APPLETON PARTNERS, INC.

Reframing Perceptions of Portfolio Risk

Thinking about risk a bit differently can be revealing. Individual interpretations vary which is why applying traditional investment techniques and individualized approaches are both essential parts of the equation. As 2022 unfolds, equity and bond markets enjoy lofty valuations by historic standards, although more speculative risk-taking is finally showing vulnerability. Encouraging clients to embrace constructive risks, a necessary ingredient in building long-term wealth, while avoiding questionable ones is simple in theory yet challenging in practice.

Trend Following Warrants Caution

The financial services industry is nothing if not creative as demonstrated by a recent wave of Special Purpose Acquisition Companies (SPACs). These securities are sold as common stock yet are shell companies set up with the intention of finding a private entity to take public via merger. At last report nearly 600 exist with 47 sporting market capitalizations > $500 mm[1]. Buyers are placing their faith in often opaque entities, perhaps based on confidence in management although that may be a generous interpretation. Regardless, SPACs are hardly alone as they jostle for investor attention with cryptocurrency[2], "meme stocks," and even esoteric instruments such as NFTs. "Fear of missing out" can be a dangerous motivation, as many learned two decades ago from a dot com bust that saw NASDAQ fall by 77%. The line between prudent, long-term investing and impulsive speculation can be blurry.

We seek to help clients optimize the right risks, not arbitrarily reduce them, yet how much and what type of risk is optimal? It ought not surprise anyone that our answer is "it depends." The challenge of developing sustainable asset allocation plans requires first evaluating a client's goals, time horizon, risk capacity, and risk tolerance.

Dampening the Downside Can Facilitate Opportunity

All risk-seeking markets introduce volatility, although tools such as portfolio diversification can have a mitigating influence. Stocks, bonds, real estate, commodities, and cash each offer distinct risk profiles and performance patterns. As conditions change, the positive performance of one asset class can offset the potentially negative returns of another, creating a more efficient portfolio. Individual holdings also introduce security specific risks and diversifying by number of holdings, market capitalization, style, and risk factors can reduce the impact of such idiosyncratic risks on overall portfolio volatility.

Widening the opportunity set also introduces new sources of capital appreciation and income. For example, the S&P 500 lacks exposure to small cap stocks, emerging markets, and other potential alpha drivers. Alternatives such as fund-of-funds, single manager hedge funds, or private equity offer an even wider range of exposures.

Too Much of a Good Thing?

As with many other beneficial endeavors, risk mitigation efforts can become counterproductive if not well calibrated. For one, excessive diversification can dilute alpha generation, or the ability of a manager to add excess returns above a benchmark. Owning too many stocks or funds minimizes the value of security selection, a product of poor execution rather than a flaw of diversification itself. Conviction matters, and we caution against paying active management fees to effectively own the market, which is why our equity strategies are typically limited to 40-45 names. Investors seeking to cost efficiently gain broad market exposures can do so through indexing, or hybrid strategies such as BetaCore.

Approaching Risk Management with an Institutional Mindset

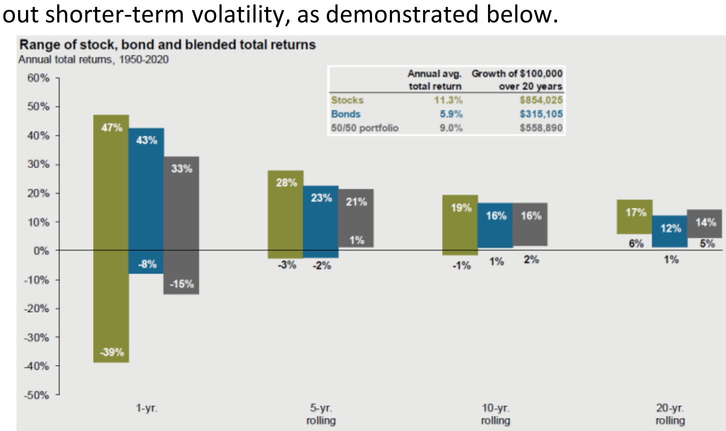
Institutional managers often model each asset class's contribution to total portfolio risk rather than measuring it solely in isolation, a process known as risk budgeting. Expected contribution to risk is allocated by asset class with the objective of maximizing a portfolio's total return given a targeted overall risk level.

We feel risk budgeting has applicability to private clients, not just institutional investors. Shying away from asset classes such as a growth stocks may appear to dampen downside volatility, but at what cost to long-term performance? Not meeting future retirement, healthcare, or other needs is of equal concern. What makes more sense to us is identifying future liabilities and/or asset goals and then combining investments in a manner aimed at getting there over a defined time horizon as risk-efficiently as possible. For example, income-producing assets such as bonds, REITs, fixed annuities, or private pensions can help meet future income needs, and offers relatively low correlation to equities. Adding such exposures allows a greater allocation of one's risk budget to be deployed in capital appreciation-focused equity strategies, thereby enhancing overall risk-return efficiency.

Back to Basics

Capitalism dictates that markets and individual security prices will fluctuate. Many factors exert short-term influence, yet quality has stood the test of time and helps separate value from hype. Buying stocks and bonds with compelling intrinsic value, and subsequently diversifying away a degree of security specific risk, is a key ingredient in building fundamentally sound portfolios.

