QUARTERLY INVESTMENT NEWSLETTER

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Welcome!

Every quarter the Investment Committee for Diversified puts together our thoughts on markets, the economy, and how it all pertains to our clients. We look to give our perspective on what it all means for investors and to share where our philosophy and processes are taking portfolios. Thanks for taking the time to give it a read...

RESISTING THE URGE – 2025 EDITION

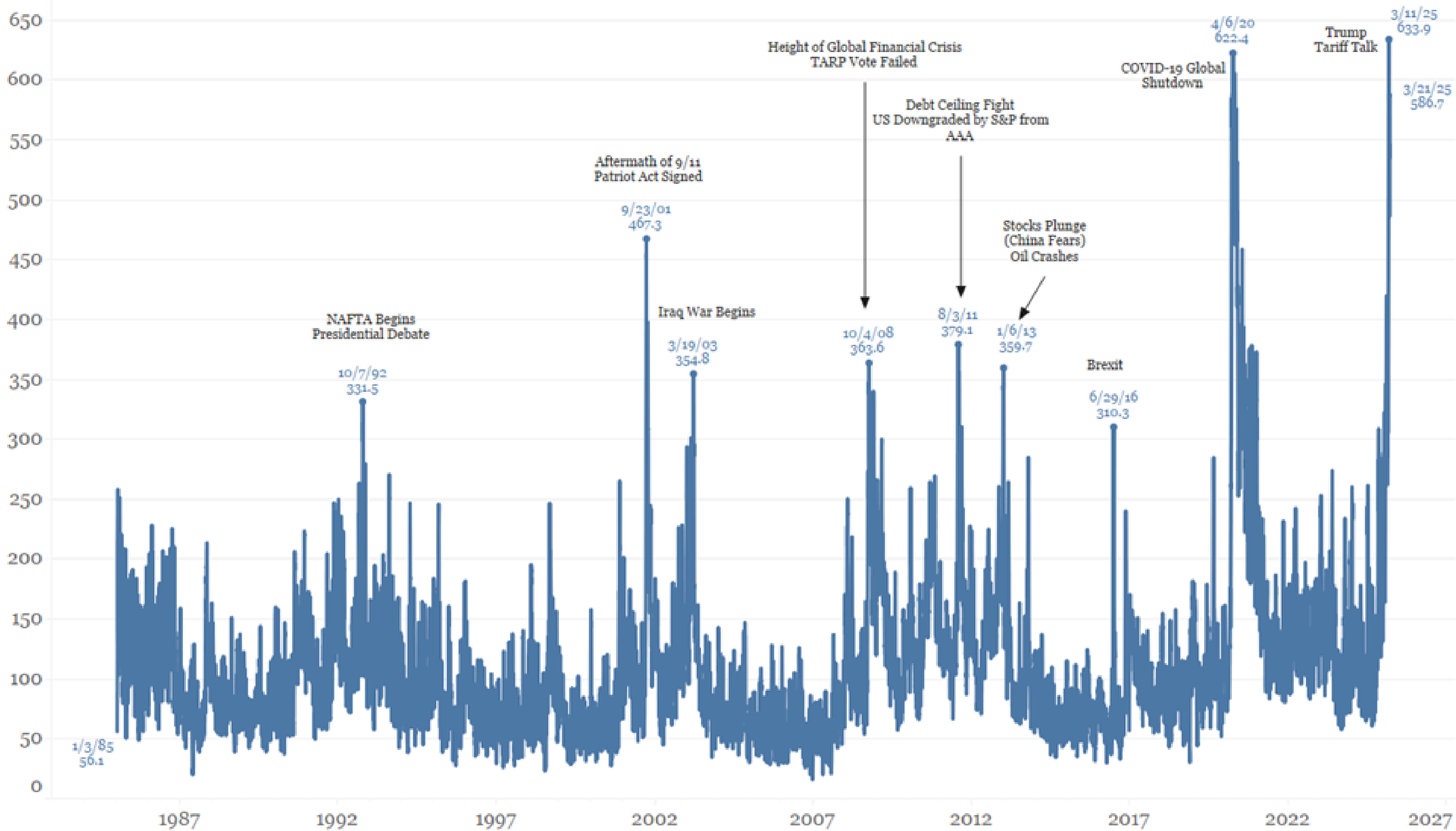
Over the last few years, I've really tried to stay consistent with both diet and exercise. As I've immersed myself in that world, it's become clear that the gym isn't the most important factor in this equation. The nutrition side of things is what separates success and failure. You can't lose weight without being in a caloric deficit, and it's hard to build muscle without sizable protein intake. I find that my morning routine of early gym visits is the easy part for me, while eating healthy and consistently is my downfall. I know I'm one of many who fight food urges on a regular basis (and the occasional bourbon cocktail).

What does my lack of food discipline have to do with markets? I can't help but relate that feeling to what I see from investors in current times.

