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2023 CIO Retrospective

"Stay focused on, not the outcome, but … process. We live in such an outcome-oriented world it's hard to do, but I think it's the key to being successful."

Nick Saban

It's not the punchiest opening quote, as my son pointed out, but bear with me. Saban called in to the broadcast of the American Express PGA Tour event I was watching as Alabama sophomore Nick Dunlap was closing in on a historic victory. Alabama football's recently retired luminary, himself a golf enthusiast, said he would advise the young amateur to stay focused on the process rather than the outcome, to play smart by evaluating the risks and rewards, and to play situational (i.e., choose the right play for the situation). He illustrated the last point, of course, in football terms: "throwing a bomb" when a short first down is needed is an ill-advised, high-risk play, even if the pass is completed.

There is nothing fancy about those remarks, but I was struck by how much they reminded me of how we think about fundamental investing. Perhaps only major sports events are measured and analyzed to the same degree as investment results. In our world, the "outcome" is relative performance vs. benchmarks over short time horizons. Although the near-term returns of market benchmarks are completely out of investors' control, they typically receive a high level of attention because they are measurable and provide a basis for comparison. The risks embedded in those returns typically receive far less attention.

In contrast, our investment process is focused on generating good risk-adjusted returns over long time horizons and under varying market conditions. We are constructing portfolios for a future which is unknowable. While myriad outcomes can occur, only one outcome at a time will occur. Real risks which threaten investment portfolios may or may not come to pass in a given time period, if ever.

Consider the performance of the components of a traditional mix of U.S. stocks and bonds in 2023. Starting with stocks, the return of the S&P 500 Index was notable, and not just for its absolute level. The 26.3% return for the S&P 500 was largely driven (~60%) by just seven companies, now known as "The Magnificent Seven," as exuberance over the future of Artificial Intelligence took hold. As of December 31, 2023, these seven stocks represented 28% of the S&P 500 and 20% of the MSCI World Index (which encompasses 1,480 stocks), indices investors have historically used to gain broadly diversified exposure to equity markets. Such unprecedented and rising levels of concentration are making investing in cap-weighted indices more akin to "throwing a bomb."

Underscoring the point that there are many possible future outcomes at any given time, the strong showing by the equity markets came in the wake of widespread expectations for a recession at the start of the year, as the Fed continued hiking interest rates to combat inflation. Expectations abruptly shifted with dovish comments by Fed Chair Powell on November 1st, spurring both the stock and bond markets through the end of the year. The fact that the yield on the 10-Year Treasury ended the year at 3.9%, roughly the same rate as it started the year, belies the extreme volatility the bond market experienced in between. In fact, the Bloomberg U.S. Aggregate Index was in negative territory going into November. Its gain of 5.5% for 2023 was boosted by significant tightening of credit spreads in the late-year rally.

The combined performance of the 60% MSCI ACWI/40% Bloomberg US Aggregate Index gained 15.7% in 2023. There are a few important things to note when evaluating 2023 performance. First of all, more limited exposure to the Magnificent Seven muted performance of domestic equity allocations. This is evidenced by the equal- weighted indices, which tend to more closely reflect the experience of active management than cap-weighted counterparts. The 2023 return differential of 12.4% between the cap-weighted S&P 500 (up 26.3%) and its equal-weighted counterpart (up 13.9%) was the second-widest spread in market history. Secondly, private portfolios were generally quiet for the year, making them a significant detractor for the year given the performance of public equities. We note that private investment returns are lumpy, non-linear, and lagging, but we believe they have been generally accretive to long-term performance of diversified portfolios.

Zooming out a bit, the past three years have been marked by significant volatility. 2021 saw strong equity returns, especially from U.S. large caps, as the post-COVID liquidity continued to fuel markets. 2022 saw a double-digit decline in stocks and bonds and one of the worst calendar year performances for balanced portfolios. We believe that more diversified portfolios generally tended to perform better in 2022 due to less exposure to fixed income. Drawdowns are even more costly for pools of capital that need to be accessed for spending needs as they can force selling at unfavorable points.

In stark contrast to a year ago, prognosticators have turned decidedly sanguine with expectations for a "Goldilocks" economy in 2024, not too hot and not too cold. The equity market reflects this optimism with elevated valuations, although not necessarily at extreme levels if corporate profits hold up. While the Magnificent Seven are indisputably great companies, their valuations are much higher than the overall market and reflect lofty expectations for continued growth in earnings which may become challenging as these behemoths become ever larger. As of December 31, 2023, the bond market was pricing in <u>six</u> rate cuts for 2024, although that has now moved to five. The Fed is signaling just three rate cuts in 2024 as recent measures of inflation move closer to its goal of 2%. A rate-cutting cycle as aggressive as the bond market is counting on would seem to coincide with economic weakness or turmoil in the markets.

The absence of one of the most widely predicted recessions last year illustrates the difficulty and danger in making macro predictions. We know what we don't know but believe the seeming dissonance between the stock and bond markets suggests uncertainty. We believe diversification is key to navigating a wide array of potential outcomes and choose to focus on our investment process.

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Tara Elliott

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