ACROPOLIS®
INVESTMENT MANAGEMENT

PORTFOLIO INSIGHTS

April 2023: Volume 22, Issue 2 // David Ott, Editor

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Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

UNCERTAINTIES ABOUND

This year is interesting because stocks and bonds rallied despite relatively difficult news.

After stocks and bonds hit what appears to be a bottom last October, both asset classes rose, and investors started to debate the possibility of a 'soft landing,' which is an economic slowdown that isn't quite a recession.

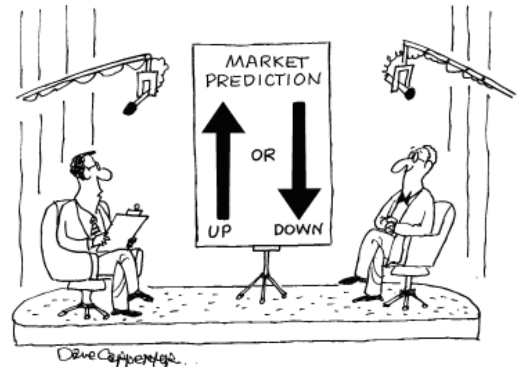
Economic data was surprising to the upside in January and February, which seemed to confirm the developing narrative.

Then, in early March, Silicon Valley Bank and Signature Bank both failed within days of each other, representing the second and third-largest bank failures in American history when adjusted for inflation.

It's often said that the Federal Reserve raises interest rates until 'something breaks,' and most market observers agree that the bank failures reflect a breaking point.

The Fed had already slowed the pace of their hikes, and before the bank failures, the market priced in interest rate cuts next year.

Once the banks failed, however, the bond market sped up their expectations for interest rate cuts to this summer.



"I must admit, I have seen bolder predictions."

The shifts in bond market expectations in the first quarter have been so rapid and dramatic that it appears the market has no real sense of what's coming next. Neither do policymakers at the Federal Reserve.

Fortunately, our approach to financial planning and investment management doesn't require us to know either. By looking at the historical record in the context of specific client circumstances, our plans are designed to weather whatever we face in the future.

With the planning side covered, the trick is maintaining the right mental attitude when facing uncertainties or headwinds.

It's often said that the optimal portfolio is the one you can live with through good times and bad. Our job, as advisors, is to find that optimal portfolio for you.

STOCK MARKET SUMMARY

By David Ott

The major stock market indexes were all higher in the first quarter, but the standout returns in the US were technology related.

The information technology index gained 21.8 percent, and other sectors with tech stock concentrations were also higher. Consumer discretionary, for example, which is almost 40 percent Amazon and Tesla, rose 16.1 percent.

Those sector returns are part of what compelled the S&P 500 Growth index 9.6 percent higher, presumably because interest rates fell. The S&P 500 Value index made 5.2 percent, which is a little surprising given that financials, the largest sector in the value index lost -5.6 percent.

The answer is that several technology and technology-related stocks fell so much last year that they were reclassified as value stocks. Meta, the parent company of Facebook, Instagram, and What's App, is a case in point, rising 75 percent in the first quarter after falling -65 percent last year.

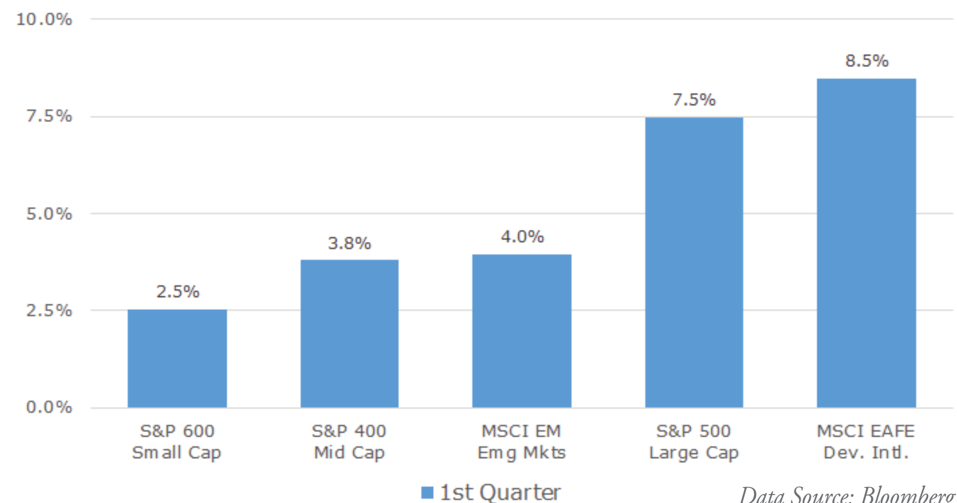
Although the financials index fell dramatically, almost all of the loss can be attributed to the banking subsector, which fell when Silicon Valley Bank suffered a classic bank run, and investors wondered what other banks might be at risk (Signature Bank failed shortly after that, though not due to a run).