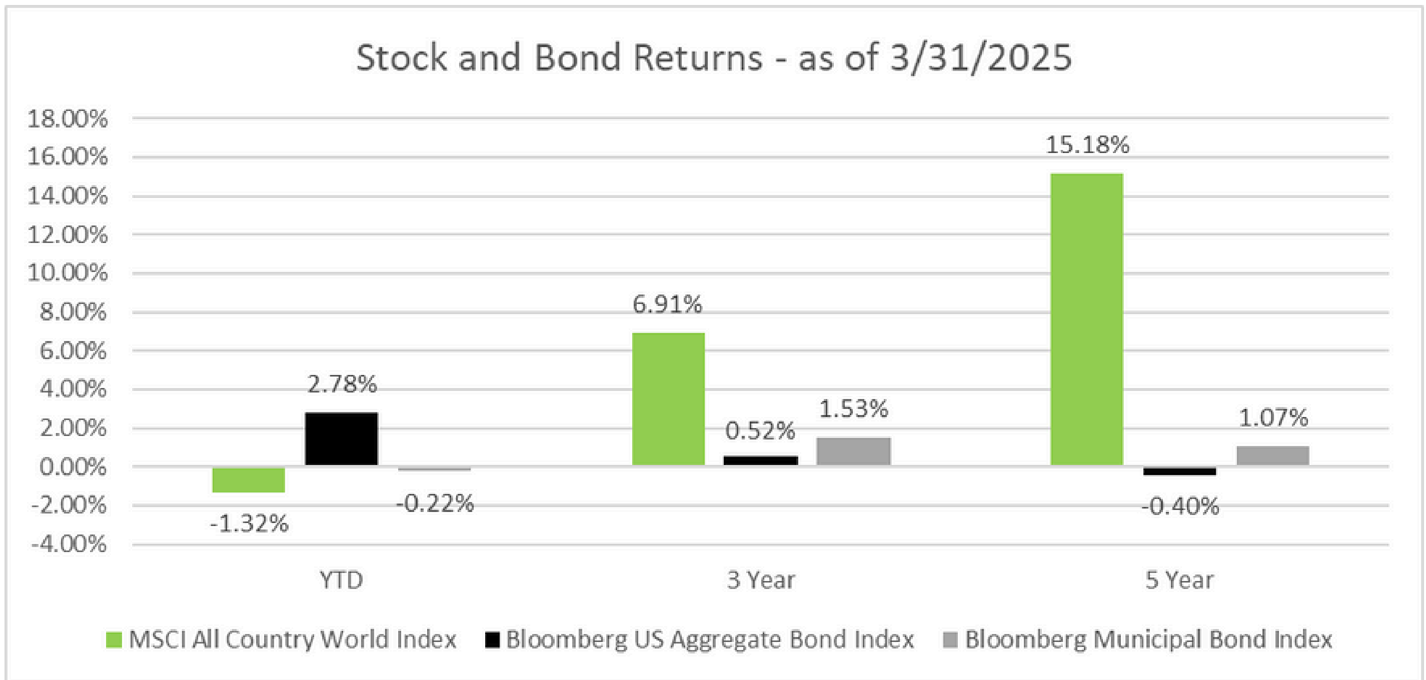
We just went through a bumpy first quarter with domestic equity markets pulling back and political disruption in full swing. The number of questions I received that started with "what changes are you making in portfolios" proved to me that so many investors struggle with their own urges to make rapid changes at the first sign of volatility. I want to focus this newsletter on what we see in markets, our outlook, current positioning, and recent adjustments. It's time for me to do my best "investment nutritionist" impersonation and help investors resist their natural urges.

Q1 2025 – THE TEMPTATION BUILDS

Let's just address the big ol' elephant in the room up front…market volatility came back in the first quarter. With the new administration taking office in January, the President signed a slew of new executive orders aimed at changing various departments within the Federal government. These orders, along with the introduction of new tariffs, have created a buzz in markets given the highly uncertain economic response and potential trade war. As should be no surprise, the level of concern tends to be highly correlated with political affiliation, so once again, we have a highly polarizing topic. I thought this graphic was a good representation of what we're looking at today. In summary, the graphic was designed to show the level of policy uncertainty based on underlying media data. Relative to history, this has been one of the most "uncertain" times for individuals.



In response to the uncertainty and concerns over economic conditions looking forward, we saw certain parts of financial markets exhibit some volatility. I've included the chart here to show returns for global equities, US taxable bonds, and US municipal bonds for multiple time periods. Given how volatile it felt in the first quarter, those returns are probably better than you expect, right?



SOURCE: YCHARTS; DATA AS OF 3/31/2025; PERIODS OVER 1 YEAR ARE ANNUALIZED RETURNS, PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

