
Spring 2022

# Discipline Over Luck

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
— Benjamin Graham

Warren Buffett's mentor, Benjamin Graham, was famous for saying that in the short run, the stock market is like a voting machine — tallying up which firms are popular and unpopular. But, in the long run, it is like a weighing machine — assessing the substance of a company. What matters in the long run is a company's actual underlying business performance and potential to earn more every year, not the investing public's fickle opinion about its prospects in the short run.

In the short run, the COVID-19 pandemic that dominated the economic news for the last two years has taken a backseat to other issues. As we enter 2022, inflation is running hot, consumer spending remains strong, and the Federal Reserve (the "Fed") is gradually raising short-term interest rates and taking more aggressive measures to reduce inflation. Russia's invasion of Ukraine and related sanctions in February added an additional inflationary jolt, significant uncertainty, and increased the probability of a global economic slowdown.

Investors face the current concerns and uncertainties:

- *What will happen in Ukraine?* Wars are always highly unpredictable, and the situation could change for better or worse at any moment.
- *Can the Fed combat inflation without tipping us into a recession?* The Fed is in a tricky position given inflation is driven more by supply issues than demand issues.
- *Is the decades-old globalization trend about to reverse course due to the combined impact of the pandemic and the current geopolitical climate, which is dividing the existing world order?* Companies already are diversifying their supply chains in response to business interruptions during the pandemic.

## Seat Belts Fastened

After two years of being constrained by COVID-related restrictions, the U.S. economy continues to show signs of strength. Unemployment is low and consumer spending is strong. Airline flights, theme parks, and hotels are busy and consumers are spending despite higher prices for almost everything. Family trips that were cancelled in 2020 and 2021 are clearly happening in 2022. Consumer and business balance sheets are healthy, increasing fortitude and resistance to the negative effects of higher prices and interest rates.

Despite the positives, nearly all investments were down during the first quarter, pressured by rising interest rates and a fear that higher food and energy prices could slow the economy. The Nasdaq (a tech-heavy index) and emerging market indexes (principally stocks in China, India, Brazil, and Russia) both fell to levels 20% below their 52-week highs while many other market indexes were down 10% or more. Markets recovered late in the quarter but still finished in the red (see chart on page 4). The value of bonds also declined because interest rates rose and certain bonds had increased default risk. Stocks also got cheaper as a result of the selloff. Russian equities and sovereign debt both collapsed under the weight of sanctions and steep declines in the Russian ruble. The index funds that **Rebalance** clients hold are removing Russian stocks as of the end of the quarter.

All eyes are now on the Fed. Interest rates have a big impact on corporate earnings and stock values. During the first quarter the Fed shifted its focus from achieving full employment to combating inflation and plans to steadily raise short-term interest rates and simultaneously eliminate cash injections into the economy. The Fed believes the economy is strong enough to withstand interest rate increases and that, over time, higher rates should reduce inflation pressures. Investors are currently expecting short-term interest rates to reach pre-pandemic levels of 2% by year-end.

## "Knock-Knock... Who's There?"

During every market tumble, clients ask us: *"What are you going to do now that [current crisis – fill in the blank]?"*

Our response is always the same: *"You don't seismically reinforce a building during an earthquake! Stay the course and rebalance."*

We understand the market pundits on CNBC and the media love to wax poetically about what they are doing now given the current state of the market. But think about it. Instead of making changes to your portfolio **in reaction** to global events, doesn't it make more sense **to anticipate** the random nature of the market and manage an "all-weather vehicle" portfolio that withstands unpredictable events and recovers from market declines?

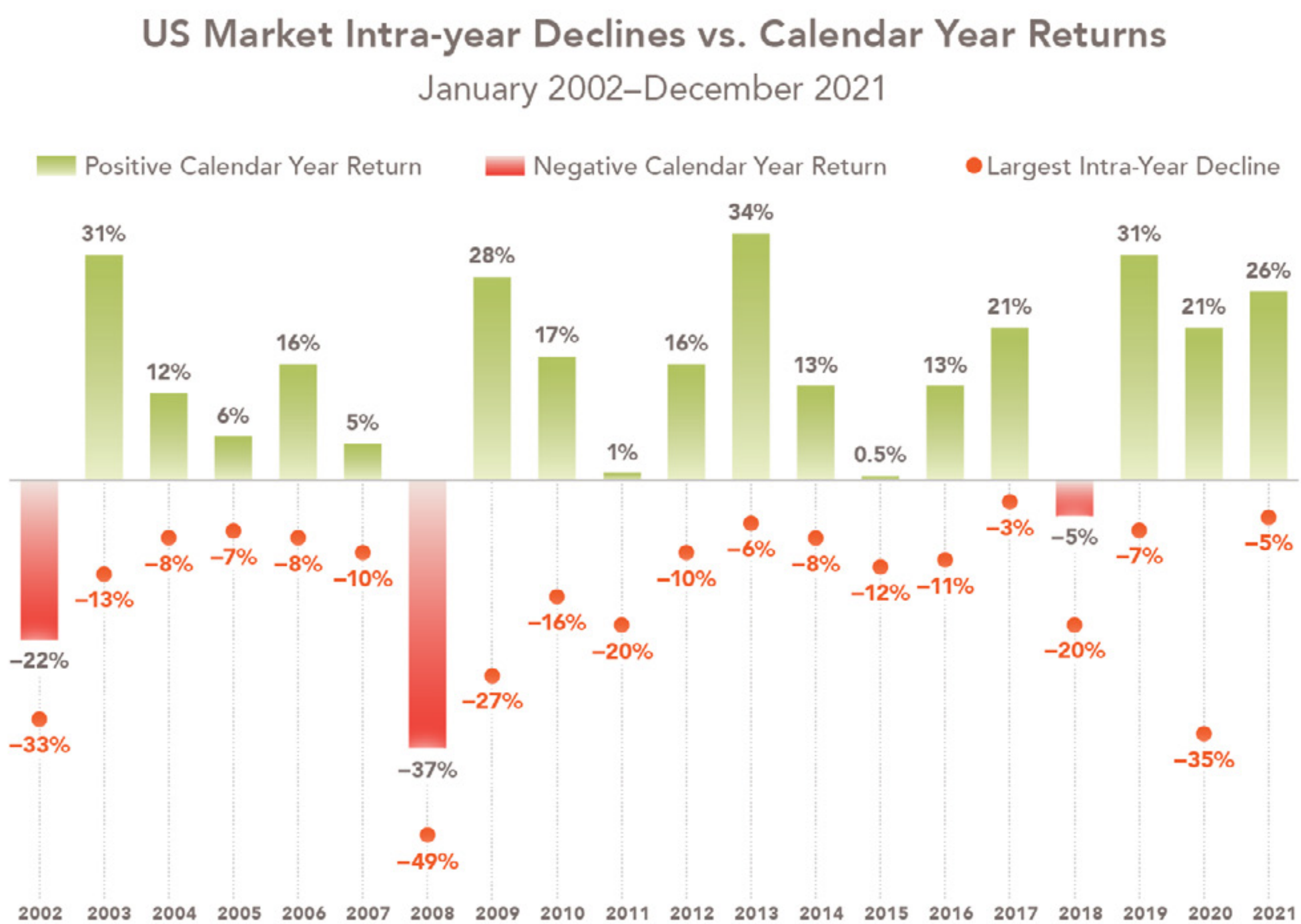
Stock market tumbles are a normal part of investing. They might be scary, but they should not be surprising. Stock market declines over a few days or months can lead investors to anticipate a down year. But the U.S. stock market has had positive returns in 17 of the past 20 calendar years, despite some notable dips in many of those years. Intra-year declines for the index ranged from 3% to 49%. Many years with large intra-year declines nevertheless saw positive annual returns.

The pandemic-influenced stock market of 2020 and subsequent recovery is just the most recent example of how experienced investors look through the fog of near-term uncertainty and see a positive long-term future. Even when there were sharp market declines every year over the past two decades, U.S. stocks ended the year with average gains of 21%.

We do not know the source of the next market curveball, but we know one is coming eventually. **Rebalance** portfolios are built to withstand and recover from volatile markets. We deeply abide by risk management approaches and build them into our clients' portfolios at the onset, expecting the curveballs, and use our disciplined rebalancing process to manage ongoing risk.

Ultimately, the focus is on the long term — what companies will earn in the future. And that is why the **Rebalance** approach works so well over long periods of time. We may periodically address new and enhanced risks. For example, two years ago, anticipating increased inflation risk during the pandemic, the **Rebalance** Investment Committee added dividend-paying stocks and Treasury Inflation Protected Securities (TIPS) to most of our client portfolios, given their historic outperformance in inflationary environments. **Rebalance** clients profited as investors flocked to both of these asset classes in the first quarter.

All of us at **Rebalance** hope for peace in Ukraine. In the meantime, we will continue to pay attention to the data, understand the complexity of the situation, relax into the uncertainty and stick with our long-term plan. Please do not hesitate to call your advisor if you have any concerns or questions.




**Source: Dimensional Fund Advisors. Past performance is no guarantee of future results. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.** In US dollars. Data is calculated off rounded daily returns. US Market is represented by the Russell 3000 Index. Largest Intra-Year Decline refers to the largest market decrease from peak to trough during the year.

The **Rebalance** Investment Committee works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the first quarter of 2022, these asset classes performed as follows:

# World Markets Review

## First Quarter 2022

| | US Stock Market | International Developed Stocks | Emerging Markets Stocks | Global Real Estate | US Bond Market | Global Bond Market ex US |
|---|---|---|---|---|---|---|
| **Q1 2022** | **Stocks** | | | | **Bonds** | |
| | -5.28% | -4.81% | -6.97% | -3.81% | -5.93% | -4.05% |
| **Since Jan 2001** | | | | | | |
| Avg. Quarterly Return | 2.4% | 1.6% | 2.8% | 2.6% | 1.0% | 1.0% |
| Best Quarter | 22.0% Q2 2020 | 25.9% Q2 2009 | 34.7% Q2 2009 | 32.3% Q3 2009 | 4.6% Q3 2001 | 4.6% Q4 2008 |
| Worst Quarter | -22.8% Q4 2008 | -23.3% Q1 2020 | -27.6% Q4 2008 | -36.1% Q4 2008 | -5.9% Q1 2022 | -4.1% Q1 2022 |

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net dividends]), Emerging Markets (MSCI Emerging Markets Index [net dividends]), Global Real Estate (S&P Global REIT Index [net dividends]), US Bond Market (Bloomberg US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Global Aggregate ex-USD Bond Index [hedged to USD]). S&P data © 2022 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2022, all rights reserved. Bloomberg data provided by Bloomberg.