Developed markets overseas enjoyed the highest return across equity asset classes, beating the S&P 500. The strong dollar detracted from returns somewhat, meaning that developed markets did even better in local currency terms.

Emerging markets, however, didn't fare as well as developed markets, largely due to worse-than-expected fourth-quarter earnings. China now accounts for almost one-third of the emerging markets indexes, so the earnings in the current year will largely depend on the strength and pace of the reopening there. Sagging global demand and faltering commodity prices have weighed on Chinese companies.

"There's no bad time to innovate."

- Jeff Bezos
Founder, Amazon



Data Source: Bloomberg

BOND MARKET REVIEW

By Ryan Craft, CFA

After a dismal 2022, the bond market began 2023 with a very strong quarter. The broad market Aggregate index posted a return of 2.96 percent. The strong returns were felt across the bond market, with corporate bonds, MBS, and Treasuries increasing by 2.5 – 3.5 percent. Volatility continues to dominate the usually sleepy bond market. Short-term Treasury bonds, typically the safest of investment options, have experienced wild swings in yield as the market tries to figure out the direction of the next move.

That narrative changed overnight as the banking system appeared to break. The failures of Silicon Valley Bank, Signature Bank caused short-term yields to plummet by 60 bps in a day and end the quarter down at four percent. The assumption by many in the market is that the Fed would continue raising rates until something broke. Well, something broke as the Fed and Treasury were forced to roll out new liquidity programs to ensure the banking system's solvency. Therefore, the market quickly pivoted, anticipating the end of the Fed's tightening campaign.

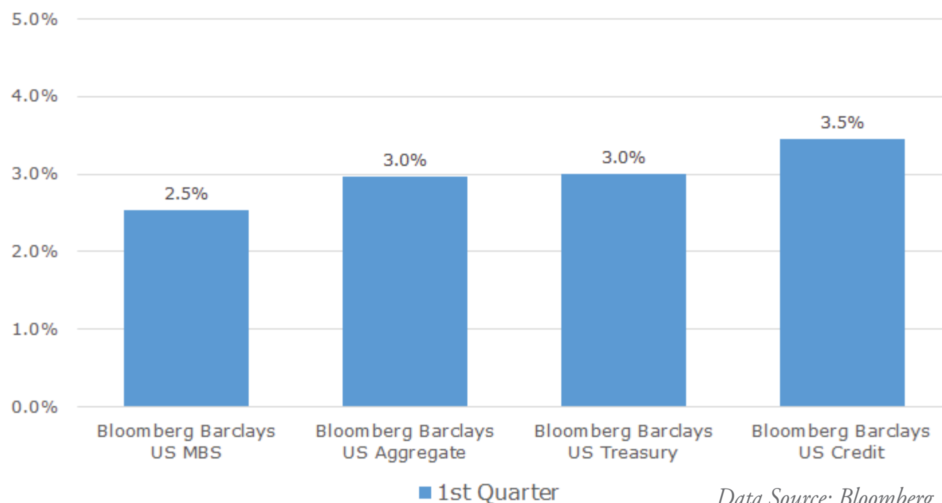
Despite the banking crisis, the Fed did raise overnight rates by 25 bps at their meeting in late March. The Fed also released new projections for the economy and interest rates. The Fed points to a couple more rate hikes and short-term rates holding steady at 5.5 percent for a while. This starkly contrasts the market expectation of Fed rate cuts beginning as soon as this summer.

