APPLETON PARTNERS, INC.

Managing Market Emotions and Biases

"Be fearful when others are greedy, and greedy when others are fearful" -Warren Buffett

Warren Buffett's contrarian investment philosophy likely resonates with many who embrace a value-oriented mindset. While there is inherent logic in this time-tested recommendation, adhering to advice of this nature presents practical challenges. Sticking with an asset allocation strategy and rebalancing into risk assets during downturns is often the right approach, although doing so can be easier said than done.

The past three years have offered yet another stress test in our ability to deal with volatility. Those who sold under duress in early 2020, or later chased highly speculative momentum plays, risked compromising long-term returns. Volatility has clearly returned in the face of high inflation, rapidly tightening monetary policy, Russia's invasion of Ukraine, and a very shaky global economic outlook. In this environment, helping clients avoid overly emotional reactions to turbulence is not easy, although gaining emotional insight can reduce the likelihood of doing the wrong thing at the wrong time.

The Roots of Investor Psychology

At their core, markets are a function of fundamentals and psychology. Last year we wrote about communication, understanding risk tolerance, and generational and experiential distinctions that influence investors. Let's now focus on the difference between emotional biases and cognitive biases, as this may be useful in recognizing potential influences on one's investment mindset.

Emotional biases involve basing decisions on individual perceptions and feelings that may cloud judgment. A few common ones include:

- **Herding** - crowd following, or buying what is popular without fundamentally based reasons;
- **Loss aversion** - a strong reluctance to acknowledge a mistake by realizing a loss;
- **Overconfidence** - excessive belief in one's expertise in a given area;
- **Endowment bias** - overvaluing what you are familiar with.

Recognizing the extent to which you may be susceptible to various emotional pitfalls does not eliminate their influence, although considering these factors in dialogue with your portfolio manager can lead to better long-term decisions.

Cognitive biases involve decision-making based on preconceived notions that may not be accurate, such as:

- **Anchoring** – focusing on a reference point such as what you paid for a stock rather than what it may actually be worth;
- **Recency bias** – excessive attention paid to the most recent information received regardless of its relevance;
- **Confirmation bias** – seeking out information that suggests one is correct in an opinion and overlooking contradictory information;
- **Small sample fallacy** – drawing conclusions from potentially insignificant data points.

Cognitive biases can shade the perspective of both portfolio managers and individuals making their own investment decisions. Here too, mitigating their potentially harmful impact demands first recognizing our underlying thought process.

Step Back to Gain Broader Perspective

Warren Buffett has long advised investors to think of common stock shares as pieces of businesses to own over the long term, not as objects to be traded. At Appleton, our equity research process evaluates stocks with this in mind and looks at factors such as sustainability of a business model as well as valuation rather than focusing on tactical trading. We seek to mitigate analyst biases in part by bringing stock recommendations to the Equity Investment Committee before names are approved.

Self-awareness is a valuable trait, and we admit to not having unique market timing expertise. Instead, our equity investment process relies on proprietary research to minimize the influence of emotion or overly short-term thinking. We look for opportunities to purchase or add to stocks our team likes on a fundamental basis when the market gives us an ability to do so at attractive prices. Capital markets history has long demonstrated that a company's market price tends to fluctuate much more rapidly than its business prospects. In essence, short-term perceptions are usually more volatile than long-term business value, a dynamic that speaks to the need to stay grounded during challenging periods while also not abandoning risk constraints during speculative times.

Most importantly, each client's asset allocation plan serves as a foundation around which investment strategy is developed and employed. Unless there is a compelling reason to adjust course, staying with a well-designed, risk-managed plan is a good way to reduce the risk of emotions and biases clouding investment judgement. In fact, it may come as a surprise that half of the S&P 500's best days over the last 20 years have come during bear markets.

A Personalized Approach

When working with clients on investment strategy, our Portfolio Managers first attempt to set expectations. In our experience, goals-based planning makes investment strategy more tangible and less susceptible to emotion. Communication is also essential, which is why we emphasize collaborative, accessible client service.

Like any other aspect of psychology, individual responses to market stress differ considerably and some investors struggle with turbulent markets more than others. "Tuning out the noise" is a challenge for many, but one that we feel can be mitigated by better understanding your investment psychology, falling back on a disciplined, risk-based asset allocation plan, and working closely with your Portfolio Manager. We're here to help in any environment, so please do not hesitate to reach out with questions or concerns.

