Fiduciary Financial Group

Q1'2023 Returns and 2022 Full Calendar Year Returns

Category	Ticker	Description	Q1'2023	2022
Major World Stock Indices	SPY	S&P 500	7.5%	-18.1%
	DIA	Dow Jones	0.9%	-7.0%
	IWM	Small Cap Stocks	2.8%	-20.5%
	IWF	Russell 1000 Large Growth	14.3%	-29.3%
	IWD	Russell 1000 Large Value	1.0%	-7.7%
	EFG	EAFE Growth (INT'L Growth)	11.2%	-22.9%
	EFV	EAFE Value (INT'L Value)	6.0%	-5.4%
	IEV	European 350	10.3%	-14.2%
	EWJ	Japanese Stocks	7.1%	-17.4%
	MCHI	Chinese Stocks	5.0%	-22.5%
	INDA	Indian Stocks	-5.4%	-9.4%
	EEM	Emerging Market Stocks	4.1%	-20.6%
Bonds Indices	GOVT	US FED Gov't Bonds	3.3%	-12.7%
	TFI	US State/Local (Muni) Gov't Bonds	2.8%	-10.2%
	LQD	US High Credit Rating Corp Bonds	4.4%	-18.0%
	JNK	US Low Credit Rating Corp Bonds	3.7%	-12.4%
	IAGG	International Bonds	2.8%	-10.7%

Category	Ticker	Description	Q1'2023	2022
Benchmark Funds	AOR	Growth (~60-70% Stocks)	5.5%	-15.3%
	AOM	Moderate (~40-50% Stocks)	4.8%	-14.5%
	AOK	Conservative (~25-35% Stocks)	4.4%	-14.0%
USA Industry Stock Sectors	XLY	Consumer Discretionary	16.1%	-36.3%
	XLP	Consumer Staples	0.7%	-0.8%
	XLE	Energy	-4.4%	64.3%
	XLF	Financial	-5.6%	-10.6%
	XLV	Healthcare	-4.3%	-2.0%
	XLI	Industrial	3.4%	-5.6%
	XLB	Materials	4.3%	-12.3%
	RWR	Real Estate Inv Trusts	2.7%	-26.1%
	XTL	Telecommunications	-0.4%	-19.2%
	XLK	Technology	21.6%	-27.7%
	XLU	Utilities	-3.3%	1.5%
Tangibles	DBC	Broad Commodities Index	-3.6%	19.7%
	N/A	US Crude Oil (Futures)	-5.7%	5.0%
	GLD	Gold Bullion	9.1%	-0.8%

Data as of market close - 3/31/2023 - pulled from morningstar.com >> performance by ticker symbol >> net asset value (NAV) total return %
**Rounded to one decimal place*

Our Review of An Event-Filled Quarter

In the start of 2023, volatility, as measured by the VIX index, was low. Stocks continued their strong recovery from the bottom in October 2022. Growth stocks have experienced the largest rebound. This is following a ~30% down year in 2022. The cooling inflation numbers and the prospects of a possible recession have led market participants to expect a “FED PIVOT” in the back half 2023/early 2024. This would lead to a lowering of interest rates and an end to the fastest FED FUNDS RATE hike cycle in history[i]. Lower interest rates tend to be especially supportive for growth stocks. In Q1’2023, the simple “expectation” of lower rates in the next 48 months was enough to fuel great returns for this category. The performance of US Value stocks, which have heavier concentrations in financials, energy, utilities, and consumer staples companies, were muted for the quarter.