This disconnect in expectations is driving the high volatility in bond yields. On the one hand, the market sees a Fed committed to a tight policy to drive inflation down to its two percent target. On the other hand, many in the market see the Fed scrambling emergency lending powers to stem a banking crisis along with contracting macroeconomic indicators. This hand is betting that the Fed will be forced to reverse course and help the economy sooner rather than later.

The Fed has a dual mandate: price stability and maximum employment. Their actions, which are intended to stabilize the economy can do the opposite.

"It's better to look ahead and prepare, than to look back and regret."

- Jackie Joyner-Kersee, American Olympic Athlete



Data Source: Bloomberg

VALUE STOCKS ARE A GOOD VALUE

By David Ott

Although there are many ways to define growth and value, the big picture is that growth stocks tend to grow faster but have expensive valuations.

Think of technology stocks that may not have a lot of profits today but are growing rapidly and will make a lot of money someday.

Value stocks, on the other hand, are cheap. They can be cheap for a reason, like a dying industry (newspaper publishing), very cyclical (energy stocks), are subject to some bad news (banks), or anything else that reduces demand for the stock among investors.

Historically, value stocks have trounced growth stocks. The rationale is simple: value stocks are underpriced and should revert to their true value, which acts as a tailwind. Growth stocks are overpriced and should revert to their true value, which is a drag.

While it's been true on average and over time, it's not always true. Growth stocks dramatically outperformed value stocks for long periods, including the 1920s, 1990s, and most of the the last decade.

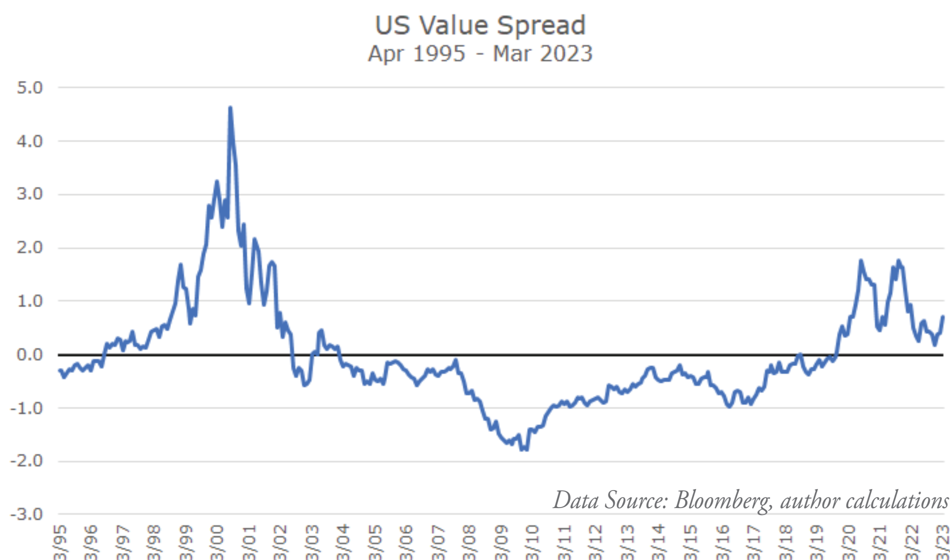
One of my favorite characters in the investment community is Cliff Asness, a quantitative investor with deep ties to academia and an incredibly sharp wit. For the last year or two, he has posted a chart on his company's website, AQR, that shows what he calls 'the value spread.'

The idea is to show growth stocks' relative expensiveness compared to value stocks' cheapness. Because Cliff is a quant, he uses global stock indexes and clever techniques to remove sector bias, showing the results as a z-score. I've recreated a less sophisticated version of the spread using the Russell 1000 growth and value indexes (on the opposite page).