We also emphasize making time your ally. Staying invested long term in quality stocks and bonds has proven to be effective in smoothing out shorter-term volatility, as demonstrated below.



Source: Barclays, Bloomberg, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management

Every day we assume risk in many aspects of our lives. As wealth managers, we seek to develop a comfortable approach to managing it that also maximizes the likelihood of our clients' achieving their financial objectives. Embracing prudent risks backed by fundamental analysis and the benefit of time is a good place to start.

1. StockMarket MBA, as of 1/3/22
2. 20-year naming rights to Staples Center were recently sold to Crypto.com for $700 million.

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Market Observations & Implications

Tax-Exempt Investment Grade Municipals

- The second half of 2021 was marked by supply chain issues, inflationary pressures, and two new COVID strains. Taper discussions pushed rates higher in Q3 although the actual Q4 announcement led intermediate to longer rates lower.
- The conversation quickly turned to how many times the Fed will raise rates in 2022, with a current consensus of three hikes beginning in March. This put upward pressure on USTs and the front end of the muni curve.
- The muni curve flattened over Q4 as 10-year AAAs dropped 11 bps and the 2-year was up 7 bps. This brought 2 to 10-year AAA muni spreads to 79 bps, down from 97 bps on 9/30.

	9/30/21	12/31/21	QTD change
2-yr AAA Muni	0.17%	0.24%	+7 bps
10-yr AAA Muni	1.14%	1.03%	-11 bps
30-yr AAA Muni	1.67%	1.49%	-18 bps

- Another $13.3B of inflows came into mutual funds in Q4 bringing total 2021 flows to a record-breaking $101.7B. Flows should remain strong over the first half of 2022 although they could dry up if rate increases substantially exceed expectations.
- Despite a strong end of Q4, total 2021 issuance fell 2% vs. 2020's record level. Taxables declined from 30% to a still sizeable 25%. This was more than made up for by a $40B increase in tax-exempt new money issuance, which rose from 57% of total issuance to 66%. Expectations for 2022 municipal issuance average $480B, creating potential for a record-breaking year.
- The Biden Administration was able to push through an infrastructure bill in 2021 but has not garnered the votes for Build Back Better. Should the bill be revitalized, the SALT cap of $10,000 cap may increase, as suggested by an initial $80,000 proposal. We are watching this closely as a change of that magnitude could negatively impact demand for municipals.
- Strong demand and limited supply kept muni/UST ratios tight, with the 10-year ratio closing 2021 at 68.2%. Market technicals should continue supporting below average ratios and such tight levels may produce price volatility as rates increase.
- Municipal performance was largely flat in 2021 despite rising yields while USTs and most taxable markets were down. Credit and long duration outperformed, while short maturity segments lagged.
- Credit spread tightening continued in 2021. BBB-rated credits tightened 39 bps vs. AAAs, while A rated paper tightened 10 bps. We could see further credit spread tightening among lower grade issues, although we remain cautious with A rated credits.

Investment Grade Corporates & Treasuries

- IG credit closed December tighter by 8 bps after much handwringing about Fed policy guidance. The Bloomberg Barclays IG Corporate Bond Index ended 2021 at an OAS of 92 bps. We anticipate slight spread widening in 2022, although market action should be orderly given sustained demand and favorable credit conditions.
- December IG corporate issuance hit an all-time high of $61B with offerings well received. Despite some rate pressure, conditions are still strong, and we anticipate a 2022 calendar similar to 2021's $1.41T of new supply.
- The $123B of IG Credit fund flows through Q3 came with limited credit spread volatility and positive risk sentiment. Year-end rebalancing, a surge of COVID uncertainty, and a strong hawkish tone from the Fed led to late Q4 outflows and an overall flat quarter. We feel sentiment is likely to rebound early in 2022.
- Notes from the Fed's Dec. 14-15 meeting emphasized earlier and faster rate increases. The Fed is also likely to begin to shrink their swollen balance sheet. USTs are reacting accordingly with the 10Yr spiking nearly 30 bps from 12/1 through the first week of January.

Equities

- The S&P 500 gained 11% over Q4, extending its current quarterly win streak to 7. The index finished the year with a total return of +28.7%. Interestingly, the S&P 500 has averaged a +11.3% return after +20% years, along with a 70% positive batting average.
- Despite handwringing that the market has gotten too top-heavy, the equal weighted S&P 500 finished slightly ahead of its more popular market-cap weighted counterpart at +29.4%. All 11 sectors posted double-digit gains, a first in the index's history.
- Investors have been able to shrug off record COVID cases as the Omicron variant appears less severe and hospitalizations have decoupled from infections. We will be monitoring the potential impact to the economy though given potential employment effects and the possibility of further government restrictions.
- Positive drivers heading into the new year include easing supply chain constraints, strong consumer demand, negative real rates, still easy financial conditions, expected corporate profit growth of 8-9% on strong margins, and fortified corporate balance sheets that may facilitate higher dividends, buybacks, and M&A activity.
- Along with a lingering pandemic, risks include Fed rate increases, the removal of historic levels of monetary and fiscal support, persistent inflation, elevated valuations, and geopolitical concerns.

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