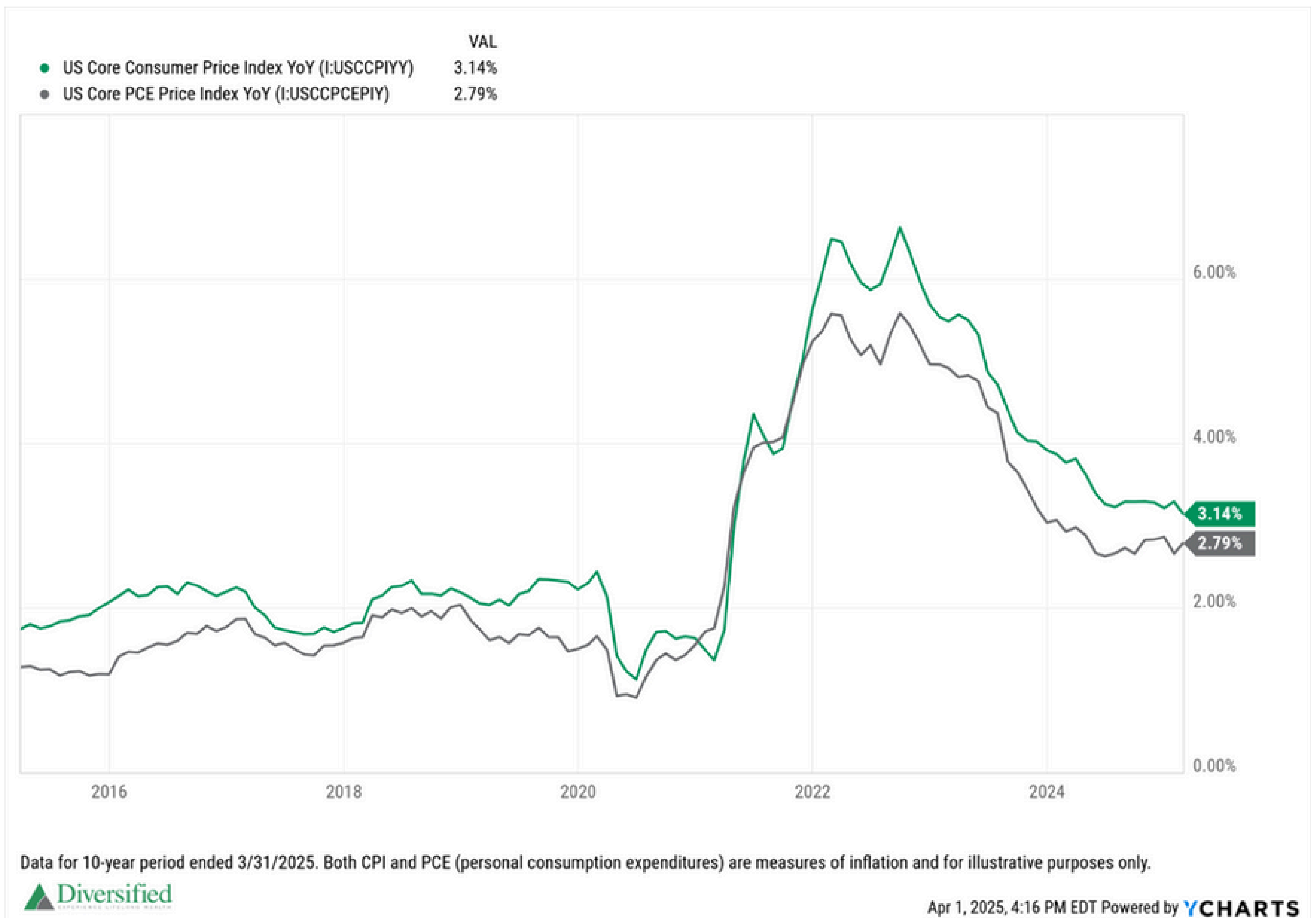
If global equities are barely negative this year and bonds are positive, why does everything feel worse? I think there are a few key takeaways from my experience:

1. A lot of investors only focus on the S&P 500, which has become top heavily with large technology companies. The volatility this year has been worse for those companies than global markets. For perspective, the S&P 500 is down -4.3% for the first quarter and saw a peak-to-trough drop of just over 10% from February 19th through March 13th. Given that US investment-grade bonds were positive over that period, most diversified investors (portfolios including both stocks and bonds) did not see that level of volatility.
2. The media has given this a lot of attention. It shouldn't come as a surprise, but I'll say it anyway…the new administration is a gold mine for media companies. This isn't to say that policy changes shouldn't be highly covered and discussed, but naturally, there is a lot of noise out there for investors (and individuals in general) to digest.
3. While economic conditions have been solid up to this point, concerns are rising over parts of the economy starting to weaken. With the Fed (Federal Reserve) still debating when to next cut interest rates, the addition of tariffs starting a trade war is exacerbating awareness.

Let's stay on that last point and work through the bad, and the good, within economic data.

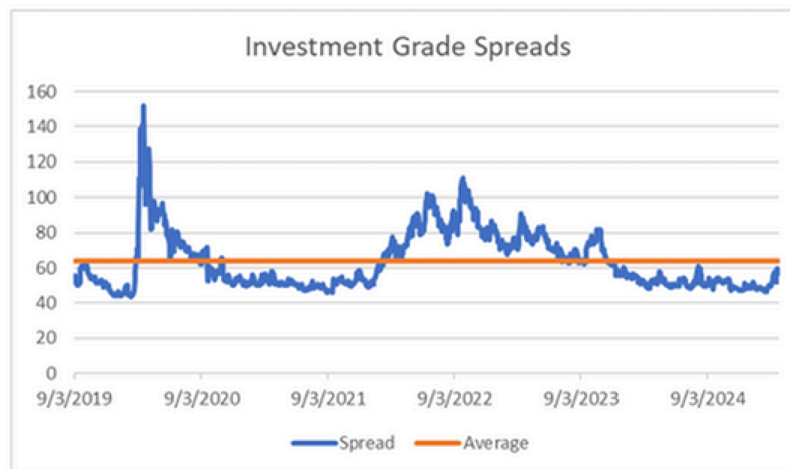
The Economy – the Bad:

1. **Growth:** A slowdown in economic growth would likely increase the risk that equity prices pull back. With tariffs and potential trade wars staring us in the face, many investors are highly uncertain as to the path of economic growth. We've seen some recent readings that show lower growth in Q1 than previously anticipated, the question is whether that is due to higher net imports to outrun tariffs or a bigger issue.
2. **Tariffs:** I don't think this one needs much time, but tariffs are a concern. It is important to understand that it's not necessary the tariff that is the problem, it's the reaction and implications of further trade war escalation. This has the potential to not only slow down the US economy, but also the global one.
3. **Inflation & Fed Decisions:** We've come a long way from the 6%+ inflation that we saw during periods of 2022. Since then, there has been a gradual drop in the inflation rate down to current levels in the high 2%'s, low 3%'s. The concern here is that the numbers have flatlined and further tariffs could exacerbate this, which in turn gives the Fed pause to cut rates. If inflation becomes a bigger problem while unemployment increases, it could put the Fed in a very difficult position.