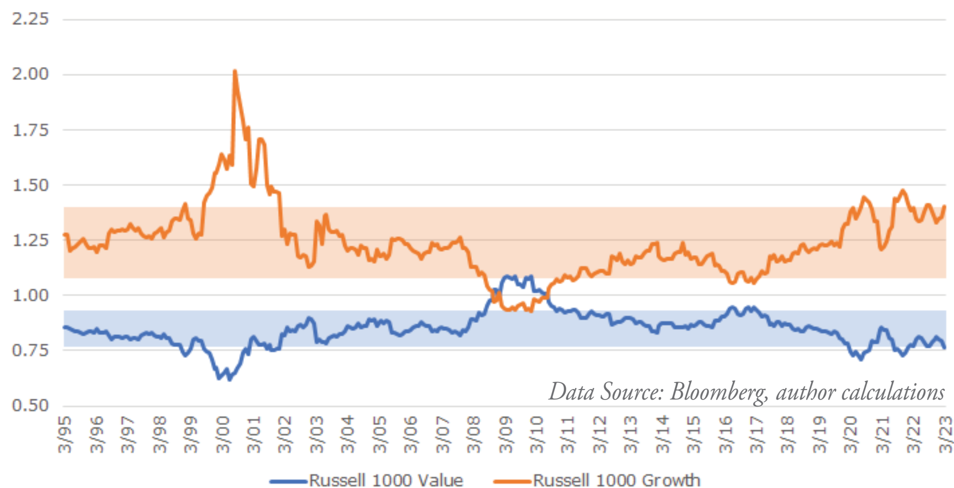
While our versions differ, they tell the same story: the valuation difference between growth and value stocks has been quite wide since the pandemic's start. Not as wide as during the tech bubble, but that was a true bubble.

"It is not true that people stop pursuing their dreams because they grow old. They grow old because they stop pursuing their dreams."

- Gabriel Garcia Marquez
Colombian Novelest



Data Source: Bloomberg, author calculations



As much as I like Cliff and admire his quantitatively backed charts, I don't love this chart because I can't tell from the spread whether growth stocks are expensive or value stocks are cheap - I can only see the difference between the two is wide.

I care about whether value stocks are cheap compared to the overall market since we're underweighting the market to increase our exposure to value.

To do that, I compared the price-earnings (PE) ratio of the Russell 1000 Value index to the PE ratio of the Russell 1000. You can see from the chart above that the value index has traded anywhere from a 38 percent discount to a ten percent premium. On average, value trades at a 15 percent discount to the market.

While the blue line shows the actual premium or discount at any point, the blue shading shows a normal range around the average.

The minimum and maximum numbers I cited above clearly fall outside the normal range. Still, you can also see that value has been unusually cheap since the pandemic's start, which matches the idea that Cliff showed in his chart.

Although I'm mostly interested in the cheapness of value, I thought it would be interesting to see the expensiveness of growth, so I did the same thing, which is in orange.

On average, growth stocks trade at a 25 percent premium to the market, and presented this way, you can see the tech bubble stand out, but the pandemic doesn't look like a bubble. It looks expensive, which it is: on average, growth stocks trade at a 25 percent premium to the market, and the premium right now is about 40 percent.

I'd argue that while both value and growth are in their normal range of the market, growth stocks are at the top, and value stocks are at the bottom of their ranges.

As usual, I'd rather hold the cheap stock with hopes that the valuation reverts to the mean than the growth stock that has to grow faster than everything else to avoid reverting to the mean.

"What we anticipate seldom occurs; what we least expected generally happens."

- Benjamin Disraeli, British Statesman

INSIDE THE ECONOMY: EMPLOYMENT

By: David Ott

Over the last 18 months, we've extensively covered inflation and growth in this publication and our weekly newsletter, Acropolis Insights. We haven't covered the labor situation nearly as much, probably because it's going well.

Before the pandemic, unemployment was historically low but shot to extremely high levels once the virus shut the economy down. For the next 18 months, the rate fell until reaching the pre-pandemic levels, where it's been for the last year. It is forecast to rise in the coming year, as the economy slows.

As is always the case with statistics (especially from any government), there is more than meets the eye. Although the calculation is simple enough, unemployed workers divided by the total labor force, the definitions of the two data points are hard to measure.

Unemployed workers are those who are currently not working but are willing, able, available, and actively searching for work. All of those criteria are logical but hard to measure. As a result, the Bureau of Labor Statistics attempts to measure 'discouraged' workers, marginally attached workers, and workers who want to work full time but can't for economic reasons. All are good efforts, but still difficult to do.

