QUARTERLY INVESTMENT NEWSLETTER

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CHIEF INVESTMENT OFFICER

As I'm sure many of you have realized already, here at Diversified we're not afraid to try something new. That culture of challenging the status quo is engrained into everything we do and is one of our core values as a company. It's taken me a long time to get comfortable being uncomfortable (...still working on it, to be honest) but that drive to improve makes us a better company and delivers a better experience for our clients, which is what we're always striving for.

STAY THE COURSE

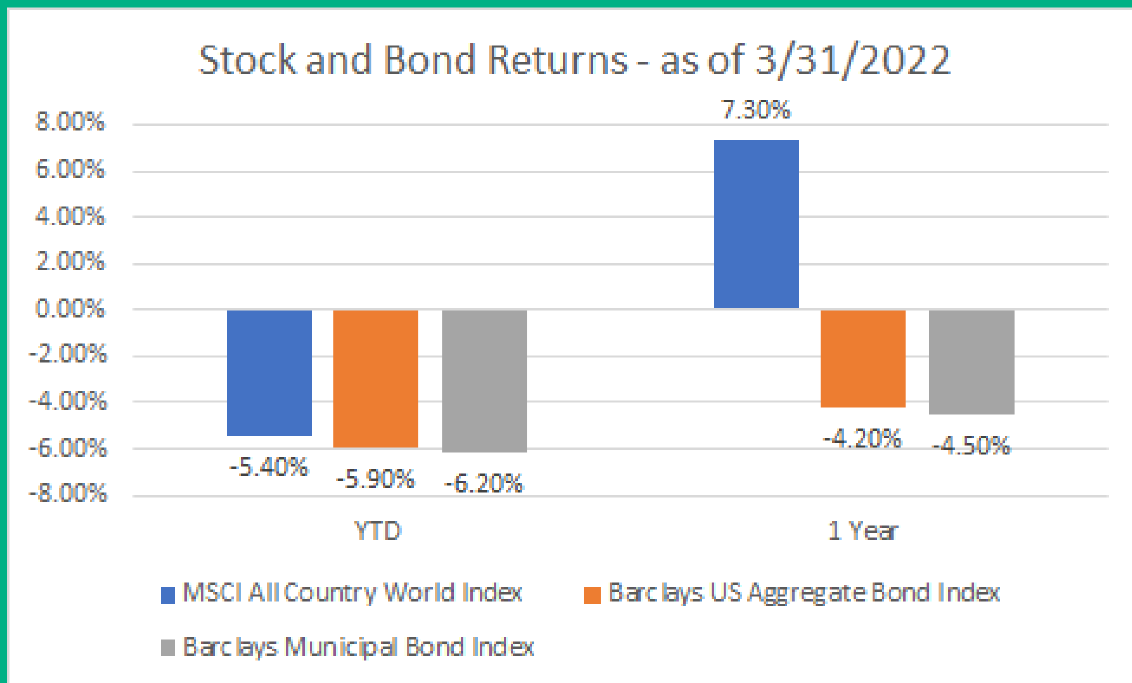
BE PROACTIVE, NOT REACTIVE

As part of that, we've really worked to revamp and adjust the way we communicate to all of you. On the investment side, we've adopted a process to send out weekly market updates, monthly videos, and periodic webinars. For those of you who read it, I sent out our first annual "Letter from the Investment Committee" in January, where we recapped 2021 and discussed how we view markets. As an extension to that, we've decided to start a quarterly newsletter that gives us (the Investment Committee) an opportunity to recap the previous quarter and to address some topics that may be timely, interesting, or just simply something we want to share. The expectation is that we'll now be producing this newsletter, along with a webinar, at the beginning of every new calendar quarter.

We communicate a lot, but just know it's fully intentional as we want to be as transparent and informative as possible. I always tell new clients when I first speak with them, that you can delete every email you receive from us on investing (full disclosure: a small part of me does die when that happens) but we refuse to not share our thoughts. If there is anything we can do better, please just let us know so we can take it under consideration. With all of that said, let's talk Q1 2022, shall we...