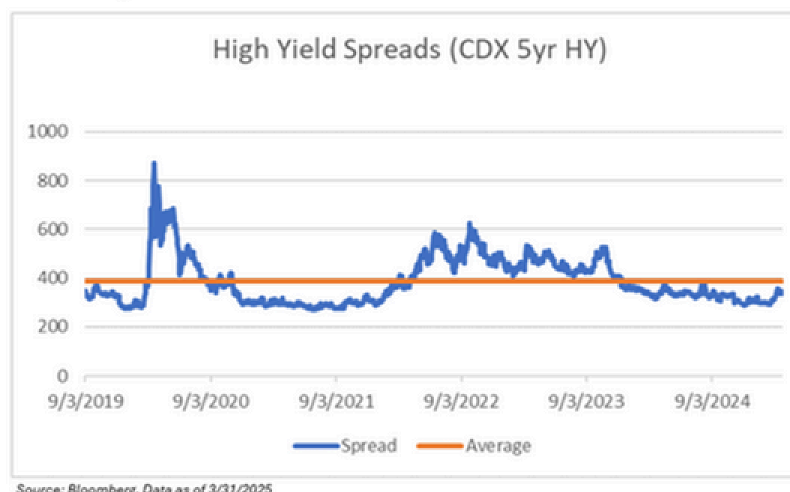


The Economy – the Good:

1. **The Consumer:** I've said this about 100 times over the last 8 years, but the consumer drives the US economy...specifically about 70% of it. Even with higher rates, the consumer has remained steady with wage growth and market returns helping boost purchasing power and overall net worth. As the consumer goes, the economy goes.
2. **Corporate Earnings:** Similarly, as corporate earnings go so does the stock market. Over long periods of time we see that corporate profits and stock market levels move very closely together, which is rather intuitive. Tariff uncertainty has brought about questions for the future but as of right now we still see earnings growth as reasonable both in 2025 and 2026.
3. **Bond Markets:** The bond markets are often referred to as the smartest people in the room. The movement within interest rates/yields and bond spreads is often an indicator of what the future holds for us. Right now, our focus is on the spread market, which refers to the difference is yield between two bonds with the same maturity (say 5 years from now) but with different credit quality (say AA versus BBB). The idea is that these spreads tell you the compensation that bond investors require to take on additional credit risk. When the economy worsens, or is expected to worsen, these spreads widen because the risk of default is higher. These spreads, as you can see in the graphics, are still very tight indicating that sentiment around recession is still benign.



Source: Bloomberg, Data as of 3/31/2025



Source: Bloomberg, Data as of 3/31/2025

In Summary...

As you can see, there has been a lot of movement this year within the economic, financial, and political worlds. While economic conditions and strong market returns have provided investors with a surge of net worth, there are plenty of uncertainties and potential concerns to keep an eye on. It's understandable that the recent equity market pullback and media headlines have given rise to the temptation to "do something" and change course on the portfolio front. As hard as it may be at times, we believe investors should stay out of the metaphorical cookie jar and resist that temptation...

