4th Quarter 2022 Review

2022 was a year characterized by rising geopolitical risks, rising interest rates, and rising inflation. This, after a long period of complacency around low interest rates and low inflation was enough to send markets into a volatile downdraft. It was a year in which both stocks and bonds moved lower across the globe. Along with some short-lived rallies, stocks pretty much grinded lower all year and bond yields grinded higher. In fact, for the S&P 500, a full seven months of the year experienced declines of at least 2.5% or more. Reflective of the extreme moves experienced in 2022 due to rapidly rising interest rates and an aggressive re-rating of valuations in the highest valued parts of the market, both the Nasdaq 100 and the long-term treasury bond market lost over 30% in value during the year. So, cheers to 2022 being over!

The quarterly (and full year 2022) returns for the major stock averages were: The Dow Jones Industrial Average rose 15.81% in the fourth quarter (down 7.07% for the year); the S&P 500 was up 7.47% (down 18.25% for the year), the Russell 2000 Small Cap Index was rose 6.36% (down 20.37% for the year), the NASDAQ fell 1.03% (down 33.1% for the year). International equities were up for the quarter but down for the year as well with emerging market stocks rising 10.3% on the quarter (down 20.46% on the year), while the MSCI EAFE Developed International Index rose 18.10% (down 14.03% on the year).

On a relative basis, value stocks continue to outperform growth stocks with the Russell 1000 Growth Index down nearly 30% in 2022 and Russell 1000 Value Index down 9.6%.

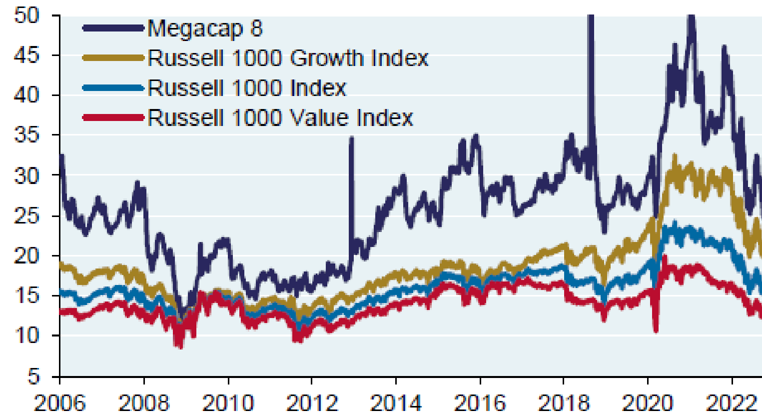
Bond markets, which have historically provided a ballast to portfolios during periods of stock declines, lost value on the year due to the rise in yields. The Federal Reserve hiked rates at the fastest pace since 1980 taking the fed funds rate from a half percent to 4 ½ percent during the year. The yield on the 10-year Treasury note started the year at 1.52% and ended the year at 3.88%. The rate on

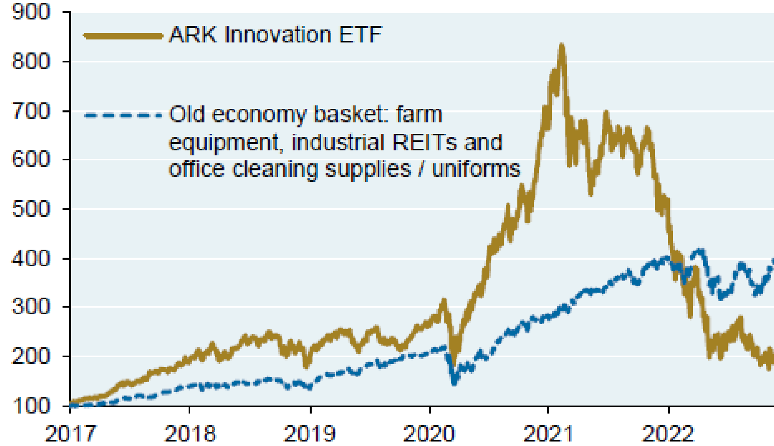
3-month T-bills began the year at only 0.06% and shot up to 4.42% to end the year. For the quarter the U.S. Aggregate Bond Index rose 1.64% but declined 12.98% for the full year.

After a year like the markets had in 2022 it is important to take a moment to reiterate that the return figures stated above are for the broad market indices. Portfolios built around specific holdings that may look quite differently from the index saw relatively better results. This can be due to several factors: the active management and value bias in the stock portfolio, the shorter duration exposure in the fixed income portfolio, and the lower correlation to broad markets that can be achieved from exposure to alternative investments. Also helpful, is active risk-management such as taking some gains off the table after a sizable move higher, and avoidance of the most over-valued, over-hyped parts of the market.

