Appleton Partners, Inc.

Thoughts on Speculation, Market Integrity, and Investor Trust

Message Board Mania

If nearly a year of health crisis and economic turbulence was not enough, Q1 introduced us to Wallstreetbets, "meme stocks," and seemingly irrational investor behavior. Besides creating headaches for Robinhood, regulators, and those buying at the wrong time or failing to sell quickly enough, is there any enduring meaning to the dizzying price gyrations of once abandoned stocks?

Rest assured that Appleton is not participating in this frenzy, although we are taking notice (while more closely following corporate earnings, inflation, and interest rates). Whether buyers believe in a dramatic digital reinvention of GameStop, are motivated by a "common man vs. hedge funds" narrative or are adherents to the "greater fool" theory, micro stock bubbles have emerged, crashed, and subsequently reinflated. At one point GameStop fell 90% off its peak in short order before partially recovering.[1]

We recognize that this is likely a sideshow to our clients but feel there is broader significance. Speculation is hardly new as the dot com frenzy of the late 1990s demonstrated, although certain stocks' highly unusual trading patterns have raised questions about market stability and even integrity.

The Perils of a Trust Deficit

That which diminishes public confidence in the capital markets is a legitimate concern. Treasury Secretary Yellen apparently feels similarly, as she quickly convened February meetings with the SEC and other top regulators to ensure trading practices "are consistent with investor protection and fair and efficient markets." This is imperative given that an erosion in public confidence would risk compromising the need for Americans to diligently invest for retirement. It remains to be seen whether market manipulation of any kind took place, yet social media promotion has arguably fed reckless retail speculation.

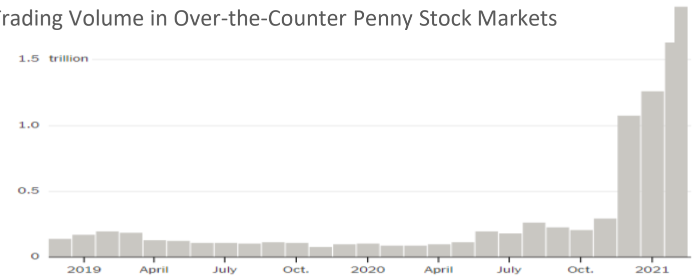
Interestingly, a recent CFA Institute study found that 81% of respondents using an adviser felt they had a fair opportunity to profit from the capital markets, whereas only 57% without an adviser expressed that view.[2] The positive association between professional advice and perceived market integrity is reassuring. However, the same study also revealed a disturbing finding. Among all retail investors, only 46% reported trust in the financial services industry at large, perhaps a legacy of the Great Recession of 2007-2009, and the percentage was even lower among millennials and Gen X investors.[2] Encouraging our clients' younger family members to become confidently engaged in personal finance is a priority of ours given the nature of estate plans and the positive impact it can have on one's financial future.

1. GameStop reached a high of $483 on 1/28, a level that briefly made it the largest capitalization stock in the Russell 2000, after trading below $10 for most of 2020.
2. CFA Institute study, 2020
3. Certified Financial Planning Board, 3/20/21
4. Barrons.com, February 18, 2021

Equities Capture the Popular Imagination

Despite lingering skepticism concerning the financial system, equity participation has surged. More than 10M new brokerage accounts were created in 2020 amid the pandemic.[3] Average daily equity trading volume rose 56% in 2020 vs. 2019 and speculative penny stock trading has sharply increased.[4]

Trading Volume in Over-the-Counter Penny Stock Markets



Source: NY Times, 3/18/21, Financial Industry Regulatory Authority

We see declining barriers to entry and market democratization as positive developments. Empowering new investors is necessary to build savings and retirement security. Yet in today's world of zero commissions and lax leverage constraints, harm can be done to those operating with a casino mentality. Encouraging market participation is desirable, although investor education, discipline and an understanding of risk is also needed.

Foundations of Successful Wealth Management

Appleton Partners strives to build resilient, high trust relationships. Our ability to deliver compelling value depends on how well we understand individual goals, develop personalized recommendations, and actively collaborate. According to Oechsli, a wealth management research firm, clients with $250,000 to $10M of assets reported being more interested in clear and timely communication than investment performance. While both are essential, sustained commitment to a prudent investment strategy becomes more likely when working closely with a trusted advisor. That is why we prioritize portfolio manager accessibility and emphasize sharing commentary and planning insight. Our experience suggests that informed, involved clients are better positioned to reach their wealth management goals.

Take the Long View

Today's headlines will invariably give way to new ones, yet certain fundamentals remain intact, including the importance of long-term asset allocation strategy. We have very limited ability to predict short-term market movements, let alone tomorrow's story stock. The reality is market anomalies and inefficiencies regularly occur. A good defense lies in understanding and controlling risk, as well as letting time and compounding work for you.