Q1 2022 RECAP – VOLATILITY IS FUN, ISN'T IT?

Welp that was boring, eh? Here I thought that the historic volatility of 2020 bought us some time before the next bout of geopolitical events. Needless to say, the first quarter of 2022 brought us changing monetary policy, a war in eastern Europe, and inflationary pressures driven by supply chains (yep this is still a thing), strong consumer demand, and now a commodity supply issue. Before we dive in, let's recap what happened in broad markets for the first quarter:



SOURCE: KWANTI PORTFOLIO ANALYTICS

First off, let me start by saying market volatility is normal. Candidly, it's more normal than the average investor realizes. For perspective, during calendar years 1980-2021 the U.S. stock market (represented by the S&P 500) was positive in 32/42 years. During those 42 calendar years, the average intra-year drop (largest drop from peak to trough during the year) was a staggering 14.0% (source: JPMorgan). Volatility is very normal.

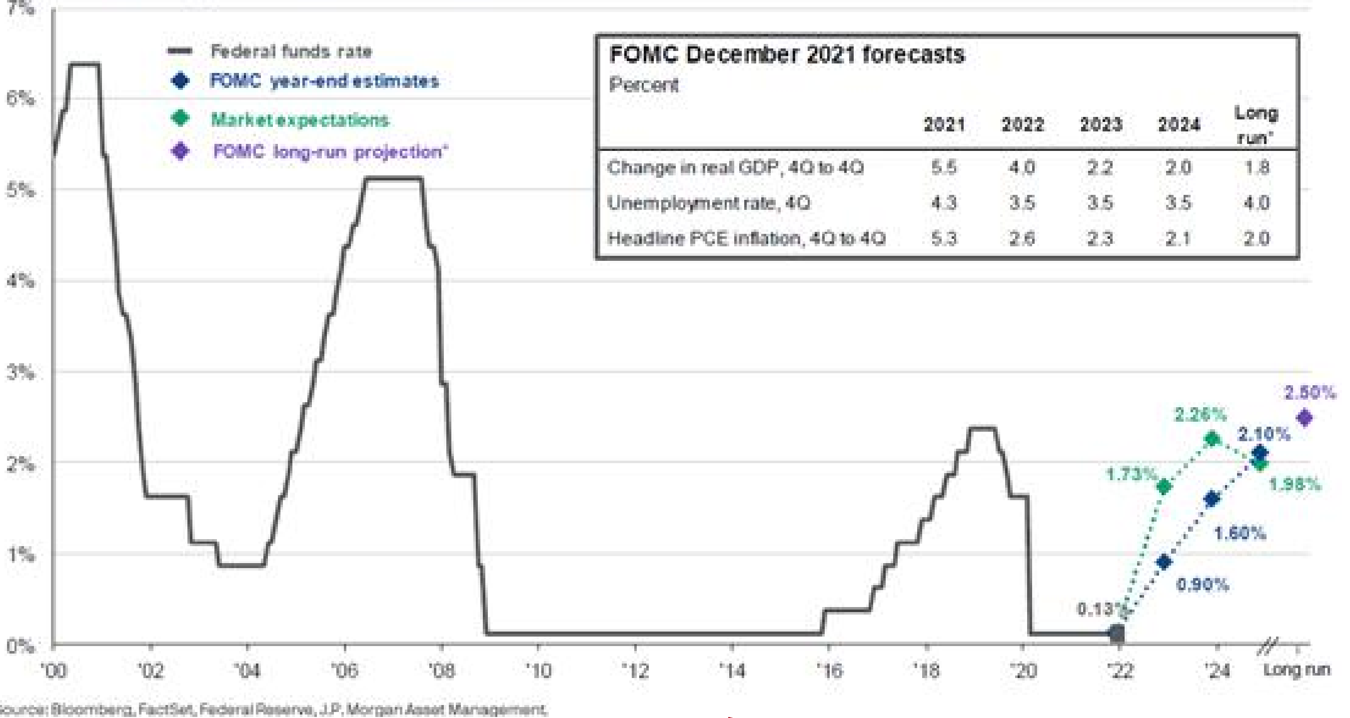
So how do we summarize what happened during the quarter? In short, I think it's best to focus on two primary areas…the Federal Reserve and the conflict in Ukraine.