RESIST THE TEMPTATION

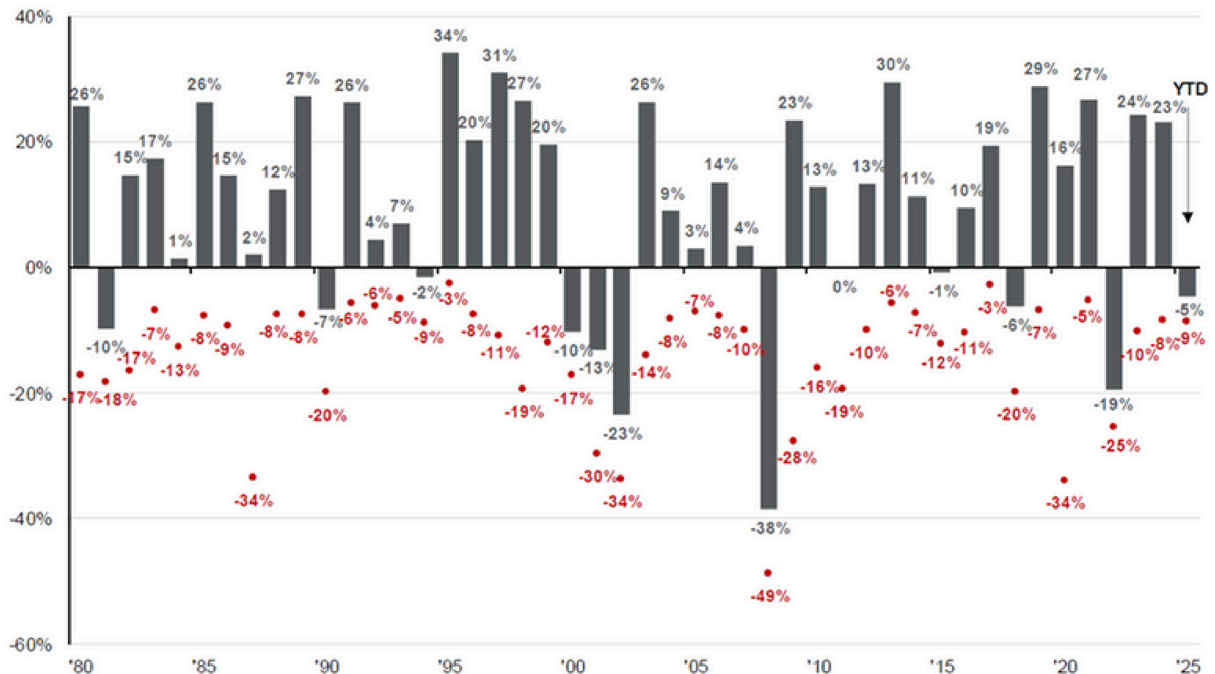
Like ice cream in the freezer or beer in the fridge, markets and media have served up temptation for investors to bail on their plans. We've seen consumer sentiment drop considerably on the uncertain political future and the first real wave of volatility since 2022. As we've always done, our job now is to provide a piece of advice that most people don't want to hear…you should resist the temptation. Resist the temptation to just "do something." Resist the temptation to radically change your portfolio. Resist the temptation to let your emotions drive the success of your financial plan. That doesn't mean we can't, or shouldn't, discuss options and what we're doing on our side, but it should be purposeful and well thought out. Why do we advise resisting the temptation…let's go through a few reasons:

1. **Market pullbacks are healthy and normal.**

It's easy to look at the long-term compounding of the US stock market and forget that in between two points in time there is likely at least one bout of downside volatility. Stocks have historically been a good source of return for investors, however, that return has come with plenty of volatility. I think most investors will admit this as their understanding of stock markets, yet it's very difficult in the moment to handle the noise.

Just how common is volatility? For perspective, the S&P 500 averages a peak-to-trough drop of at least 5% over 3x per year. Very normal. Not only is it common, its healthy. Markets often gain momentum and can become a bit inflated, so these corrections offer a chance of fixing that problem. When markets don't correct themselves over time, that is when the term "bubble" can come into play.

Check out this graphic. This shows the S&P 500 calendar year returns (grey bars) and the largest peak-to-trough during that calendar year (red dot). As hard as it can be to remember, every single year sees some sort of pullback off market highs. Despite that, the S&P 500 finished positive in 34 of the last 45 calendar years. Resist the temptation.



RESIST THE TEMPTATION

2.It may not be as bad as it feels...diversification has worked.

In a conversation with a client back in February regarding the market volatility, the individual made the comment that they hadn't looked at their accounts because they were "worried about the recent bloodbath." On the one hand, the comment surprised me a bit because I'm reviewing market and strategy returns daily. On the other hand, that was a helpful perspective for me because it became clear that I need to make sure our investors understand where portfolios stand.

Diversification is both in our name and a core philosophy of the firm. It sometimes comes across as a buzzword but, in our opinion, it works. So many investors have tied the volatility in both political and financial media directly to their portfolios. Even though the US large cap (namely the S&P 500) maintains a primary role in our equity portfolios, we aim to diversify our portfolios to other major asset classes. The volatility this year has largely been focused on US stocks, especially the big tech names that have become major weights in the index. Many of our investors own international stocks (at a much smaller weight), which have held up better than their US counterparts (as measured by the MSCI EAFE index; source yCharts). Additionally, the bond market has done its job and diversified portfolios from the volatility of equity markets (as measured by the Barclays US Aggregate Index; source yCharts).

I wanted to give an example of a moderately-aggressive investor that is diversified and owns a combination of US stocks, international stocks, and US bonds. Even if we use our heavier weight to US stocks, you can see that the return at the portfolio level is different than just looking at the return of US stocks. I think many investors would be surprised by this perspective, as it's not as bad as many "feel." The power of diversification often comes through during times like this,s as you can see with a hypothetical investor in a 70% stock portfolio diversified across asset classes.

70% Equity | 30% Fixed Income Portfolio Hypothetical

	Asset Class	Index	YTD	Weight
Stocks	U.S. Large Cap	S&P 500 Index	-4.27%	50%
	U.S. Small Cap	Russell 2000 Index	-9.48%	9%
	International Developed	MSCI EAFE Index	6.86%	7%
	International Emerging	MSCI Emerging Markets Index	2.93%	4%
Bonds	U.S. Aggregate Bonds	Barclays US Aggregate Bond	2.78%	30%
			Weighted Portfolio	**-1.56%**

Source: Ycharts. Hypothetical 70/30 portfolio is a simple weighted average return for the portfolio based on YTD performance and portfolio weight. The return is for illustration only. Past performance is not indicative of future results.

