FA Financial Alternatives
integrated wealth management

Investing Newsletter **January 2023**

Quarterly Market Review Newsletter

In addition to this newsletter, be sure to read our Quarterly Market Review newsletter – available on our website – which contains both long and short-term investment return data from markets around the world. This quarter's Market Review also contains an interesting article entitled, "Time the Market at your Peril" which discusses the dangers of market timing.

Overview

In this quarter's investing newsletter, we put the 2022 bear market returns in historical context and briefly mention what we did that helped improve returns in 2022. We then take a closer look at historical returns and discuss the odds of experiencing a second consecutive year of negative returns in 2023.

We also discuss the compelling opportunity that exists now for clients to earn a higher return on their cash reserves than they are currently earning from their banks, and we offer a few general thoughts on what it takes to be a successful investor during difficult bear markets.

2022 Review

Last year was one of the worst years ever for the U.S. stock market as represented by the S&P 500. See the chart below:

The Worst Years Ever For the U.S. Stock Market

Year	S&P 500	Reason
1931	-43.8%	Great Depression
2008	-36.6%	Great Financial Crisis
1937	-35.3%	1937 Crash
1974	-25.9%	1973-74 Bear Market
1930	-25.1%	Great Depression
2002	-22.0%	Dot-Com Crash
2022	-18.1%	The Great Inflation
1973	-14.3%	1973-74 Bear Market
1941	-12.8%	WWII
2001	-11.9%	Dot-Com Crash
1940	-10.7%	WWII
1957	-10.5%	1957-58 Recession

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Executive Summary

- 2022 was the seventh worst calendar year loss for the S&P 500 Index since the 1920s, down -18.1%.
- The 13% drop in the Aggregate Bond Index for the year was over 10% greater than any other annual drop in this index's history!
- Value stocks and some alternative strategies such as trust deeds, hedged equity investments, and private equity may have helped reduce portfolio losses.
- Since 1928, the S&P 500 Index has experienced two or more consecutive negative years just eight times.
- The S&P 500 Index's worst 11 years were succeeded by positive returns the following year six times and by negative returns five times.
- When stock and bond markets decline, their expected future returns should increase.
- After the Fed's recent interest rate increases, banks have been slow to raise the yields they pay depositors; but money market yields have responded more quickly – presently yielding more than 4%.
- The most important thing an investor can do during a bear market is to unemotionally stick to their plan while maintaining a long-term perspective.

In 2022, the S&P 500 Index had the seventh worst calendar year loss since the 1920s. To make matters worse, the bond market also experienced a historic drop with the intermediate term, high quality Bloomberg Aggregate Bond Index dropping 13%! This index dates back to 1976, and only experienced four negative annual return years prior to last year:

- 1994 - 2.9%
- 1999 - 0.8%
- 2013 - 2.0%
- 2021 - 1.5%

The bond index's decline last year was more than 10% greater than any other annual decline and the worst year in its history! It was a tough year for bonds to say the least.

This drop in stocks and bonds caused a balanced 60/40 portfolio of U.S. stocks and bonds to be down -16.9% in 2022 or the third worst year since the 1920s as you can see from the chart on page 2.

The Worst Years Ever For a 60/40 Portfolio

Year	60/40 Portfolio	Reason
1931	-27.3%	Great Depression
1937	-20.7%	1937 Crash
2022	-16.9%	The Great Inflation
1974	-14.7%	1973-74 Bear Market
2008	-13.9%	Great Financial Crisis
1930	-13.3%	Great Depression
1941	-8.5%	WWII
2002	-7.1%	Dot-Com Crash
1973	-7.1%	1973-74 Bear Market
1969	-6.9%	Nifty Fifty Crash
2001	-4.9%	Dot-Com Crash
1966	-4.8%	1966 Bear Market

Source: NYU

What Helped Reduce Losses Last Year

Value Stocks

In a down year for stock markets, value stocks were a bright spot - significantly outperforming growth stocks. You can clearly see this in the style box showing 2022 returns pictured below – tilting toward value stocks helped mitigate the losses across sizes, from small cap to large cap. As an aside, this is a noteworthy reversal of the trend of growth stocks outperforming value stocks over the past several years.

	Value	Blend	Growth
Large	-7.5%	-18.1%	-29.1%
Mid	-12.0%	-17.3%	-26.7%
Small	-14.5%	-20.4%	-26.4%

Source: JP Morgan Guide to the Markets 12/31/2022

Trust Deeds and Alternative Strategies and Funds

In the fixed income area, trust deed investments which maintain low loan-to-value ratios and provide very short duration loans likely fared better than bond markets – possibly mitigating losses in other asset classes of a portfolio. In addition, due to the nature of their strategies, private equity and stock investments that use hedging were likely to fall less than the overall stock market.

Cash

Obviously holding cash in a down market helps reduce losses. While we are not advocating timing when to be in or out of the market, we believe setting some cash aside for planned withdrawals can make a lot of sense. Having a pre-established cash reserve can provide the opportunity to wait out very high volatility periods without having to sell investments; plus, depending on the investor, it can provide the right amount of comfort when experiencing the type of year we just had.