Let's start with the Federal Reserve, which is the central bank of the United States. For many of you, you're aware that interest rates have been extremely low. Personally, I'm not sure I've received interest in my bank account for the last five years. On the flip side, I refinanced my home at an incredible rate a couple of years ago. Debt has been cheap as interest rates have been kept low to support the economy. By mid-2021, the Federal Reserve was now faced with a challenge that they hadn't seen in some time…inflation. For the Fed to fight inflation, one of their tools is to slow economic growth through higher interest rates. While we expected interest rates to rise coming into 2022, we've seen a shift to a more aggressive expectation as inflation has only been amplified by the conflict in Ukraine. Higher interest rate expectations caused a repricing in markets, with growth-oriented sectors such as technology falling more than the broad market. Additionally, interest rate sensitive bonds faced headwinds, which led to high quality government bonds selling off a little.

NEWSLETTER

APRIL 2022

FEDERAL FUND RATE EXPECTATIONS



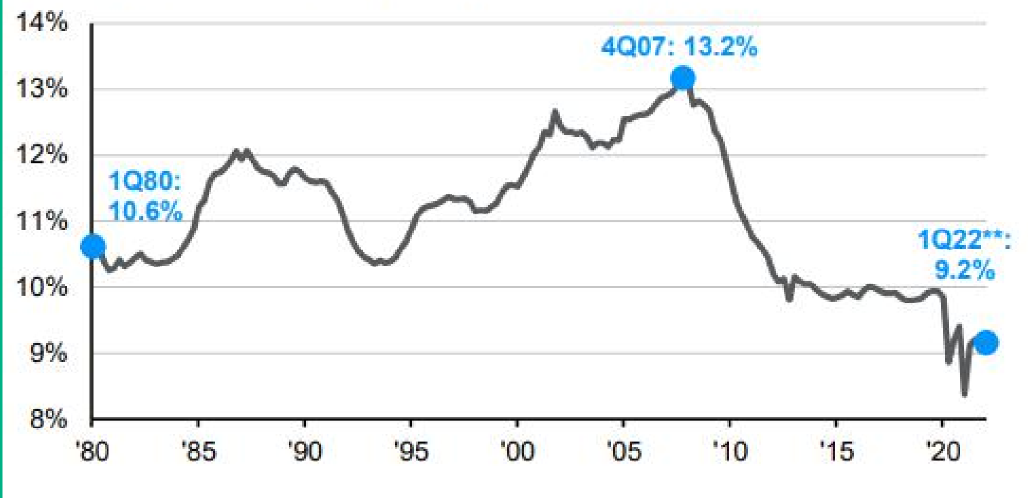
FOMC December 2021 forecasts
Percent

	2021	2022	2023	2024	Long run*
Change in real GDP, 4Q to 4Q	5.5	4.0	2.2	2.0	1.8
Unemployment rate, 4Q	4.3	3.5	3.5	3.5	4.0
Headline PCE inflation, 4Q to 4Q	5.3	2.6	2.3	2.1	2.0

On top of a big change in monetary policy, Russia invaded Ukraine on 2/24/2022. This caused a natural panic in markets, which eventually eased as an understanding of the repercussions took hold. From an economic perspective, the biggest impact was in the energy and food industries, where these two countries export a sizable amount of oil, metals, and agricultural goods. The net effect of that is continued concern over inflationary pressures, which in turn then may mean the Federal Reserve must be more aggressive than it wants to be. Despite all the volatility surrounding Q1 2022, global equity markets are actually up 4.6% since 2/24/2022.

