1st Quarter 2022 Review

The major stock averages all experienced declines for the first quarter of 2022. While the month of March posted gains across most major averages, the weakness in January and February drove negative returns for the quarter. Various stock indices saw declines in the range of 4% to 9% over the quarter. In what has been a rare occurrence, this quarter also saw bond prices decline along with stocks as interest rates continued to rise.

The quarterly returns for the major indices were: The Dow Jones Industrial Average declined 4.11%; the S&P 500 was down 4.62%, the Russell 2000 Small Cap Index was down 7.5%, the NASDAQ fell 9.1%. International equities underperformed the U.S. markets with emerging market stocks falling 7.5% on the quarter, while the MSCI EAFE Developed International Index fell 6.4%.

Bond markets experienced their worst quarterly returns in nearly 40 years as inflation pressures have persisted and the Federal Reserve began what they have indicated to be the first of many interest rate hikes. The broad investment grade bond market declined 5.85% for the quarter, as the 10-yr treasury yield rose from 1.5% to start the year to 2.32% at the end of the first quarter. Short term interest rates have risen dramatically in the last two years as the 2-year treasury yield went from 0.12% to 2.30%.

The macro environment is presenting challenges for the market as both stocks and bonds deal with higher inflation, higher interest rates, rising commodity prices, and reversal of the long-standing low interest rate policy of the Federal Reserve. On top of this we have the elevated geopolitical risks emanating from the ongoing war in Ukraine. Volatility has risen and the dispersion of returns within various segments of the market has widened.

Value stocks have outperformed growth stocks in this latest period of rising rates and volatility. The Russell 1000 Value Index was down about 1% in the quarter while the Russell 1000 Growth Index fell almost 9%. The worst performing sectors were those that are typically higher weights in the growth indices such as technology, telecom services, and consumer discretionary. Growth stocks are usually more impacted by rising interest rates due to their valuations being largely influenced by future earnings and cash flows as

opposed them having high levels of current cash flows. Outside of the energy sector that saw outsized gains from the sharp rise in oil and gas prices related to the Russian invasion of Ukraine, the better relative performance in the quarter came from the traditionally more defensive, value sectors such as utilities, healthcare, consumer staples, and financials.

In the bond market, the rise in interest rates caused the most damage on the longer end of the maturity spectrum. The 20-year plus part of the treasury market as represented by iShares fund, TLT, was down over 10% in the quarter, while the 7–10-year maturity fund, IEF was down 6%, and the shorter 1–3-year maturity fund, SHY was down 2.5%. The bond market performance in the quarter highlights the duration risk of bonds where the impact of rising rates hits the hardest on the longer end of maturities. We purposely have lower exposure in our fixed income portfolios to longer dated treasuries and credit.

Important to remember for bond investors is that there are two sides to bond market total returns- the income return (coupon or interest rate paid by the bond) and the price return. The price return is what declines when interest rates go higher based on the type and maturity of the bond. The income return has the future benefit of being able to reinvest matured bonds now at higher interest rates. This has a compounding effect where over the medium and longer term the income side makes up the greater component of total returns.

Our diversified portfolios are built with a value emphasis in the stock portion, shorter duration and active exposure in the bond component, and an allocation to various alternative investments to further diversify return streams away from equity market volatility and interest rate risk. The combination of these, working together in a broadly diversified portfolio, served us well in the recent volatile quarter.

While we have no reason to believe that a recession is imminent, we do see some indications that risks are rising. Whether looking at the signals from an inverted yield curve (when short term interest rates exceed longer term rates) or elevated valuation measures for the U.S. equity market, neither of these can be used as a definitive short-term timing mechanism for markets. They can inform as to the overall level of risk in markets and whether the valuation embedded in markets is more likely to be a tailwind or a headwind for investors. At the same time, we monitor leading economic indicators to watch for divergences in trend. With markets being forward-looking, many times it is not so much about the absolute level of activity in the economy, but rather is rate of change getting better or worse.

When you take the position as we do that one cannot successfully call recessions in advance, and time the market, it pays to have an investment approach that incorporates a margin of safety by consciously not overpaying for good businesses. We feel we have done this with our portfolio construction mentioned above. That value emphasis for stocks gives us a margin of safety at the time of purchase that should let us ride out a cyclical downturn over our long-term holding period. Stock returns are driven by the components of earnings growth, the change in the valuation multiple that is put on those earnings, and dividends. It is the valuation multiple (the PE) that is at a lofty level when comparing a universe of value stocks to growth stocks. Based on data from S&P Capital IQ, at the end of 2021, the S&P 500 Value Index was priced around 18 X forward earnings, while the S&P 500 Growth Index was

priced at 28 X. This difference of ten multiple points is double the valuation difference between these two historically. When we see such extremes, our risk-management radar is active. The potential for declines in the valuation multiples for many growth stocks could easily overwhelm the earnings growth component and send the stocks lower.

The drawdowns in many individual stocks far exceed the declines for the major averages. This has resulted in many companies that we follow but do not own to become more interesting to us as that margin of safety presents itself in the stock's valuation. We will not be shy to add new long-term holdings to portfolios when the opportunity for exceptional risk/reward presents itself.

As always, we thank you for your trust and confidence. Reach out at any time if you have questions about your portfolio or planning goals.

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