After two months of relative calm, the US was hit with the “scariest” banking crisis since 2008. The run on Silicon Valley Bank ended with its failure on Friday, March 10th. This was the second largest bank failure in nearly 100 years. Worries of “contagion” spread quickly on podcasts and social media with venture-capital backed firms and retail banking clients alike scrambling to reduce their deposit exposure in excess of measly FDIC insurance limits ($250k per depositor per institution per category)[ii]. We believe that the FED’s emergency announcement on Sunday, March 12, (**click here** for press release) at least delayed, and hopefully prevented, what could have been a waterfall of bank failures in the week of March 13th when it came to light that many of the nation’s major banks had a significant portion of their deposits above FDIC insured levels. Despite the relief, banking stocks overall, and regional banking stocks in particular, were hurt. The SPDR® Regional Bank ETF "KRE" ended the quarter down nearly 25% as US regulators were cryptic in their willingness to backstop ALL deposits vs. just those of the *Systemically Important Financial Institutions* "SIFIs".[iii] On that theme, the "BIG 4" banks saw more modest volatility with Citigroup actually posting a ~4.7% positive return for the quarter. Bank of America ("BAC") fared the worst ending Q1 down slightly over 13%.* Across the pond in Europe, emergency measures by the Swiss Government were released to save Credit Suisse in partnership with UBS, who purchased CS for only $3B, wiping out 95% of all stockholder value that existed 5 years prior.* In Germany, Deutsche Bank also exhibited distress, albeit less severe, with the stock down > 10% YTD for 2023 and the price of credit default swaps on their bonds increasing.*

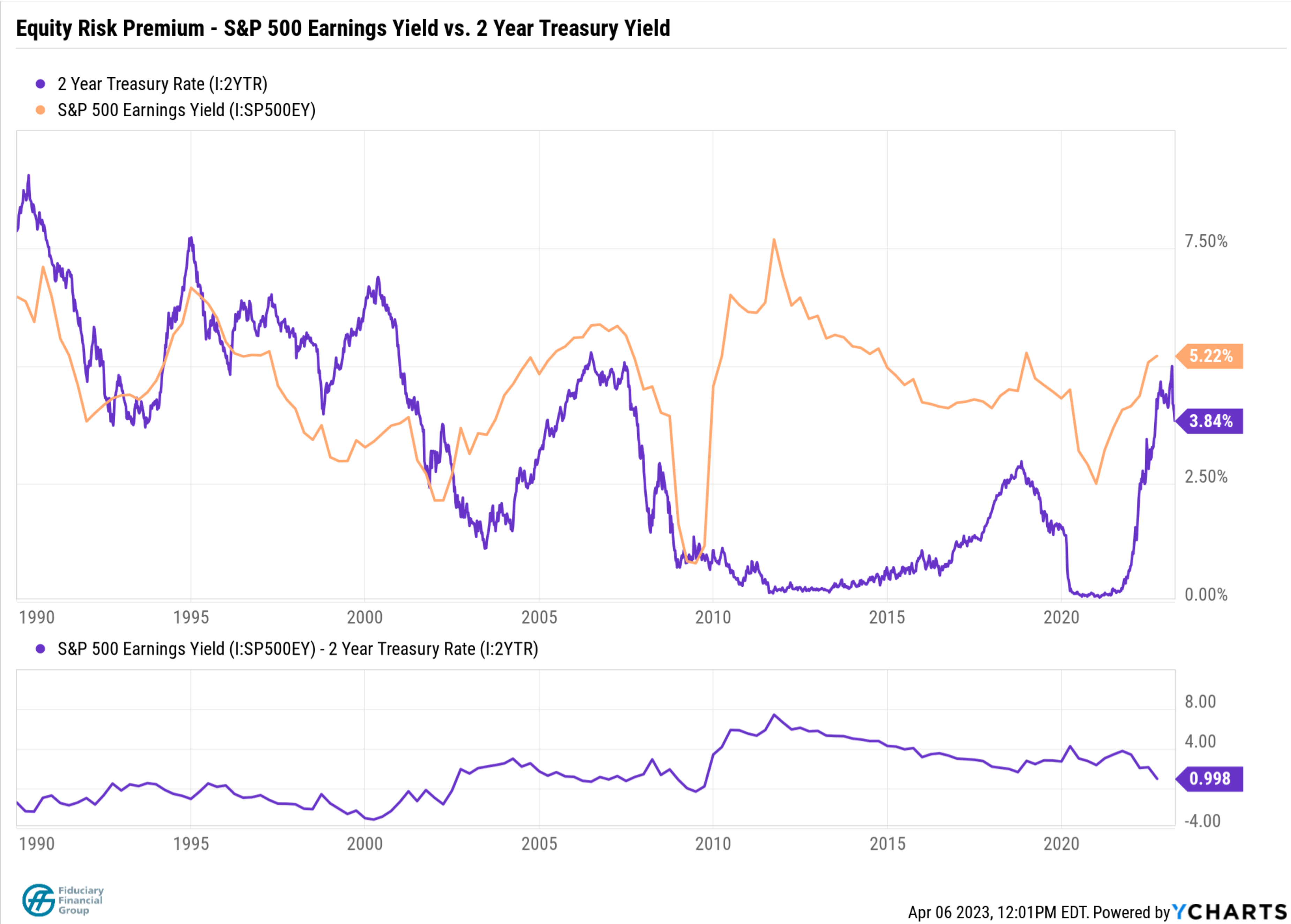
What Caused the Banking Crisis? Well, this could be a 100-page paper, but to summarize some of the key drivers:

- *Poor risk management practices at Silicon Valley Bank* ("SIVB") related to (1) venture debt lending, (2) extreme duration / interest rate risk in their investment portfolio, and (3) depositor concentration in the tech industry. Technology companies, entrepreneurs, and employees with sizable employer stock holdings (common clients of SIVB) faced considerable wealth destruction in 2022 which put stress on their deposit levels. These problems were exacerbated and realized with the exponential rising of interest rates in a short amount of time.
- *Financial technology ("Fintech") advancements in the field of money movement that have made bank deposits "less sticky".* Investors can now shift funds from bank accounts into 'nearly as safe' short-term treasury bills and money market funds with a couple mouse clicks.
- *Social media has facilitated rapid information (and panic) spread.* During the first week of March, social media enabled podcasters, Twitter influencers, economists, & venture capitalists to advise their followers and portfolio companies to reduce bank deposit balances down to FDIC limits.
- *We have an antiquated FDIC insurance system with insufficient limits for corporations.* Corporate bank accounts are only covered to $250,000… the same level offered to individuals. Many large companies must keep bank balances running well in excess of $250,000 to meet disbursements for large items such as payroll and inventory purchases. These limits will likely rise, and FDIC insurance coverage will likely be strengthened, as result of this crisis.

Fed Policy Past and Future

With hindsight being 20/20, it is clear that the Fed policies of the past helped to create the environment where this recent bank crisis could have been predicted. The heavy-handedness in the use of Zero Interest Rate Policy and money printing (aka quantitative easing) for too long expanded a dangerous bubble in bonds that was bound to pop. All it took for the bubble to pop was the Federal Reserve attempting to rapidly reverse the problems created with their exceedingly dovish policies over the past 13 years. The victims of this rapid reversal were the largest holders of treasury bonds (banks) who were stuck with the most rapid realized losses on these "safe" investments" seen in a century. It's no longer a political statement that the FED was late in responding to inflation. Monetary policy was kept loose throughout 2021 when inflation was already spiking well before the Ukraine War started in Spring'22. CPI spiked from ~1% to 7% between Jan'2021-Jan'2022. During this period, we saw unprecedented money printing when M2 money supply increased 33% from $15T to $20T in ~18 months (Jan'21 to Jun'22). These FED actions coupled with supply constraints brought on by COVID lockdowns were the kindling & logs for the inflation fire. The war in Ukraine and its impact on oil and food prices was the kerosene that fueled inflation above 9%, the worst level since the early 1980s. We estimate that had the FED started their rate hiking program in the 2nd half of 2021 (when still characterizing inflation as "transitory"), losses in bank bond portfolios would have been more gradual, and therefore easier to manage.

Looking ahead, we are constantly monitoring Fed statements and market indicators to understand interest rate trends. This not only impacts the bond portfolios we manage but also our decisions on equity (aka stock) weightings. This is because interest rates play a key role in equity valuations. One important measure that we are tracking is the equity risk premium, which is the equity earnings yield over the bond yield. This provides a measure of how much reward an investor can expect to receive for taking on the higher risk of loss & volatility associated with equities.



As of early Apr'2023, the equity risk premium hit its lowest level since ~2010. The chart above illustrates how severely this spread has narrowed. We anticipate that it could get worse admist the recession when analysts tend to revise their S&P 500 earnings estimates lower. If this "earnings revisions dynamic" plays out as in past recessions, bonds appear even more attractive (today) vs. stocks.