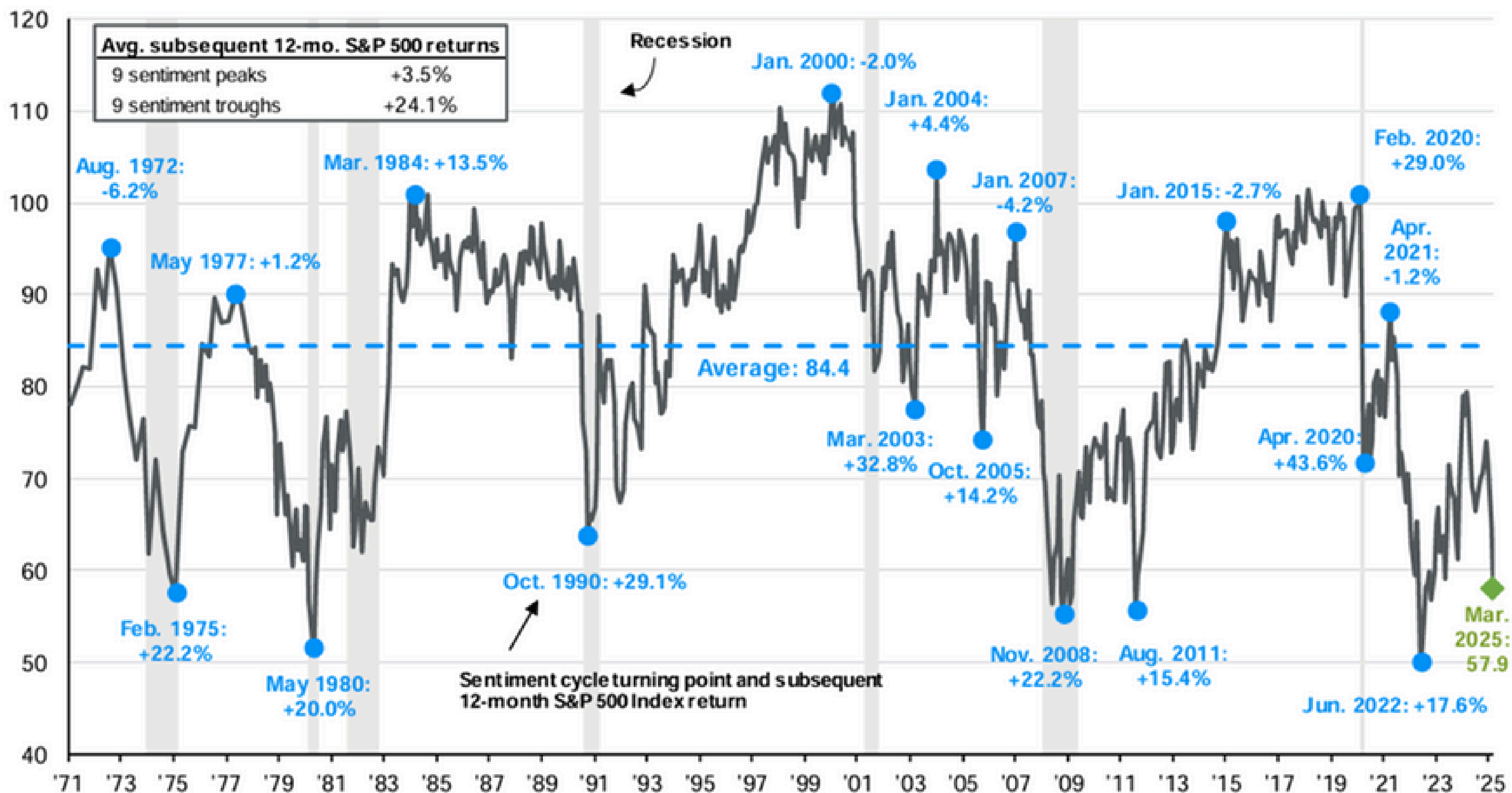
RESIST THE TEMPTATION

3. The times that feel the worst are often the best entry points.

Over the last several months, we've seen consumer sentiment measures drop in measures such as the University of Michigan survey. What has become clear is that the ambiguity around tariffs, specifically what is actually going to happen, has weighed on how consumers are viewing the economy and its outlook. That makes sense and aligns with the many questions we're receiving from our clients.

The interesting part to this is what happens on a forward-looking basis when sentiment falls. While the past is certainly not guaranteed to repeat itself, forward returns when sentiment is low have been better than when sentiment is high. It may feel counterintuitive, but sentiment often falls in tandem with markets, so a trough in sentiment can be a chance to buy in (or at the very least a chance to not sell) at a time when markets have pessimism priced in. Resist the temptation.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: JPMorgan Asset Management Guide to the Markets. FactSet, Standard & Poor's, University of Michigan. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Data as of March 17, 2025.

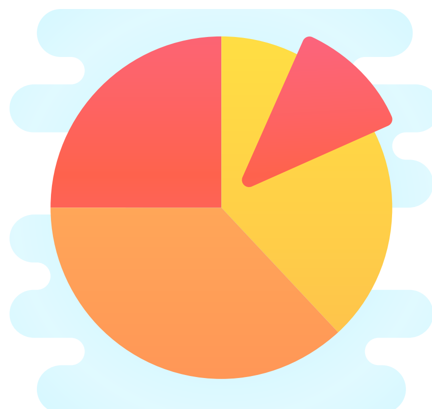
PORTFOLIO CHANGES & CURRENT POSITIONING

Our focus for the last several weeks has been helping investors sift through the noise and to manage their emotions. The most important item at times like this is to avoid making a potentially catastrophic change in portfolios from which it can be very difficult to recover. With that said, it doesn't mean that we won't be looking to adjust within portfolios. I thought it would be helpful to lay out some of the recent changes that we've made, strategies we'll utilize at times like this, and ultimately what our portfolio positioning looks like.