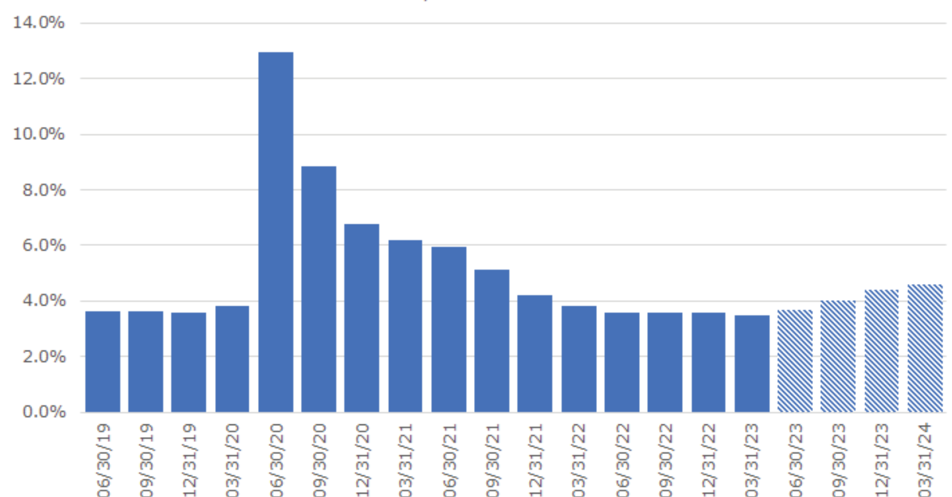
The total labor force is a little easier to measure because it's the unemployed population, as defined above, plus the employed people, which is easier to measure.

We see a different picture if we look at the related but easier-to-measure employment-to-population ratio, which is the number of people working divided by the number of people over 16. As of March, the employment-to-population ratio is 60.4 percent, below the pre-pandemic high of 61.1 percent and well below the pre-2008 global financial crisis high of 63.4 percent.

Why that hasn't fully recovered is a difficult question to answer, but economists suggest a mix of childcare constraints, excess savings, shifting work preferences, and, believe it or not, video games.

"It does not matter how slowly you go as long as you do not stop."

- Confucius, Chinese Philosopher



Data Source: Bloomberg

WE NEED TO TALK ABOUT CASH

By: David Ott

Talking much about cash didn't make sense when cash yielded nothing for over a dozen years. The yield on cash is attractive now, but the failure of Silicon Valley Bank (SVB) is a reminder that cash carries certain risks that need to be managed (even though the government protected the uninsured depositors at SVB).

The default cash option for brokerage accounts held at our primary custodian Charles Schwab is a Schwab bank account. Like many brokerage firms, Schwab opened a bank years ago, and because client deposits automatically sweep into their bank, it is now the eighth largest bank in the US.

That's good news for account balances up to $250,000 because money at Schwab Bank has the same FDIC insurance as any bank gets. And the $250,000 limit can be higher depending on certain circumstances - check out the FDIC website for more information and a useful calculator.

When clients have cash balances beyond the FDIC limits, we don't leave the money uninsured unless the client has requested it for some reason, which is rare. Instead, we buy money market mutual funds that own very short-term government instruments backed by the full faith and credit of the US government.

Some money market funds yield more than the government funds that we buy. The yield differentials can vary, but right now, they yield about a quarter of a percent more than what we buy.

The higher-yielding money market funds get the higher yield by investing in securities that the US government doesn't back. Sometimes, they buy things backed by foreign governments or financial institutions like banks or other corporations.

We do not think the extra yield is worth the credit risk – a quarter of a percent is too small of a return to justify the risk. Admittedly, the risk is small, but cash should be safe. Stocks have a lot of risks, bonds have some, but cash should not.

The funds with credit risk are also less liquid. The government money market fund we use could sell 99.6 percent of the assets in a single day, according to their reporting. Only 42.2 percent of the non-government fund holdings could be sold in a day and just 55.2 percent in a week.

If client withdrawals start pouring in, they might have to start selling securities that aren't as liquid and be forced to accept low prices. Again, for the paltry extra yield, it does not seem worth it to us.