Returns

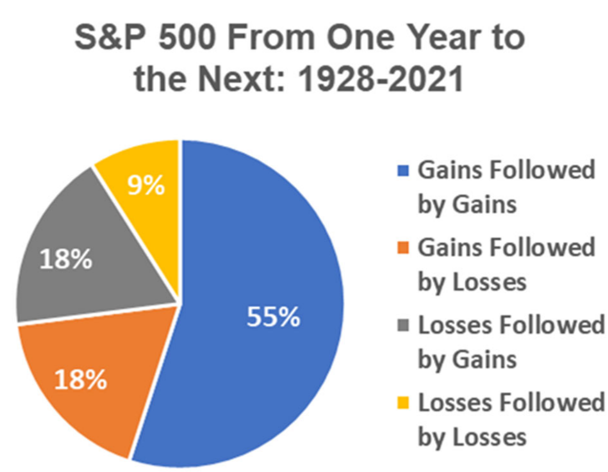
Look at your portfolio report which shows your total return for 2022 and compare your return to the -18.1% return for the S&P 500 Index, the -13% return for the Bloomberg Aggregate Bond Index and the -16.9% return for the 60/40 balanced index.

Tax Swaps & Rebalancing Portfolios

Due in large part to the widespread volatility this past year, we were very active in harvesting tax losses - executing tax swaps to realize losses for tax purposes while still maintaining the same portfolio allocation strategy. While implementing tax swaps, we often rebalanced portfolios to maintain the desired portfolio allocation.

What Are the Odds of Stocks Having Year Over Year Losses?

Since 1928, the odds of having year over year negative returns in the S&P 500 have been 9% - as pictured in the chart below.



If we review annual returns since 1928, we'll see that 8 out of 94 years had back-to-back losses. The last time it happened during the Dot-Com Crash, we actually had three down years in a row 2000-2002. Before that, you had to go back to 1973-1974 (dropped the gold stand-ard/oil crisis). Prior to that, there were two periods where we had several down years in a row: 1939-41 (World War II) and 1929-1932 (Black Tuesday and the Great Depression). If we eliminate that last period, the 9% chance of back-to-back negative returns drops to about 6% (5 out of the last 89 years).

As you can see, negative stock market returns have occurred in several back-to-back years (and could easily happen again), but this may not happen as often as you think. As people, we tend to think about recent events and expect them to continue, so it's important to look at the historical record to balance this predisposition.

Let's take a look now at what happened in the past after the S&P 500 experienced its worst return years to see if that can give us a historical clue as to what might happen this coming year.

S&P 500 Annual Returns: 1928-2022

1928	43.81%	1952	18.15%	1976	23.83%	2000	-9.03%
1929	-8.30%	1953	-1.21%	1977	-6.98%	2001	-11.85%
1930	-25.12%	1954	52.56%	1978	6.51%	2002	-21.97%
1931	-43.84%	1955	32.60%	1979	18.52%	2003	28.36%
1932	-8.64%	1956	7.44%	1980	31.74%	2004	10.74%
1933	49.98%	1957	-10.46%	1981	-4.70%	2005	4.83%
1934	-1.19%	1958	43.72%	1982	20.42%	2006	15.61%
1935	46.74%	1959	12.06%	1983	22.34%	2007	5.48%
1936	31.94%	1960	0.34%	1984	6.15%	2008	-36.55%
1937	-35.34%	1961	26.64%	1985	31.24%	2009	25.94%
1938	29.28%	1962	-8.81%	1986	18.49%	2010	14.82%
1939	-1.10%	1963	22.61%	1987	5.81%	2011	2.10%
1940	-10.67%	1964	16.42%	1988	16.54%	2012	15.89%
1941	-12.77%	1965	12.40%	1989	31.48%	2013	32.15%
1942	19.17%	1966	-9.97%	1990	-3.06%	2014	13.52%
1943	25.06%	1967	23.80%	1991	30.23%	2015	1.38%
1944	19.03%	1968	10.81%	1992	7.49%	2016	11.77%
1945	35.82%	1969	-8.24%	1993	9.97%	2017	21.61%
1946	-8.43%	1970	3.56%	1994	1.33%	2018	-4.23%
1947	5.20%	1971	14.22%	1995	37.20%	2019	31.22%
1948	5.70%	1972	18.76%	1996	22.68%	2020	18.01%
1949	18.30%	1973	-14.31%	1997	33.10%	2021	28.47%
1950	30.81%	1974	-25.90%	1998	28.34%	2022	-13.80%
1951	23.68%	1975	37.00%	1999	20.89%		

Source: NYU

2022 Returns as of 12/13/2022

The Positive Spin

Year	Loss	Next Year
2008	-36.6%	25.9%
1937	-35.3%	29.3%
1974	-25.9%	37.0%
2002	-22.0%	28.4%
1941	-12.8%	19.2%
1957	-10.5%	43.7%

Data: NYU

The Negative Spin

Year	Loss	Next Year
1931	-43.8%	-8.6%
1930	-25.1%	-43.8%
1973	-14.3%	-25.9%
2001	-11.9%	-22.0%
1940	-10.7%	-12.8%

Data: NYU

In the above-listed years the market experienced significant positive returns after a negative year.