Even with all this noise, we're still optimistic for equity markets moving forward. There are several reasons for our optimism:

1. Domestic economic conditions are still very strong. First, while higher energy prices will reduce GDP estimates, the expectation is still for above-trend growth around 3%. While interest rates are rising, they're still far under the long-term expectation and the Fed is simply becoming less accommodative.

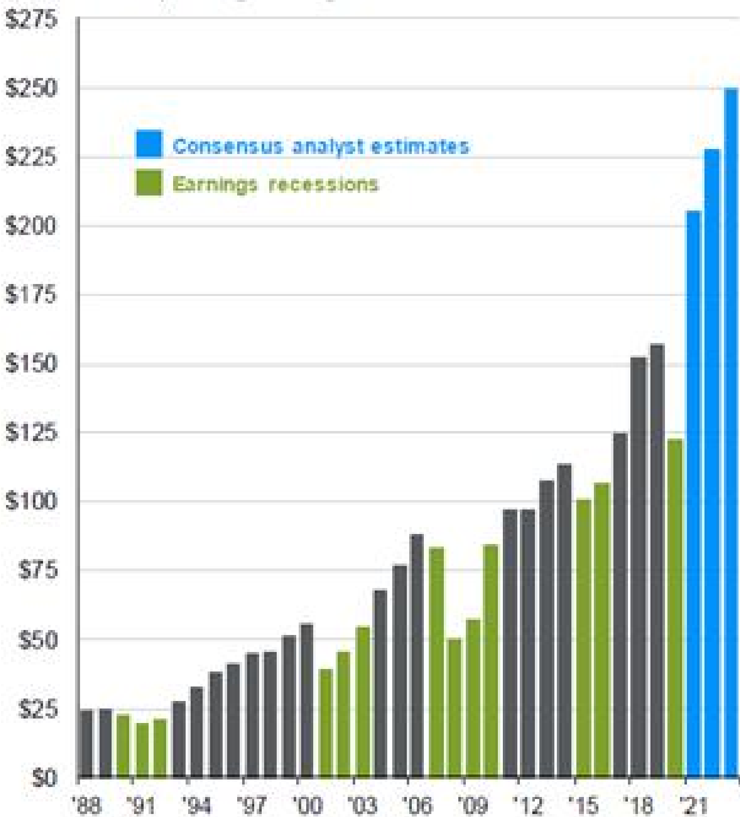


Source: JP Morgan Asset Management

2. The consumer is very healthy. You can see from the chart included that the average household balance sheet is strong. Throw in the fact that unemployment is sub-4% (it may get back down to 3.5%) and wage growth has been increasing, the labor market appears to be close to pre-pandemic levels.

3. Corporate earnings should continue to impress. While we won't see the incredible numbers from last year, corporate earnings growth should still fall in the 5-10% range. As of recently, estimates for 2022 earnings growth above 2021 are 9% for S&P 500 companies (source: Yardeni Research).

4. Stock valuations are more attractive now than they were not too long ago. With prices falling and earnings expectations remaining strong, markets (both domestically and internationally) appear cheaper than they were in 2021.