Buying money market funds instead of using the standard bank sweep does slow down the money movement process by a day. The money market funds aren't cash; they are mutual funds that we buy and sell and have a one-day settlement. That doesn't slow things down much, but giving us a heads-up is a good idea.

We seek to optimize risk and return with stocks and bonds at the asset class level and do the same with cash. We may be a bit rusty since we didn't need to pay attention to cash for such a long time, but given both the risk and return, it's worth it now more than ever.

"There is only one corner of the universe you can be certain of improving, and that is your own self."

- Aldous Huxley
English Writer

Major Indexes	2023 YTD
Dow Jones	0.93%
S&P 500	7.48%
S&P 400 Mid-Cap	3.79%
S&P 600 Small-Cap	2.54%
MSCI EAFE (Intl)	8.47%
MSCI Emerging Mkt	3.96%

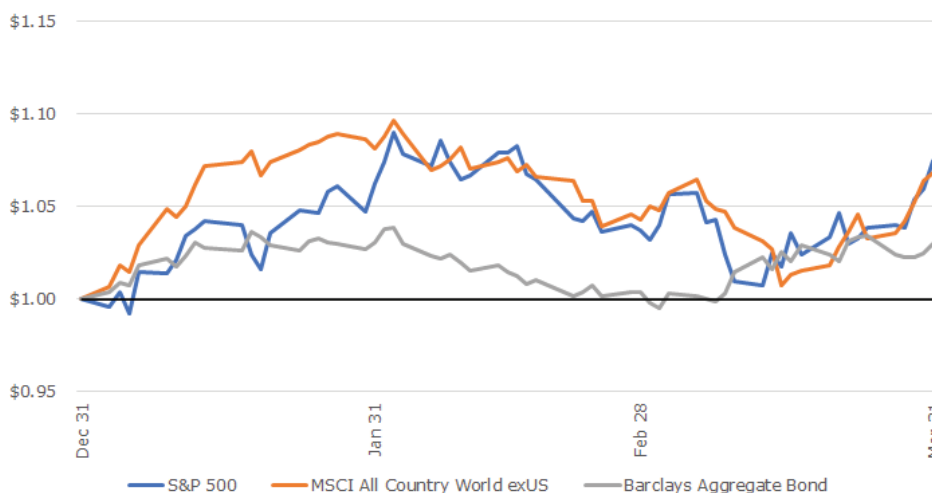
Equity Styles	2023 YTD
S&P 500 Growth	9.63%
S&P 500 Value	5.15%
S&P 500 Quality	8.10%
S&P 500 Momentum	-3.35%

S&P Sectors	2023 YTD
Basic Materials	4.29%
Communications	13.29%
Consumer Discretion.	16.05%
Consumer Staples	0.83%
Energy	-4.71%
Financials	-5.56%
Healthcare	-4.31%
Industrials	3.47%
REITs	1.88%
Technology	21.82%
Utilities	-3.24%

Interest Rates	2023 Q1
Fed Funds	5.00%
Prime Rate	8.00%
3-mo. Treasuries	4.75%
2-yr. Treasuries	4.03%
5-yr. Treasuries	3.58%
10-yr. Treasuries	3.47%

All Data as of 03/31/23

THE BIG PICTURE



FAST FACTS: BANK FAILURE EDITION

$327 billion: The combined assets of Silicon Valley Bank and Signature Bank at the time of their failure. Adjusted for inflation, these two failures represent two of US history's three largest bank failures. The largest failure was Washington Mutual in 2008. At the time, their assets were $307 billion but adjusted for inflation, that is $386 billion in today's dollars.

535: The number of US bank failures in the last 20 years. Approximately 85 percent of those failures occurred between 2008 and 2012 due to the global financial crisis. Most of the bank failures after the first year, 2008, were relatively small in size.

$42 billion The amount pulled from Silicon Valley Bank on March 9th, representing about 20 percent of the bank's assets. Before the collapse, approximately 85 percent of the deposits were above the FDIC insurance limit and concentrated in the technology sector. A reportedly small number of venture capital firms told their portfolio companies to pull the deposits.

Notice to Clients

Please remember to contact ACROPOLIS® Investment Management, LLC if there are any material changes to your financial situation or investment objectives or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement as set forth on Part II of Form ADV continues to remain available for your review upon request.

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