The phase of aggressive rate increases by the Fed is likely behind us. We may see one or two more hikes but then we expect to enter a more stable (but higher) rate environment. Therefore, the portfolios at FFG will continue to expand our bond holdings for the foreseeable future. The fixed income platform we use allows us to effectively compare the after-tax returns between the major bond categories including US Treasuries, Municipal bonds, corporate bonds, and mortgage-backed securities to find the best after-tax yield. We often mix and match our purchases as we build out our clients' fixed income allocation, which creates bond portfolios with laddered maturities and diversified credit risk.

Other Considerations As We Look Ahead

- Recession in the US in 2023 looks all but certain. Franklin Templeton's Anatomy of a Recession Gauge (click here)[iv] hasn't looked this unhealthy since 2007. Most of the classic leading indicators such as housing permits, job sentiment, retail sales, wage growth, profit margins, the yield curve, etc. are hitting recessionary levels.
- We are particularly concerned about failures in the private tech and commercial real estate sectors which will face trouble as bank lending tightens. The ultimate success of these fledgling technology firms (which are rarely profitable) and "in process" real estate projects tend to depend on refinancing debt under reasonable terms. We worry that such favorable financing won't be there in 2023-2024 as banks, particularly regional banks, shut off new loans for all but the most promising start ups and most conservative real estate deals. We will see "distressed deals" in real estate and technology M&A as a result.
- Value stocks remain a better deal than growth stocks both in the US and abroad looking at relative price-to-earnings ratios, price-to-book value ratios, and dividend yields. As noted previously, we don't see rates declining rapidly as inflation is still a problem with CPI running north of 6% which is triple the FED's 2% long-run target.
    - Famous value investor Rob Arnott, founder of Research Affiliates, was recently cited in the Wall Street Journal saying, "When inflation has run between 4% to 8% a year, value stocks have outperformed their growth peers by 6 to 8 percentage points annually."[v]
- We feel strongly that any money that [might] be needed in the short-term (1-5 years) should remain in highly liquid investment grade bonds and cash so that clients can ride out near-term volatility that is more common during recessions.
- Simultaneously, we view long-term money as being far better off in stocks, real estate, precious metals, and higher yielding bonds. We view "long-term money" being funds earmarked for a 5+ year holding period for younger clients and an 8+ year holding period for retired clients. Retirement accounts (IRAs/401ks etc.) are typically considered long-term by default.
- Per research from JP Morgan Chase, the average US investor allocates nearly 80% of their stocks to US domiciled companies. This bias has generated an enormous "positive wealth effect" for US investors during the 2010s when US stocks outperformed most other countries' equity markets. Having said that, a more market-weight / neutral allocation to US stocks would see only 58% allocated toward US stocks.[vi] As valuations and therefore return estimates remain more attractive abroad, we feel one of the most important measures investors can take to prevent unnecessary risk, is reducing US stock bias in their portfolios.
- Real estate must be analyzed locally and by sector. While we anticipate office and low-quality retail to see more significant losses, residential inventories and vacancy rates nationwide remain near 40-year lows.* Higher mortgage rates may depress prices somewhat (10-15%), probably more significantly in 2nd home markets, but the low vacancy and inventory levels should act as a buffer preventing devastating losses such as those seen during 2007-2010.

Your Circumstances Are Important

As always, these statements above are fairly generalized. We feel that allocation decisions for clients are more nuanced and should factor in not only market dynamics (valuations, recession risks, interest rates, etc.), but also your specific circumstances. Key drivers influencing our investment recommendations include:

- Risk capacity – How much risk can you afford to take in light of your job stability, responsibility for dependents, cash flow surplus / deficit, outstanding tax liabilities (if any) and existing insurance coverages?
- Risk tolerance – We note that while many clients are unphased by market fluctuations due to their long-term faith in stock markets, others are sickened by any form of loss, even if the data suggests those losses being temporary. We do not believe any single behavioral risk tolerance assessment is perfect in quantifying a client's ability to emotionally withstand fluctuations in their portfolio. That said, we feel all clients must strike a balance between comfort with volatility, and their need for growth in excess of inflation that only stocks and real estate have reliably provided over history. Given that most of our clients have worked with us through the COVID-19 sell-off (fastest 35% drop in the S&P 500 in history) and the 2022 bond market meltdown (worst bond market since the Great Depression), we are confident that we are not taking risks in excess of most clients' comfort levels as evidenced by virtually no "panic selling" or notable client attrition that is more common in these stressful market environments.
    - *Still, we urge you to reach out to us if you ever need reassurance in our game plan with your investments.* We live in uncertain times where both cash assets and "growth-oriented investments" (i.e. real estate and stocks) pose risks. There is no one safe place to store all your wealth.
        - The value of our cash holdings face debasement by our government to address our enormous national debt ($31T or $95,000 / US citizen) & ongoing annual deficits ($1.4T estimated for 2023)[vii]. More cash being printed will likely reduce its value significantly over the next 10-20 years. For this reason, too much cash, or bonds that involve a repayment of cash with interest over time is dangerous and could lead to significant "real wealth" destruction. We feel investors should only allocate money to cash-denominated investments (dollars / foreign currencies / bonds) sufficient to cover distributions expected from their portfolio over a normal market cycle (usually 5-10 years). The risks facing cash are mitigated by owning assets that possess intrinsic value beyond currency. These investments *should* appreciate (in dollar terms) if the dollar's value diminishes. Stocks (ownership interests in "for profit" organizations) and real estate are the best vehicles for this, although precious metals & other commodities may have a place as well.
        - The value of our stock & real estate investments face significant interim price volatility during periods of recessions and / or debt crises when business failures and job losses occur. You must have sufficient allocations to assets that tend to experience low volatility in these environments (cash & investment grade bonds) to ride them out.

In conclusion, it's a delicate balance between managing short-term volatility risk and long-term cash devaluation risk. We view our job as crafting an investment plan that strikes an appropriate balance for you, while mitigating the risks of permanent losses that tend to occur from too little diversification, too much leverage, or panicked/forced selling of your stock/real estate assets at inopportune times.

END NOTES

[i] "US Interest Rates Are Rising Faster than at Any Time in Recent History. Is This Creating a Risk of Recession?" World Economic Forum, 12 Oct. 2022, https://www.weforum.org/agenda/2022/10/comparing-the-speed-of-u-s-interest-rate-hikes-1988-2022/#:~:text=Measuring%20Periods%20of%20Interest%20Rate%20Hikes&text=Here%20is%20the%20duration%20and,rate%20hike%20cycle%20since%201988.&text=The%202022%20rate%20hike%20cycle,of%20'88%2D'89.

[ii] "Deposit Insurance FAQs." *FDIC*, Federal Deposit Insurance Corporation, 20 Mar. 2023, https://www.fdic.gov/resources/deposit-insurance/faq/#:~:text=The%20standard%20deposit%20insurance%20coverage,held%20at%20the%20same%20bank.

[iii] Person, and Rami Ayyub David Lawder. "Yellen Says Not Considering 'Blanket Insurance' for All U.S. Bank Deposits." Reuters, Thomson Reuters, 22 Mar. 2023, https://www.reuters.com/markets/us/us-working-restore-capacity-designate-non-bank-finance-institutions-systemic-2023-03-22/.

[iv] Franklintempleton.com, Franklin Templeton Investments, 28 Feb. 2023, https://www.franklintempleton.com/insights/anatomy-of-a-recession#recession-risk-by-comparison.

v Person, and Rami Ayyub David Lawder. "Yellen Says Not Considering 'Blanket Insurance' for All U.S. Bank Deposits." Reuters, Thomson Reuters, 22 Mar. 2023, https://www.reuters.com/markets/us/us-working-restore-capacity-designate-non-bank-finance-institutions-systemic-2023-03-22/.

[vi] Published by Statista Research Department, and Mar 30. "Global Stock Markets by Country 2023." Statista, 30 Mar. 2023, https://www.statista.com/statistics/710680/global-stock-markets-by-country/.

[vii] Wallerstein, Eric. "Stocks Haven't Looked This Unattractive since 2007." The Wall Street Journal, Dow Jones & Company, 6 Apr. 2023, https://www.wsj.com/articles/stocks-havent-looked-this-unattractive-since-2007-78fc374c.

* Data derived from FFG's professional Ycharts.com subscription.

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