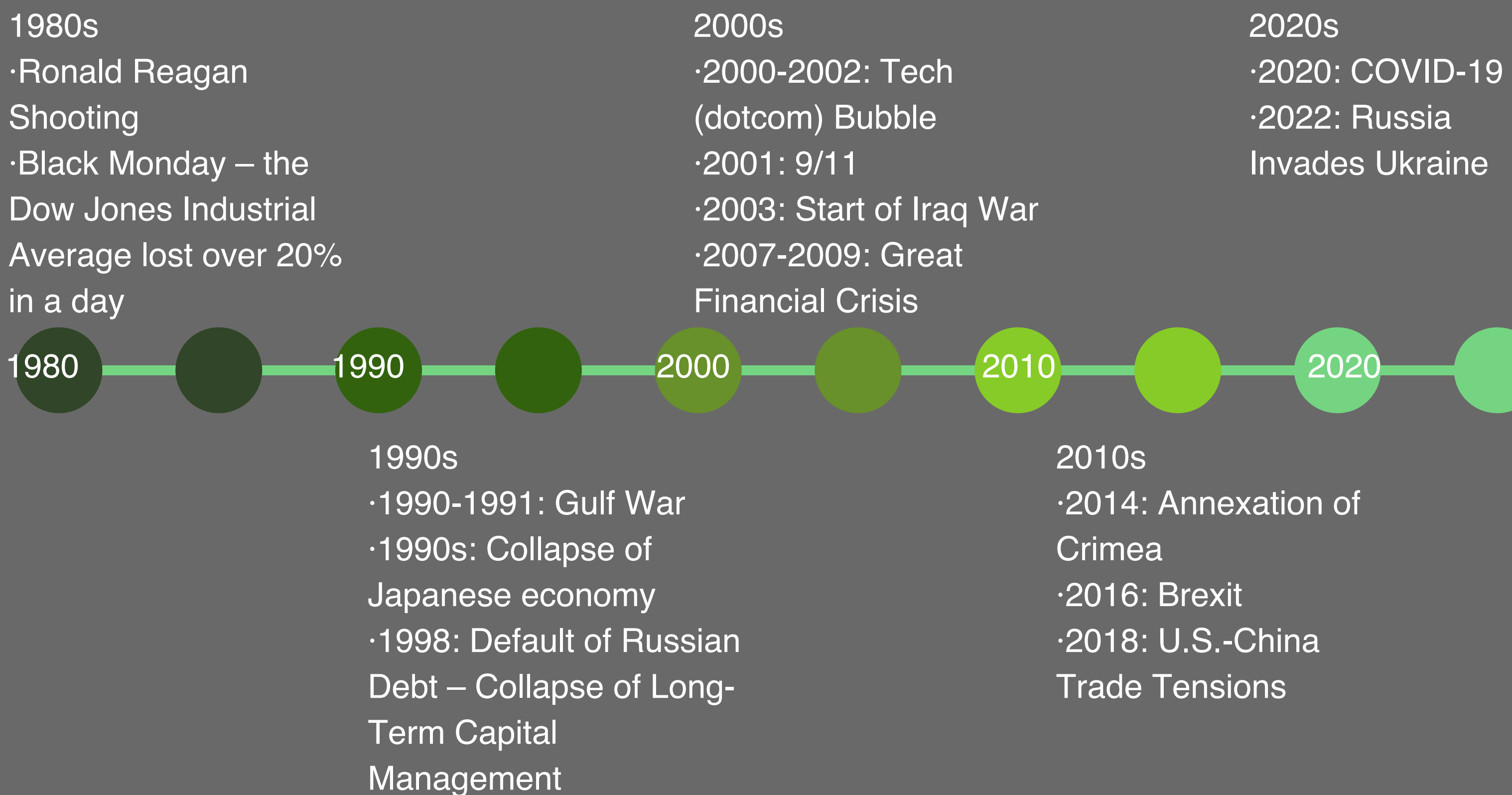
5. Lastly, the contribution of Russia and Ukraine to global GDP is limited as they only account for under 4% combined. Naturally both countries are going to face economic issues for some time, but the impact to the globe will be narrowed to energy and food prices.

What has changed over the last three months, in my opinion, is that downside risks have increased. Our base case expectations align with much of what I just said, meaning economic growth will still be above average, corporate earnings still growing, and consumer spending still at a healthy level. We see equity valuations as reasonable and not as extended as they were last year. The risks are higher that the Fed becomes too aggressive due to higher inflation, where they feel the pressure to act quickly. There is also a higher risk for geopolitical escalation if the Ukraine conflict moves onto NATO territory. Lastly, there is still the risk that a COVID-19 variant becomes more deadly and additional lockdown measures are required. As I said, these are the risks we see but none of them are our base case expectation.