Investment discipline is much more valuable than elusive market timing or trend following. We urge clients to temper the influences of daily prognostication. Despite the nature of our digital world, try and tune out the noise. Credible investment strategies are developed by thoughtful analysis of personal needs, not reacting to "horserace" stock coverage, let alone anonymous online recommendations. Ultimately, a well-structured asset allocation strategy coupled with time still represent a proven formula for success.

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q1 focus shifted to the new stimulus plan as well as prospects for a sizeable infrastructure proposal. Coupled with accelerating growth, inflation concerns have risen. Time will tell whether inflation pressures are transient or sustained. Key indicators lie in the direction of Core PCE, which was revised down to 1.40% in March, and wage inflation.
- Despite open market purchases likely continuing into 2022 and an anchored Fed Funds rate, intermediate to long-term yields rose. 10Yr UST yields increased from 0.92% to 1.74% over the quarter, leading to corresponding municipal price weakness.
- As anticipated, the municipal curve steepened in Q1, with 10Yr AAA yields rising 41 bps and 2Yr yields unchanged. An increase in 2-10 spreads from 57 bps to 98 bps now offers intermediate investors more attractive portfolio income.

	12/31/20	3/31/21	QTD change
2-yr AAA Muni	0.14%	0.14%	0 bp
10-yr AAA Muni	0.71%	1.12%	+41 bps
30-yr AAA Muni	1.39%	1.75%	+36 bps

- Throughout this cyclical transition the bid for municipals has remained strong though with +$31.7B of Q1 net flows into tax-exempt funds. Long strategies received over half the cash flows with Intermediate and High Yield funds also solidly positive.
- Sustained pressure on USTs dragged the 10-year AAA Muni/UST ratio down from 77.2% to 64.5% in Q1. Nonetheless, the prospects of higher taxes coupled with better than anticipated credit trends have enabled very favorable municipal market conditions to persist. We believe that 10-year ratios may remain in the 70s for some time.
- Rising yields hurt performance on a duration basis, although improving credit characteristics and demand for yield led lower grade credits to outperform. The Bloomberg Barclays Municipal Bond Index returned -0.35% for the quarter. BBB rated credits led Q1 performance at +1.28% while AAA-rated credits returned -0.90%.
- After a slow start to the New Year, March municipal issuance doubled the same period of 2020. Q1's total of $102.1B was up 7.1% YoY. With sizeable infrastructure investments likely, issuance may get a welcome boost.
- Our anticipated trading range on the 10Yr UST has increased to 1.40 – 2.00% although we see catalysts that could temporarily cause yields to spike above the high end of that band. We are aiming to be duration neutral in our Intermediate Municipal portfolios at about 4.50 years and are targeting high grade issues in a 6 to 12-year range.

Investment Grade Corporates & Treasuries

- Q1 closed with one of the strongest single IG Corporate spread tightening weeks since November 2020. Rebalancing, benign credit conditions and sustained flows helped drive OAS to a cyclical low of 88 bps.
- UST yields reflected concern over inflationary prospects with the 10Yr moving up sharply to 1.74%. Curve structure shifted in a bear steepening move and the 2-10Yr differential reached 160 bps.
- With rates pressured, long duration exposure fared worse than its shorter counterparts and positive excess return from IG credit spread compression was not rewarded in Q1. The Bloomberg Barclays US Corp. Index (8 1/2-year duration) posted a -4.85% return. More modest duration and lower credit quality fared better.
- Looking forward, we expect sustained corporate credit strength given balance sheet fortification, positive economic momentum, and investor demand. We see limited value at the short end of the IG corporate curve, and question whether longer maturities are being adequately compensated. With this in mind, our High-Grade Int. Gov't Credit strategy duration target is about 4 years.

Equities

- A bull market brushed off the above-mentioned concerns in Q1 with the S&P 500 returning +6.2%. All 11 sectors were positive.
- Looking more deeply, evidence of accelerating economic recovery (6-9% US GDP growth is forecast by most economists) fueled outperformance among cyclicals and other economically sensitive sectors. Higher growth, "longer duration" stocks that led the past year's remarkable rally have recently lagged, as an increase in interest rates discounts future cash flow.
- Earnings drive long-term stock performance and sustained momentum is needed given high current valuations. Wall Street consensus is calling for Q1 earnings growth of +23.8%.
- The positives that have driven recent equity returns largely remain intact, although market complacency is on our mind. VIX, a common measure of volatility, has sunk to close to a pandemic low of 20, and investor optimism, a contrarian indicator, is up.
- Our portfolios remain diversified with exposure to cyclical and secular growth, as well as maintaining an aversion to more speculative, deep value stocks.

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ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM