. The markets, which had been drifting near flat for the day, tumbled sharply as this story was pushed. See the market indicators above the photo.

The article on the right from Annie Lowrey of the Atlantic also speaks to how the media always seem to cast the news in a negative light

The Annoyance Economy

Data alone don't capture how frustrating and stressful it is to be a consumer right now.

Annie Lowrey | The Atlantic | Oct. 19, 2023

Has the American labor market ever been better? Not in my lifetime, and probably not in yours, either. The jobless rate is just 3.8 percent. Employers added a blockbuster 336,000 jobs in September. Wage growth exceeded inflation too. But people are weary and angry. A majority of adults believe we're tipping into a recession, if we are not in one already. Consumer confidence sagged in September, and the public's expectations about where things are heading drooped as well.

The gap between how the economy is and how people feel things are going is enormous, and arguably has never been bigger. A few well-analyzed factors seem to be at play, the dire-toned media environment and political polarization among them. To that list, I want to add one more: something I think of as the "Economic Annoyance Index." Sometimes, people's personal financial situations are just stressful—burdensome to manage and frustrating to think about—beyond what is happening in dollars-and-cents terms. And although economic growth is strong and unemployment is low, the Economic Annoyance Index is riding high.

There's plenty to be annoyed about. Voters are just not excited about the Joe Biden versus Donald Trump rematch. Trump's favorability among Republicans has fallen. Half of Democrats want someone other than Biden to be the nominee. And voters really hate the guy running on the other side of the aisle. Polarization is fueling a huge gap in partisan economic expectations: Republicans don't think the economy is good when Democrats are in charge, just as Democrats refuse to believe the economy is good when Republicans are in the White House. The effect has grown big enough over time to lower Americans' aggregate views of the economy.

The media environment is not helping matters either. *We've now had several years of headlines warning about an impending recession that has not yet materialized, or anything close to it. Consider how the New York Times covered the great job news earlier this month. When I looked at the top of the homepage one recent Friday, I saw three headlines about the employment numbers: "U.S. Job Growth Surges Past Expectations in Troubling News for the Fed"; "The Jobs Report May Hamper the Federal Reserve's Efforts to Cool the Economy and Wrangle Inflation"; and "Interest Rates Are Jumping on Wall Street. What Will They Do to Housing and the Economy?" Meanwhile, in Ne Wall Street Journal: "The Markets Are Jittery. Here's Why the Strong Jobs Report May Not Help." Each of these stories was a good story with a lot of nuance.* ***But the overall message was This is bad!,*** *not Wow, what a labor market!*

The relentless focus on bad news *helps explain the enormous differences between how people say they are doing and how they say the world is doing, as my colleague Derek Thompson has noted. Most Americans think their personal-financial situation is pretty good—that makes sense, given the unemployment rate and income figures we've seen over the past few years. But most think the country is doing horribly, because of all the worries about the Fed, interest rates, and inflation, putting us in a "vibecession," as the writer Kyla Scanlon has memorably described it.*

Those surveys asking people about their personal situation may also be missing the tenor of their response: Something is driving a wedge between economic sentiment and the headline economic reality, and people might be admitting that they're doing okay only through gritted teeth. Almost everyone who wants a job has one—that's great. Wages are rising across the board—also good. But a lot of economic factors that are frustrating and vexing to deal with are tempering people's feelings about the economy as a whole.

First and foremost: inflation. Yes, price growth has moderated. Yes, people's incomes are rising faster than prices are rising, leaving most consumers better off overall. But people hate inflation. They hate doing the mental math and realizing how expensive everything is every single time they go to the grocery store, pick up takeout for dinner, and stock up on shampoo and painkillers at the pharmacy. Inflation does not just erode people's earning power. It ticks people off. (Student loans have a similar effect. Most people who take out student loans come out ahead. But folks hate feeling like they have a second mortgage to pay down month after month.)

Second, and relatedly: interest rates. Borrowing money is very, very expensive right now. As a result, credit-card defaults are way up, and many people are putting off buying big things on credit. The average monthly payment on a new car is more than $700, well beyond what many families can afford. The housing market is a nightmare too—something that is not easy to see in headline economic statistics. Rental prices are sky-high in many metro areas. And the real-estate market is frozen solid because of those high interest rates. Nobody can sell, because who wants to give up a low mortgage rate? And nobody can afford to buy. The situation is going to be miserable for years to come too: If interest rates go down, buyers will flood into the market, pushing prices up even higher. Lots of people are trapped in places they don't want to be living, with no end in sight.

Finally, nostalgia, true or false, is driving up the Annoyance Index. Even if things are pretty good at the moment, many Americans remember them feeling better in the recent past. Families had way more cash on hand during the pandemic. Interest rates were much lower. Wage growth was faster a year ago. Prices were lower—a lot lower—before the pandemic. And many employees have been forced back to the office, when they were happy working at home.

Things are great, but folks are mad. All we need is for prices to come down, interest rates to stabilize, housing markets to normalize, polarization to decrease, and the news media's incentives to change. Until then, the Economic Annoyance Index will just keep getting higher.

A Word About Executive Compensation

We have been observing for quite some time now the growing disparity between executive compensation and worker compensation. Below is an article from Yahoo Finance about the excessive compensation for the board members of a high profile company that were shamed into returning the egregiously large packages. So excessive that they were shamed, sued and embarrased into giving it up.

TESLA DIRECTORS AGREE TO RETURN $735 MILLION FOLLOWING CLAIMS THEY WERE MASSIVELY OVERPAID

In a lawsuit, shareholders claimed they were massively overpaying themselves.

Elon Musk, Larry Ellison and other current and former members of Tesla's board of directors will return $735 million to settle claims that they massively overpaid themselves, Reuters has reported. The deal wraps up a saga that started in 2020 stemming from a lawsuit filed by a police and firefighter retirement fund challenging stock options granted to Tesla's board starting in 2017. Directors also agreed not to receive compensation for 2021, 2022 and 2023, and change the way compensation is calculated.

Tesla's current board includes Elon Musk, his brother Kimbal, Fox News mogul James Murdoch, Airbnb co-founder Joe Gebbia and former Tesla CTO JB Straubel. The case is separate from a lawsuit filed by shareholders against a $56 billion compensation package awarded to CEO Elon Musk.

The Police and Fire Retirement System of the City of Detroit accused Tesla's board of giving itself unfair and excessive compensation in the form of 11 million stock options between 2017 and 2020, saying it grossly exceeded norms for a corporate board. The $735 million settlement will be paid back to Tesla in what's called a "derivative lawsuit" — the largest ever awarded by Delaware's Court of Chancerty, according to Reuters.

Tesla argued that stock options were used to ensure Director's incentives were aligned with investor goals. Tesla has yet to comment on the affair, but in court documents, said that it agreed to settle to eliminate the risk of future litigation.

Tesla CEO Elon Musk is fighting a separate lawsuit to defend his $56 billion pay package. It was brought by shareholder Richard Tornette, who claimed that "the largest compensation grant in human history" was given to Musk, even though he didn't focus entirely on Tesla. In 2020, he received the first of 12 $700 million payments as part of that package.

It is very revealing of the mindset of the executive suite. The numbers are astonishingly large, and this for board members who might only convene several times a year.

We have no words regarding Tesla's Elon Musk defending his $56 billion pay package.

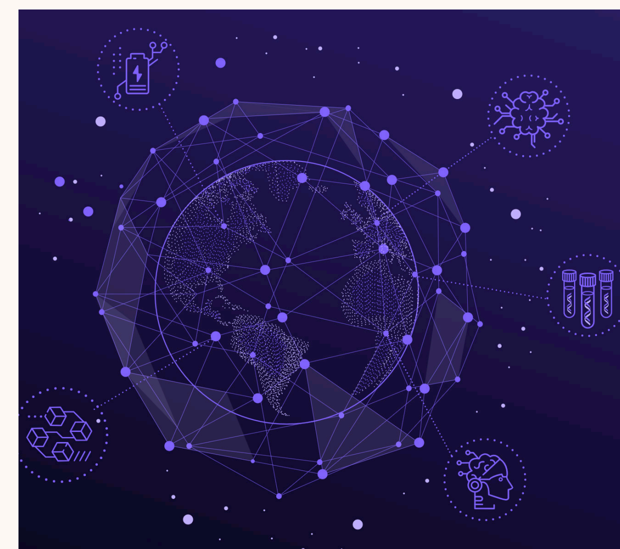
Revisiting "Star" Investor Cathie Wood

Returning to a theme we have consistently featured we note that a prominent financial journalist for Forbes Magazine (John S. Tobey) has echoed our sentiments and added some quantitative data to show how bad the performance of her flagship fund has been.

From Forbes on 2023-10-31:

Cathie Wood's ARK Innovation Fund Retains Loyal Losers for Now

The article points out that her flagship fund/ETF (the Ark Innovation ETF) has returned a negative 5% since 1/1/2019, while the S&P 500 has gained 76%, the Dow Jones is up 52% and the tech heavy NASDAQ 100 up 128%. However, the damage to investors is much worse.