A Historical Perspective

Not too long ago we were having a discussion during one of our internal investment meetings where the primary topic was the Russian invasion of Ukraine. By extension, I thought it would be helpful to put in perspective the events of the last 3.5 years, starting with Q4 2018. For those who don't remember, that was a very volatile quarter when the U.S. and China were in a dispute over trade and markets pulled back sizably. Fast forward to 2020, and we were staring directly into the eye of a global pandemic. As we all know, 2022 has been dominated by Russia invading Ukraine.

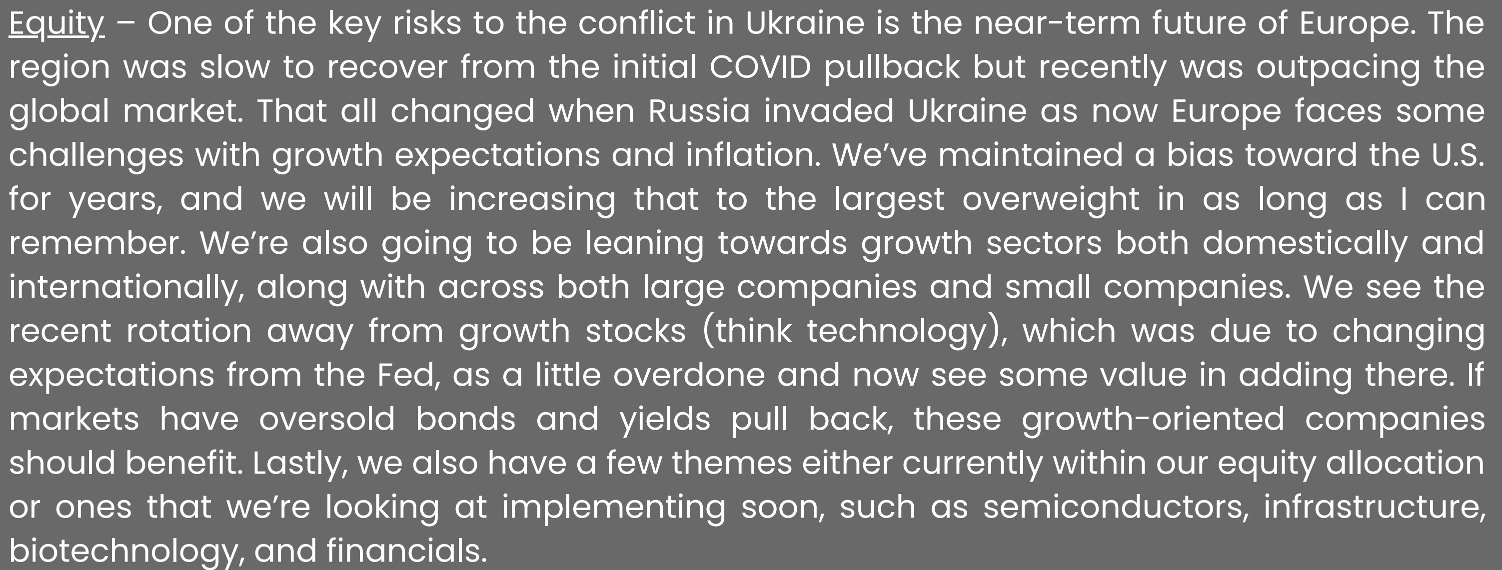
While it's natural for us to "complain" about various events that have occurred and driven market volatility, I think it's an important point to keep some perspective. A quick history lesson reveals that these types of events happen quite frequently. Individuals who have been investing since the 1970s should remember all the historic events along the way, many of which surely made a good case for panic and abandoning the long-term strategy.
I'm sure the below list will bring out investing-related PTSD for some people, but the overarching theme here is that patience matters. There is always something going on that will give pause to investors. Always. There are plenty of other events not depicted here, but this is a good starting place...



Portfolio Implications

Our Perspective on Portfolio Positioning:

As we always do, we've been patiently evaluating markets despite all the noise. There are some key themes to our current portfolios and areas we're looking into:



Equity – One of the key risks to the conflict in Ukraine is the near-term future of Europe. The region was slow to recover from the initial COVID pullback but recently was outpacing the global market. That all changed when Russia invaded Ukraine as now Europe faces some challenges with growth expectations and inflation. We've maintained a bias toward the U.S. for years, and we will be increasing that to the largest overweight in as long as I can remember. We're also going to be leaning towards growth sectors both domestically and internationally, along with across both large companies and small companies. We see the recent rotation away from growth stocks (think technology), which was due to changing expectations from the Fed, as a little overdone and now see some value in adding there. If markets have oversold bonds and yields pull back, these growth-oriented companies should benefit. Lastly, we also have a few themes either currently within our equity allocation or ones that we're looking at implementing soon, such as semiconductors, infrastructure, biotechnology, and financials.

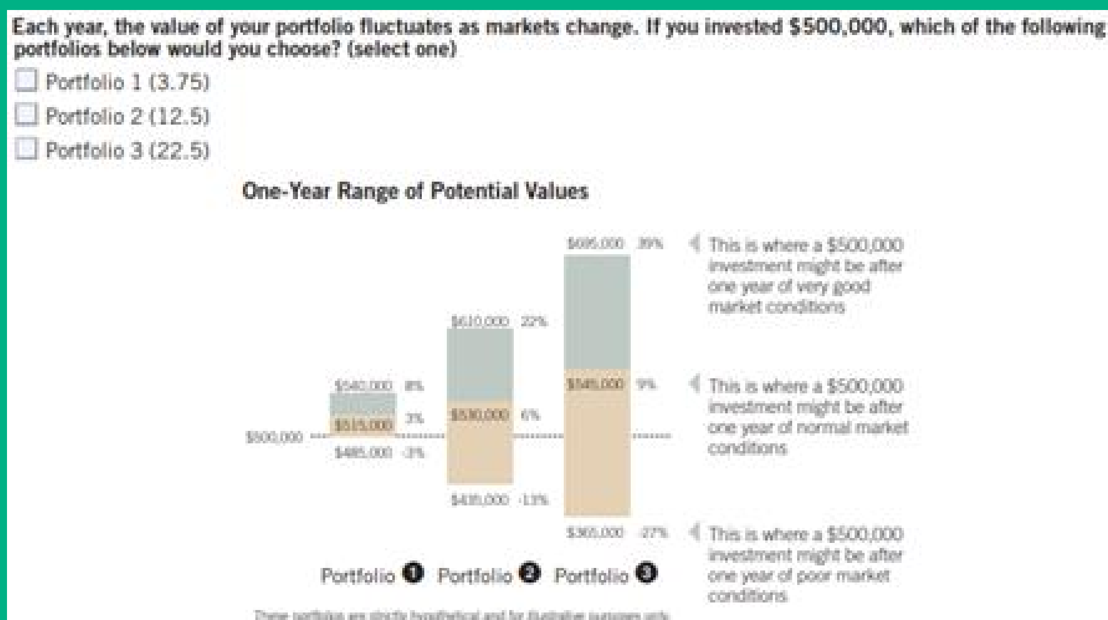
Fixed Income – The bond market has gone through a whirlwind over the last few months, driven by both changing interest rate expectations and a flight to safety due to the conflict in Ukraine. We currently view the bond market as likely oversold and see it as a better entry point than we did three months ago. Beyond the diversification and income benefits that bonds provide, we also see yields as more attractive and better spreads for sectors like high yield. Rates are going up, everyone knows that. The market has aggressively priced that into prices as they're forward-looking. Our bond portfolios will lean towards credit, meaning an overweight to areas like corporate bonds and bank loans. We've added, and will be adding more soon, to various areas to hedge different fixed income risks such as bank loans (floating rate so they fight rising rates) and short-term TIPS (in case inflation stays persistently higher than expectations). Overall, we're remaining diversified and leaning to areas that will benefit from a healthy economy with low default rates, which is still our base case.

MIKE'S QUARTERLY TANGENT –THE FALLACY OF RISK-TOLERANCE QUESTIONNAIRES:

A little nugget about me is that I really enjoy listening to podcasts. My “break” from the workday or everyday life is typically when I take my dog for a walk and listen to podcasts on all kinds of topics.

It has gotten to a point where my dog gets excited when I put my AirPods in my ears because she knows what’s usually about to happen. I’ll listen to a wide array of topics, anywhere from investing (shocker…), philosophy, and history, to even interviews with random experts. I was recently listening to an episode on behavioral finance and the topic of risk-tolerance questionnaires (RTQ) came up, which I thought was a timely discussion for today.

For those of you who aren’t familiar with RTQ’s, they are often used by wealth management firms to help investors identify how much risk they can/should take. These tools can be anywhere from a few questions to a couple dozen, and hit on topics of emotions, experience, objectives, etc. Below is an example of a question you’ll typically find on an exam.



Here’s my problem – these questionnaires cannot be the sole information used to help investors identify their risk tolerance. There are wealth management firms out there who will simply take the answer to a 5-question exam, pretend they now know the investor, and use it to build their portfolio asset allocation. Crazy. Look at the question above, specifically portfolio 3. There are plenty of investors who will say that they’d be fine with a 30% drop in their portfolio knowing that markets will rebound. Here is the nuance to that…you cannot just assume that all variables (economic, geopolitical, public health) will be the same. Markets don’t just fall for no reason, there is typically psychological pain that comes with it as news organizations bombard consumers with scary headlines that the economy is forever broken. As advisors and coaches to our clients, we must understand that psychology and make sure we’re prepared to block out the noise and focus on what really matters.

Our approach to risk tolerance focuses on two primary areas, what we refer to as one’s ability and willingness to take risk. In short, someone’s ability to take risk requires that we understand the quantitative side to the story. Therefore, we focus so much on financial planning, as understanding one’s assets, liabilities, time horizon, liquidity needs, and financial goals can help us form this. On the other side, someone’s willingness to take risk is a much more personal question. This requires us to know our client’s deeply, what’s been their experience in investing, how to they perceive risk, and questions of that nature. Sure, a RTQ should be part of that, but it cannot be the sole factor or you’re otherwise setting everything up to fail when volatility hits.

I once heard a great quote about risk, and the gist of it is that investors perceive market downside as risk and upside simply as performance. No one truly knows their risk tolerance until they live through some of the most uncertain times. Our job is to coach our clients on investing and ensuring everything aligns with a personal plan, and we fully believe there is more to it than answering a few questions on the computer.

Stay the Course – Be Proactive, Not Reactive:

Our commitment to you is to always be the voice of reason, at least to the best of our ability. We know that all our financial planning and investing acumen is useless if we cannot collaborate with our clients to keep them on track during uncertain times. We know it can be difficult. We really do. In our personal lives, we're investors just like you. Staying the course doesn't mean we aren't proactively discussing investment changes or that we cannot reevaluate your risk tolerance over time, but rather that we cannot let all of that planning and preparation get thrown away due to bad emotional investing behavior. We focus so much on financial planning and employ an internal investment team to handle the day-to-day just for this reason, which is ultimately to give peace of mind and help our clients hit their long-term goals. We're excited to be in your lives for a long time and cannot thank you enough for putting your trust in the Diversified team.

Connect With Us

Mike Horwath, CFA®

Mike is the chief investment officer at Diversified LLC, where he heads the Investment Committee and is responsible for the investment direction of he firm. He works closely with financial planners to support the investment side of the financial planning process. Mike oversees the ever-changing global investment landscape and evaluates the impact on each of our client's strategies. He's a proud father and husband and loves spending time with his dog.