We wrote in our 2021 year-end commentary (as we began 2022) that we believed stock selection and fundamentals still do matter. We thought then and still do, that this would be even more important in 2022 as some cracks in the story were emerging for the mega-momentum names with little or no current earnings. Well, the cracks we saw in 2021 became craters in 2022. The factors noted above as well as our avoidance of the overvalued, over-owned segments of the market helped our relative performance in what was the worst performing market since 2008.

A major theme of 2022 was the re-rating lower of the multiple on earnings for companies across the board- but it was particularly damaging to the most speculative growth segments of the market which experienced declines of 70-80% from their highs. These two charts below from JP Morgan Chief Strategist Michael Cembalest, vividly illustrate the point. The top chart shows how the forward PE multiple for various segments of the market re-rated lower from their peaks, with the largest impact to the Mega cap and Growth names. The bottom chart is a clever illustration of the rise and fall of the ARK Innovation ETF which focuses on companies that Cembalest refers to as YUCs and MUCs. (Young Unprofitable Companies and Mega-valued Unprofitable Companies).





The high-flying ARK fund has given back all of its spectacular rise, while a basket of what could be referred to as "anti-ARK" type companies (boring, old economy names) has shown steady compounding over that same wild ride period. The good news from both of these charts is that equity multiples have come down making many more stocks attractive potential buy opportunities. The

caveat is that active selection is needed to sort through the quality from the junk to determine long term profitability potential and risk/reward.

Limiting the magnitude of drawdowns in bad markets and participating in the upside when markets recover is what drives the compounding machine in investing. This is because mathematically, the gain required to recover from a loss is exponential. A portfolio down 20% needs a 25% gain to recover that loss, and a 40% loss needs a 67% gain, and it just gets harder from there. Undisciplined strategies that care nothing about the level of overvaluation going in, suffered the worst declines, and we would suggest, also have worst prospects for recovery value and the impact on the portfolio's compounding.

The rate hikes by the Federal Reserve usually impact the economy with a lag. We have seen a weakening in economic activity as the higher rates reverberate through the economy. It would be quite a feat by the Fed to succeed in their desire to defeat inflation without causing some damage to the economy along the way. The degree to which this occurs and the impact this has on company profits will be a major factor in how 2023 goes for the stock market.

Stressing our upside and downside potential targets for our specific investments given the higher chance of recession in 2023 gives us sound confidence in the ultimate resiliency of our portfolio holdings. This confidence comes not from a strong opinion on the direction of the economy but rather the potential growth in revenues and profits from our specific companies and their own unique valuation metrics.

We don't make bold predictions on the economy or markets, and hope is certainly not a strategy. We don't believe in blind hope; we don't cheer when stocks go up; nor do we sink to despair when they go down. Disciplined investing is about having an investment philosophy and adhering to it. This applies to the upside by monitoring valuation risks as investments perform well and equally applies to the downside by having conviction in the process and buying good value when fear is high, and prices are low. Reliance on hope, cheer, and despair stands no chance against discipline, research, and process.

A lot of the speculative fervor (but not all) in the market has come out, valuations have improved broadly, and interest rates now actually provide some yield to portfolios for the first time in years. From a global perspective, the U.S. stock market has dramatically outperformed the rest of the developed world equity markets for over a decade. This relative strength of the U.S. stock market to international stocks is starting to turn after a period of very strong outperformance by the U.S. We've been underweight developed international equity for a long time. We are conscious of the sector composition differences across U.S. and EAFE Indices (for example, more tech weight in the U.S., and more defensive energy, staples, and healthcare in Europe for example); but we're also alert to the potential for a multi-year shift in the relative strength of the U.S to the rest of the world. When more international

exposure is warranted, we could seek this in the form of more exposure to companies that generate a high level of revenue outside the U.S., as well as direct investments in international funds.

A New Year brings new opportunities as well as new challenges. We will be watching inflation, which has begun to turn lower and the Federal Reserve reaction. Economic activity has also slowed, and earnings estimates for the broader market have come down a bit but likely have further to go. It's important to remember amid the talk of recession in 2023 that stock markets have historically bottomed well before the bottoms are in for GDP and earnings.

We thank you for your trust and wish you all a very happy, healthy, and prosperous New Year.

Justin B. Whelan III, CFP
President
jbw3@biechele-royce.com

Matthew C. Sanchez, CFP, CEPA
Senior Investment Advisor
msanchez@biechele-royce.com

J. Anthony (Tony) Milburn
Senior Investment Advisor
tmilburn@biechele-royce.com

Thomas A. Barrett, AAMS
Chief Investment Officer
tbarrett@biechele-royce.com

Stephen R. Allen, CPA, PFS
Senior Investment Advisor
steve@allen.cpa

Rachel A. Rhiver, CFP
Director of Operations
Senior Investment Advisor
rrhiver@biechele-royce.com

George S. Sparks Jr., CPA, PFS
Barnes Dennig – Director
gsparks@barnesdennig.com

Andrew J. Bertke, CPA, PFS, MBA
Barnes Dennig – Director
abertke@barnesdennig.com