## Growth Asset Classes

**Large U.S. Stocks.** Large-cap U.S. stocks fell in Q1 2022 based on fears over continued inflation, tighter monetary policy, and geopolitical uncertainty after Russia invaded Ukraine. Volatility was high during the quarter, with the S&P 500 finishing off 4.9% after being down nearly 13% at the lows of the period. High-dividend paying stocks outperformed based on their historical performance during inflationary periods.

**Small Cap Stocks.** Small company stocks fell in concert with their large company counterparts during the first quarter based on concerns that the Federal Reserve will be increasingly aggressive in its battle against inflation and related economic concerns.

**International Developed Stocks.** Foreign developed markets fell slightly more than U.S. stocks during the first quarter, given Europe's reliance on Russian energy and significant exposure to the detrimental effects of higher gasoline and natural gas prices. Investors favored international high-dividend paying stocks based on the idea that they are resilient in the face of inflation.

**Emerging Market Stocks.** Emerging markets stocks fell during the first quarter as their currencies weakened vs. the dollar, continued COVID-related concerns and geopolitical issues. Russian stocks fell sharply based on sanctions and a collapse in the ruble. Russian stocks were removed from emerging market indexes and related ETFs during the quarter.

**Real Estate.** U.S. real estate investment trusts (REITs) fell during the quarter. Investors continued to favor the yields offered in real estate stocks but were concerned about interest rate and economic sensitivity as borrowing costs rose for the sector.

## Income Asset Classes

**U.S. Government Bonds and TIPS.** Yields on the benchmark 10-year Treasury rose markedly during the quarter, causing prices to fall across all bond maturities. TIPS prices also fell, although they remain positive from a total return standpoint over the last 12 months based on inflation-based price adjustments.

**U.S. Corporate Bonds.** U.S. investment-grade (higher-quality) corporate bond prices fell in the first quarter as interest rates rose and credit concerns negatively influenced pricing.

**High-Yield Corporate Bonds.** U.S. high-yield corporate bonds fell during the quarter based on increased perceived credit risk and rising interest rates.

**Emerging Market Bonds.** Emerging market bonds fell sharply during the quarter as fear of higher U.S. interest rates and a strengthening dollar increased credit concerns for sovereign issuers, who face higher repayment burdens when their local currencies weaken. Like emerging market stocks, EM bonds also were hurt by concerns about Russian sanctions.

**Preferred Stocks.** As a "hybrid" security that is part fixed income and part equity, preferred stocks are influenced by forces influencing both stock and bond markets. In the first quarter of 2022, both stock and bond markets fell based on rising interest rates and economic concerns, meaning both sides of the hybrid equation were under pressure.

## The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.


The **Rebalance** Investment Committee members, April 2022. Left to right: Charles Ellis, Burton Malkiel, Jay Vivian, and Kristi Craig.
**Rebalance** Managing Partners Mitch Tuchman and Scott Puritz are also members of the Investment Committee but not pictured here.

**Rebalance** and its clients are fortunate to have such respected and savvy financial experts guiding key investment decisions.

Professor Malkiel is an emeritus Princeton University economics professor, a former longtime board member of The Vanguard Group, and a highly respected voice in the investment industry. Professor Malkiel has written hundreds of scholarly articles and opinions, notably the investment classic *A Random Walk Down Wall Street*, now in its 12th edition and mandatory reading in economics and finance courses in colleges around the world.

Dr. Ellis was Chairman of the Investment Committee of the famed Yale Endowment, working closely with investment legend David Swensen. He was co-founder and Managing Partner of Greenwich Associates, a consultant to institutional investors. In addition, Dr. Ellis served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide. *Treasury & Risk* named him among the "100 Most Influential People in Finance." In 2010, *Plan Sponsor* gave him its Lifetime Achievement Award. He is on the Board of Directors and Investment Committee of ICMA-RC, which manages more than $40 billion in public sector retirement assets.

Kristi Craig is the most recent addition to the Investment Committee. She is the Chief Investment Officer at the National Geographic Society, overseeing a $1.4 billion endowment. Previously, she was Director of Private Investments for the Georgetown University endowment, currently valued at $2.6 billion. Ms. Craig also led business development for the Small Business Investor Alliance and served as a Senior Investment Officer for the U.S. Small Business Administration.

We thank them for their input and wisdom.

Very truly yours,

Your **Rebalance** Team