Given that each individual portfolio can have unique constraints, I need to make a disclaimer that not every account will see the below perfectly. Depending on the strategy in place, potential tax ramifications, and other unique circumstances, there may be instances where the exact changes are different.

Portfolio Rebalancing: Let's start off with one of the easiest, yet most neglected strategies we can implement during volatile times. Portfolio rebalancing is a process that we strongly believe in during both good and bad markets. The rationale is that it's a systematic way to sell the assets that have outperformed and buy into the ones that have underperformed. Buy low and sell high, right? The last couple of years, this has allowed us to trim things like U.S. large cap, which have outperformed other major asset classes. This year is the opposite, we can use rebalancing to buy into U.S. large cap if its relative weighting has dropped. We've been rebalancing across portfolios during the month of March to take advantage of the market movement.

Another part of this that investors may not notice is rebalancing portfolios that have cash flows. Meaning, if someone is adding or withdrawing funds from their portfolio, we'll use that cash flow to rebalance the account over time. If you're adding new funds to your portfolio, we'll invest in the underweight positions heavier than the ones that have outperformed. Vice versa, clients that need cash raised to withdrawal funds will see the outperforming positions sold heavier than normal. We look at all these cash flows as a chance to get portfolios back into balance.

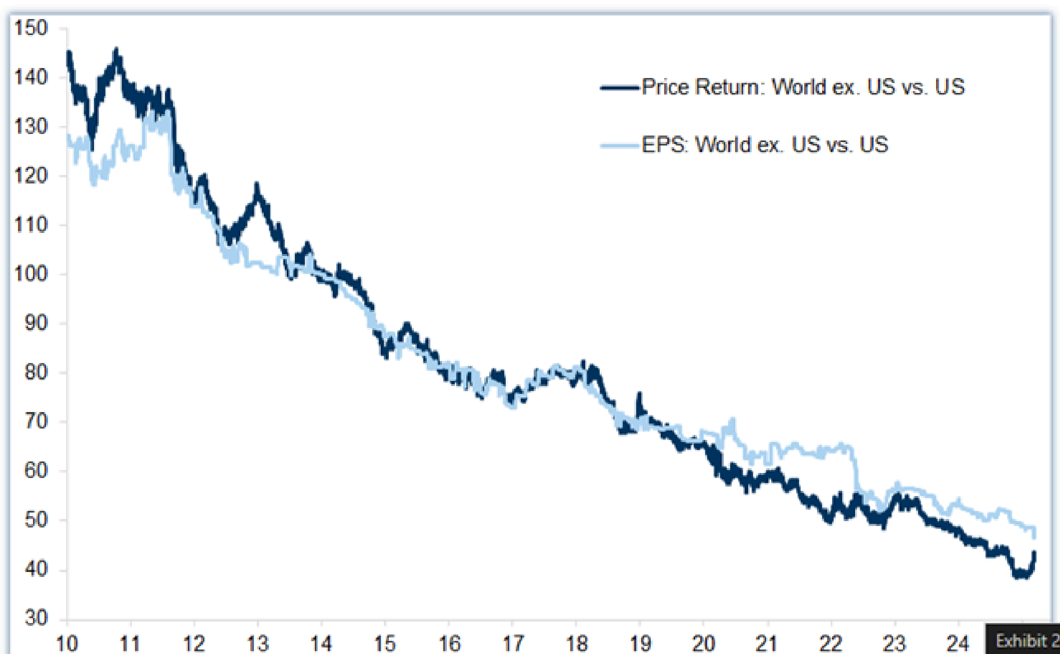


PORTFOLIO CHANGES & CURRENT POSITIONING

Portfolio Positioning – US Large Cap: As many of our clients know, we've tilted our portfolios towards U.S. equities heavily over the past couple of years. It has been our opinion that an overweight to domestic stocks (relative to the global weight) was prudent, especially towards larger companies. With the recent political uncertainty and international outperformance, we've been asked whether our mood on this has changed. Short answer…No. International stocks will often be in our portfolios, comprising a smaller 10-20% weight of our equity portfolios. While that is about half of the weight of global markets, it has helped this year to offset some of the pullback in U.S. stocks. Our preference for U.S. equities stems from our belief that the earnings landscape is generally better than international. As earnings go, so will stocks for the most part. This graphic shows the return of US versus non-US stocks with the EPS (earnings per share) of those same indexes. It's no surprise to us that the historical US outperformance has correlated with the relative earnings per share outperformance.

One theme that you'll notice in many of our portfolios has been a preference to add some quality dividend equities to portfolios. The earnings in the US have been heavily driven by the biggest tech companies, and their weighting in the S&P 500 index has correspondingly increased above 30%. Our focus has been to reduce that weight and add more mature, dividend-paying stocks to portfolios to reduce our reliance on those massive businesses. That isn't to say we won't own plenty of the biggest companies, but rather we're using their strong performance to help rebalance to cheaper alternatives here in the US.