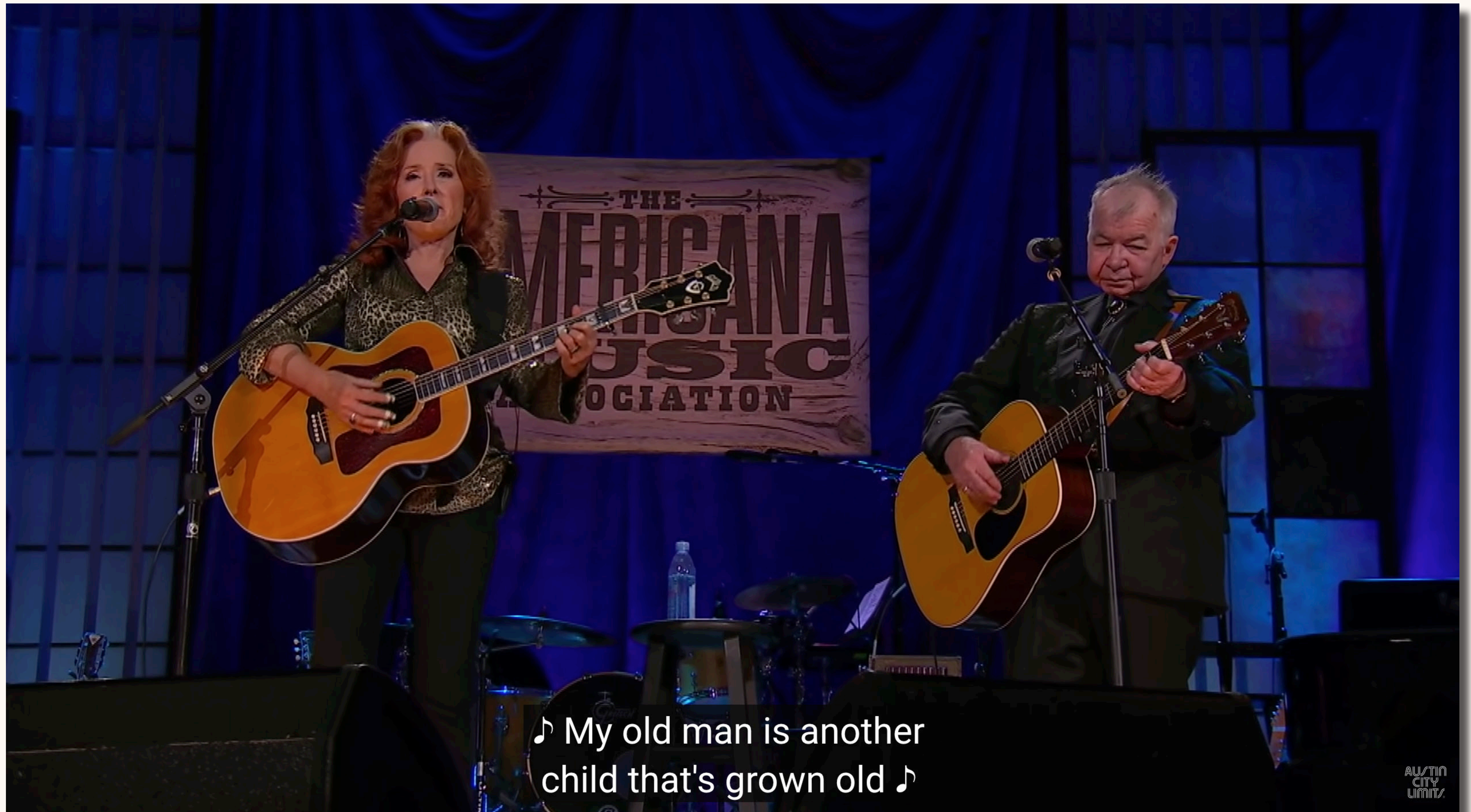
The fund was a $1 billion fund at the beginning of 2019. When the Covid lockdowns were imposed many tech and meme stocks went on an irrational tear and her fund rocketed to an enormous gain of more than 300%. This of course attracted investors eager to join the party...bringing in more than $15 billion...after the huge gains.

The ETF is now down to roughly $6 billion. The article points out that investors have not withdrawn their assets. The decline is purely due to investment performance. Investors in the ARKK ETF have absorbed a 63% loss of $9 billion.

From Forbes:
Note: This is a common problem with riskier funds. When performance happens to get hot, so do investors' desires to get in on the action. The difference here is that when performance soured, investors didn't. Importantly, investors only see "time-weighted" performance numbers that remove the effect of investor inflows and outflows. "Dollar-weighted" performance numbers take size and flows into account. Hence, the time-weighted -5% vs the dollar-weighted -63%.

Investing history is littered with "brilliant" stars who once caught fire. However, when they flamed out, that was the end. It's a rare, repeat event that they will return. Instead, they usually produce dismal results by struggling to repeat their once-famous dazzle.

And yet, here is Cathie Wood still getting plenty of notoriety and shareholder loyalty even as she continues to lose. But this extended situation will finally collapse. When? Likely, as the next, new bull market excitement occurs.



Bonnie Raitt and John Prine performing Prine's classic "Angel From Montgomery."
This performance is especially soulful and melancholy. Aired in November 2019, Prine was gone by early 2020, swept away by the first wave of Covid. RIP.

Closing Thoughts

The markets have not given us much for the better part of two years. The primary culprit has been the aggressive rate hikes by the Federal Reserve aiming to curtail inflation. Once the markets perceive that rate hikes are over, we should return to a normal market environment and upward equity trajectory.

We may be there already. After the Federal Reserve meeting earlier this week, Secretary Powell said there was no need for a rate hike, although he left the door open for future hikes. With inflation already well down from a year ago, the markets appear to be discounting a future hike and the equity markets have responded with a near 5% rally this week through mid-afternoon on Thursday.

Is this the long awaited inflection point? Only time will tell. But as the market has hung on every pronouncement by the Fed for almost two years, if in the fullness of time this turned out to be, it would not be a surprise. It would be a welcome return to a market where we all made steady returns and edged closer to our return targets.

Thomas F. McKeon, CFA | November 2, 2023

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Structure IS the Strategy