But in the years listed to the right, the reverse happened, and the market dropped a second consecutive year. In fact, in four out of five of these years, the second year's negative returns were larger than the first year's.

In summary, roughly half the years of very bad returns were followed by positive returns and the other half of the time they were followed by negative returns.

In the end we are left with what we are always left with when it comes to predicting the short-term direction of the stock market, **nobody can predict with any degree of accuracy what the market will do in the short term.** Fortunately, you do not need to be able to predict the short-term direction of the market to be a very successful long-term investor.

Opportunities Created by the Stock and Bond Market Correction

It's crucial to remember that when stock and bond markets decline, the expected future returns increase - and the steeper the drop, the higher the future expected return. Essentially this is because when investment prices drop faster relative to expected earnings, fundamentally, we should expect more return (earnings divided by price). If we have another negative year in the markets in 2023, the future expected returns in 2024 will be higher than they are today.

Investment companies develop valuation models based on this concept to offer a perspective of what returns could look like in the future - and Vanguard's 10-Year Return forecasts offers a good baseline example. In our January 2022 Investing Newsletter we showed you their forecasts for a variety of asset classes at the time:

- 2.3% to 4.3% for U.S. Equities
- 5.2% to 7.2% for Global Equities ex-U.S. (unhedged)
- 1.4% to 2.4% for U.S. Aggregate Bonds
- 1.3% to 2.3% for Global Bonds ex-U.S. (hedged)

Now, considering the 2022 bear market, the Vanguard 10-Year Return forecast shows the following:

- 4.7% to 6.7% for U.S. Equities
- 7.4% to 9.4 for Global Equities ex-U.S. (unhedged)
- 4.1% to 5.1% for U.S. Aggregate Bonds
- 4.0% to 5.0% for Global Bonds ex-U.S. (hedged)

As you can see, the expected returns for stocks are higher than the year prior – and even more noteworthy their outlook for bond returns is more than double what it was last year! While there are of course no guarantees when it comes to investing we believe that intrinsically, investing today offers better potential that just a year ago.

Get Serious About Earning a Competitive Return on Your Cash Reserves at the Bank

We all know that the Federal Reserve raising short-term interest rates to slow inflation and the economy was a major reason why stock and bond markets corrected in 2022. The silver lining to this is that you can now earn 4% or better in money market funds.

We encourage you to evaluate the yield you are getting from your bank relative to these money market rates. Often it can make sense to keep just the bare minimum of cash reserves for emergency purposes at your bank and move cash into a money market fund because the yield on your checking accounts, savings accounts, and CDs (Certificates of Deposit) is not very competitive.

We have assisted several clients by helping them move large cash balances at their bank to a money market fund in their brokerage account. Please let us know if you would like to discuss various options for investing cash and how we can help.

What to Do Now

The most important thing an investor can do during a bear market is to maintain a long-term perspective and remain disciplined and unemotional. Reviewing the historical patterns of positive and negative returns in charts and graphs like those contained in this newsletter can be helpful in maintaining this long-term perspective. No matter how many times you've been through it, a year of negative returns is no fun, two years of negative returns feels like forever, and three or more years of negative returns seems like an eternity and can feel almost unbearable.

Remember each year of negative returns means expected future returns are increasing. Stock market returns never come evenly year by year. To be a successful investor it takes knowledge, discipline, and patience. It's not complicated but it's also not easy.

Maintain an appropriate spending plan and pay attention to your withdrawal rate if you are drawing funds from your portfolio. Stick to your plan and be willing to rebalance your portfolio if it strays too far from your target weights after negative return years.

We will continue to help and assist you as we work our way through this difficult period.

Summary

In 2022 stock and bond markets experienced one of the worst years in history.

The following factors may have helped some mitigate their losses for the year: Exposure to value stocks instead of growth stocks, equity investments involving private equity or hedging strategies, other non-traditional fixed income investments such as first trust deeds.

Tax loss harvesting trades will reduce taxable income for the year, and if not used up, will carry over to future years.

The odds of experiencing two consecutive years of negative returns are low but based on the historical record, it would not be surprising to see another down year in 2023. Even if this were to happen, it's important to keep the mindset that when stock and bond markets decline, their expected future returns increase. Expected future returns are higher now than they were at the beginning of last year.

Due to dramatically higher short-term interest rates, we may be contacting clients to evaluate whether they can reasonable earn a higher rate with money market funds when compared to their bank checking accounts, saving accounts and certificates of deposit.

We recognize it can be difficult to maintain your perspective and contain your emotions in a seemly endless bear market. Reviewing the historical patterns of positive and negative returns over the decades can help maintain a healthy perspective.

Again, review your withdrawal rate with your advisor to confirm that it's suitable given your circumstances, and be willing to rebalance your portfolio after negative return years.

We hope you and your family are well. Please contact us if you would like to discuss any aspect of your financial life in greater detail.

Happy New Year!

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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