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q3 began with a short July rate rally that quickly turned after a strong jobs report and another high CPI reading. The Fed's hawkish tone drove the 10Yr UST to 3.83% by quarter-end, +125 bps relative to the 8/1 low of 2.58%.
- Municipal yields followed USTs with 10-year AAAs finishing Q3 at 3.30%, +111 bps off the quarterly low. Rate hike concerns led the front end to rise even higher as the curve flattened.

	6/30/2022	9/30/2022	QTD change
2-yr AAA Muni	1.95%	3.09%	+114 bps
10-yr AAA Muni	2.72%	3.30%	+58 bps
30-yr AAA Muni	3.18%	3.90%	+72 bps

- The Fed increased rates by another 75 bps after both Q3 meetings, bringing Fed Funds to 3.00%-3.25%. CME Fedwatch is pricing in 2 more rate hikes and a 4.25%- 4.50% year-end level.
- Yields across the municipal curve have priced in these rate hikes in our view. We expect weakening economic indicators to cause the Fed to pause after December and the curve to steepen.
- Municipals have settled into fair value territory with the 10-year AAA Muni/UST ratio of 84% close to 30-year averages.
- YTD mutual fund net outflows of $91.5B represent the largest negative cycle since data tracking began in 1992. Over 52% of outflows are from Long Term Funds with Intermediate accounting for 25%.
- Credit spreads tightened slightly in Q3. A rated spreads of 44 bps are attractive relative to the 2021 and 2020 averages of 27 bps and 34 bps. We are building A rated exposure where we see credit and market value.
- A large drop off in taxable refunding led to a 26% YoY decline in Q3 municipal issuance. Most new deals in the 1 to 15-year range remain oversubscribed and we are accordingly increasing our secondary market activity.
- Municipal repricing has created an ability to reinvest income and new cash flow at significantly higher yields and we feel income and total return potential is more favorable than any time over the past decade. We see the greatest value in 9 to 12-year issues.

Investment Grade Corporates & Treasuries

- IG Credit spreads still face headwinds spurred by recession fears, inflation, and growth concerns. After tightening in August, spreads retreated to only 4 bps away from where Q3 began.
- The IG primary market was lumpy in Q3, and September issuance fell 50% short of market expectations. Trading volatility and higher rates drove funding costs to levels not seen since 2009 and concessions have remained well above average.
- Supply limitations and generally sound credit fundamentals have helped keep spreads range bound, although lack of buyer conviction continues to produce volatility swings.
- Investors redeemed just over $32B of IG mutual fund assets in Q3, culminating with a $10.3B redemption week to end September. YTD net outflows stand at $100.3B and we feel outflows are likely to continue over the near term.
- A hawkish Fed has put enormous pressure on the front end of the UST curve leading to sustained inversion. Anticipation of these hikes pushed 3M bills higher by 160bps to 3.27%, while 2-year paper climbed 132 bps to 4.28%. By contrast, 30-year bonds rose by only 59 bps to 3.78%. With our Q4 UST trading range at 3.25%-4.00%, we do not anticipate significantly higher UST yields.

Equities

- Equities remained under considerable pressure in the face of rising rates and recession fears, as the S&P 500 fell 4.88%, marking the first 3-quarter losing streak since 2008. Weakness was broad-based with all eleven sectors declining.
- Volatility is likely to remain elevated as the markets digest economic data, the trajectory of inflation, interest rate expectations, and fluctuating risk appetite.
- Wall Street analysts have lowered Q3 earnings expectations by the widest margin (down 6.8% from 6/30) since 2Q 2020. Lower expectations could lead to positive earnings surprises.
- Unsettled markets can also create good long-term buying opportunities, and our research team is looking for companies with strong balance sheets, healthy free cash flow, earnings power in the face of a weaker economy, and reasonable valuation.
- Optimists can point to the upcoming midterm elections as a potentially positive catalyst. Strategas reports that the S&P 500 has posted a positive Q4 return in 19 of the past 23 midterm election years, and 9 of the 11 midterm years in which the Index was negative going into elections.
- It bears repeating that staying invested is much more effective than trying to time the market, provided one has an adequate risk tolerance and time horizon. Half of the S&P 500's best days over the past 2 decades have occurred during bear markets.

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