Exhibit 2: The US had generated exceptionally strong earnings growth relative to other markets ever since the financial crisis, largely driven by the exceptional profitability of the technology sector
Price return and 12m fwd EPS in local currency. Indexed to 100 in Jan-2014



Source: Datastream, STOXX, Goldman Sachs Global Investment Research

Data as of 03.10.2025

PORTFOLIO CHANGES & CURRENT POSITIONING

Tax Loss Harvesting: Back in 2022, we had this conversation with many of our clients with taxable accounts (non-IRAs). Essentially, since both stocks and bonds were down over 10% each, it was an opportunity to harvest losses to offset any gains and potentially carry forward. I'll be the first to admit that after strong runs in both 2023 and 2024, most portfolios aren't sitting on many unrealized tax losses.
That said, loss harvesting is a technique that we'll use during negative markets to help manage taxes today, and potentially in the future. The strategy sells positions that are at a tax loss, and either redeploys the proceeds immediately or holds off for a specified period before reinvesting. In our opinion, it's a way to address the tax part of portfolios during a negative time. We'll look for these types of opportunities during markets like Q1 2025.

Summary: A lot of the adjustments we've made this year have been around rebalancing portfolios back to targets. We look to leverage market volatility as a chance to buy low and sell high (rebalancing in a nutshell) and harvest losses from a tax perspective. You'll notice much of our positioning has held steady in that we're overweight US (especially large cap), leaning towards dividend-paying equities, and own primarily investment-grade bonds. We do have allocation to international (both developed and emerging), US small cap, and high-yield bonds but they're smaller in weighting. What you won't see are drastic changes that reshape the outlook for portfolios. There is a lot of noise right now in markets, media, and politics, and our focus is on what matters in the context of portfolio positioning. We're resisting the urge to make bigger, bolder changes until we know the facts and piece together our outlook based upon them. In reality, that is always what we're doing except today the uncertainty factor feels a bit more extreme.

MIKE'S QUARTERLY TANGENT: LESSONS FROM TWO CHARLIES

When markets are behaved and performing well, it's easy to stay the course. Everything is going to plan, right? When we start to see signs of economic turmoil or a market "pullback," charting the course feels a bit harder. As we've discussed throughout this newsletter, that's a natural reaction and the behavior of emotional creatures (which I'd say humans certainly fall into). It's during these times that I think revisiting history is helpful and often helps with some additional perspective. As Mark Twain wrote years ago – "History doesn't repeat itself, but it often rhymes."

Two of my favorite investors of all time are the two Charlies…Ellis and Munger. Charlie Ellis is an investment consultant who founded Greenwich Associates years ago. He has also written many books on the topic and provides incredible insight into long-term successful investing. Charlie Munger needs less of an introduction. As many of you already know, he was Warren Buffett's business partner and Vice Chairman of Berkshire Hathaway. In my opinion, both men have provided great stories and quotes over the years that encapsulate the mind of successful, long-term investors. I thought it would be helpful to share a couple of them, given the situation in markets, the economy, and politics.

Charlie Ellis – Charlie compared investing to the game of tennis. He separated expert players from amateur players, just like institutions versus individual investors. In professional tennis, the experts win by playing aggressively and focusing on the most "wins." In amateur tennis (or investing), the focus should be on not losing. That means continuing to volley and avoiding self-inflicted errors. The amateur tennis player should not try to play like a professional, or the unforced errors will likely lead to a loss. In the book The Loser's Game, he says most amateur (and even professional) investors should try to win by not losing.

Charlie Munger – "It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent."

While one is an analogy and the other a very blunt quote, both focus on the same principle. We need to acknowledge that it's in our nature to be emotional and to make bad decisions. The underlying root of all of this is that losing wealth is an extremely uncomfortable situation. The important thing to remember is that we build financial plans to prepare for decades, not month-to-month or certainly day-to-day. Markets will ebb and flow, and our job is to align your portfolio and manage it over time, in accordance with a risk level that matches the needs of your plan and you as an individual. What we need to avoid is making a decision that can severely impact the future of your plan without truly understanding the implications.

I think in times like this, we should all do our best to channel our inner "Charlie," regardless of which one you're referencing. We look to build and maintain financial plans and portfolios by not losing. That isn't to say portfolios won't go down, as that is just part of investing, but rather that we're going to do our best not to create self-inflicted wounds that can possibly derail the outcome of our long-term planning. As Mr. Munger pointed out years ago, sometimes it's as simple as just not being stupid. Going back to the common theme here…let's resist the urge within our portfolios, as that is the smarter thing to do. Maybe I can let this trickle into my personal life and stop eating peanut butter by the spoonful directly from the jar. History tells us that I'm likely to fail in that endeavor…

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Keep Perspective

Just remember that your team here at Diversified is always working on your behalf to adjust portfolios in a quickly changing landscape. We strive to always remain unemotional, proactive, and transparent as to what we're seeing, thinking, and ultimately doing. We sincerely appreciate our partnership and just know that we're always here if you have any questions on your financial plan, portfolios, or just would like to talk. Thank you for the trust you put 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.

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S&P 500: The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

Russell 2000: The Russell 2000® Index is a capitalization-weighted index designed to measure the performance of the 2,000 smallest publicly traded U.S. companies based on in market capitalization. The Index is a subset of the larger Russell 3000® Index.
MSCI All Country World Index: The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets

(EM) countries. With 2,937 constituents, the index covers approximately 85% of the global investable equity opportunity set.
GDP: Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

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