Building Strength Through Diversity

According to Fundera, diverse companies are 35% more likely to outperform, while diverse teams are 70% more likely to capture and penetrate new markets.

Source: "How Diversity Can Help With Business Growth", Forbes

Human capital lies at the heart of business as well as society at large, and maximizing employee opportunity, motivation, and productivity has been a staple of organizational behavior for decades. The subject of **diversity, equity, inclusion, and belonging ("DEIB")** transcends academic analysis and has recently taken on a heightened cultural focus. Setting politics aside, and today that can be a considerable ask, enhancing DEIB attributes in the workplace is an aspiration most likely support. However, defining what it means and implementing actionable solutions is much more challenging.

We chose this as a quarterly theme given the prominence of these issues not only in professional circles, but also in our communities. As a business, we strive to exceed client expectations and thrive in dynamic, competitive markets. Sustaining excellence demands attracting, developing, and retaining the best possible range of talent while forging these unique individuals into a cohesive team. That leads to a difficult question – what does DEIB really mean? Lacking absolute definitions, here are our interpretations.

- We see **diversity** as representation that can be measured through many lenses, including gender, race, ethnicity, religion, and national origin just to name a few. It refers to the extent to which we can coalesce various backgrounds, identities, and perspectives into a stronger collective whole.
- Equal opportunity remains a much broader societal challenge, yet viewed somewhat narrowly, **equity** is about ensuring we maintain an unbiased, adaptable, and supportive environment for all employees, as well as our clients and business partners.
- We interpret **inclusion** as creating a culture in which individuals are given a seat at the proverbial table and can have their voices heard.
- **Belonging** in a business environment references how individuals feel about their work and the extent to which they are supported and emotionally invested.

Many studies have tried to assess the impact of DEIB on corporate performance, and once you weed through a surplus of data, positive indicators seem evident. Building and operating an organization comprised of many distinct backgrounds and perspectives is not only the right thing to do, doing so enables us to better serve clients. A great deal of objective data supports that belief.

A study conducted by Harvard Business Review in 2018 found that "companies with above-average total diversity, measured across an average of six dimensions . . . had 9% higher EBITA (earnings before interest, taxes, and amortization) margins and 19% higher innovation revenues on average."[1] Thinking about why this might be the case, it strikes us that considering a broad range of input when making decisions of any kind is often beneficial, as overly narrow insights that tune out valuable contributors can be limiting.

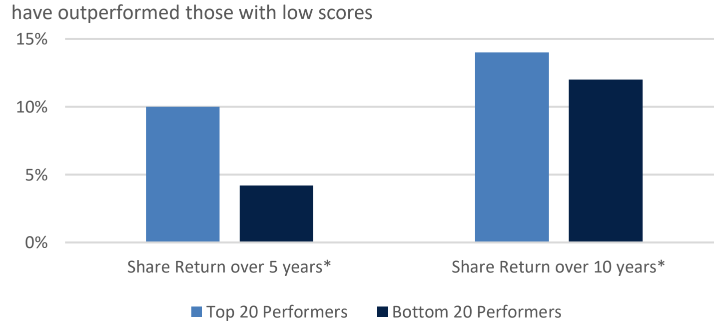
Three years later, Harvard Business Review surveyed over 19,000 business leaders and found that one characteristic more than any other differentiated more diverse and inclusive organizations - an open-minded, learning-orientated culture.[2] The data strongly suggested that companies cultivating an environment encouraging diverse input demonstrate better decision-making and greater innovation.

So, even if one embraces these aspirations, how might organizations proceed? McKinsey & Co. argues in a recent post, "Why Do Some DEIB Initiatives Work,"[3] for starting by defining specific objectives rather than simply initiating DEIB related activities out of a desire to show activity. After thinking through goals of our own, Appleton decided to focus on trying to recruit as wide a range of talented professionals as possible; ensuring all our employees are empowered to learn and grow in their careers; and identifying and addressing unique client needs influenced by characteristics such as gender.

We recently offered initial thoughts on our website, although an endeavor of this nature will admittedly always be a work-in-progress. There are no easy solutions to DEIB challenges, yet we believe that striving to make progress will be productive for our employees, clients, and business. By fostering an environment of diversity, we seek to broaden our talent base and enhance our ability to deliver exceptional services aligned with clients' personal circumstances.

Diversity & Market Returns

The stocks of companies that performed higher in diversity scores have outperformed those with low scores



*Average compounded annual stock return data is for 5 and 10 years ended 6/28/19
Source: WSJ environment, social and governance research analysts

1. Harvard Business Review, "How and Where Diversity Drives Financial Performance," 1/30/18
2. Harvard Business Review, "What Inclusive Companies Have in Common", 6/18/21
3. McKinsey & Co., 1/13/23

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Municipal yields followed UST yields lower over the last month of Q1, as the 10Yr AAA Muni rallied in the face of Silicon Valley Bank's implosion to finish at 2.27%, 36 bps lower than year-end.
- Front-end curve inversion remains with a negative 27 bps spread between 1 and 5-year AAAs. The spread between 2s and 10s dropped from 3 bps at year-end to -11 bps on 3/31.

	12/31/22	3/31/23	QTD change
2-yr AAA Muni	2.60%	2.38%	-22 bps
10-yr AAA Muni	2.63%	2.27%	-36 bps
30-yr AAA Muni	3.58%	3.30%	-28 bps

- The Fed increased rates 2 more times in Q1, bringing Fed Funds to 4.75-5.00%. CME FedWatch is now pricing in 1 more rate hike at the May meeting. Should this be the end of the hiking cycle, today's inverted yield curve would likely reverse itself.
- Strong municipal demand has led to higher prices and lower yields relative to high grade taxables. The 10-year AAA Muni/UST ratio traded in a mid-60% range for much of Q1 and we anticipate a 65% to 75% range for the foreseeable future.
- Market turbulence prompted renewed fund outflows in March, raising Q1's net to -$1.7B, although this pace is far below that which produced -$122.6B for all of 2022.
- YTD municipal issuance of $75.5B is 27% off 2022's pace. UST volatility has been a contributing factor along with the Fed's hiking cycle. The Street has been quick to cut expectations, most notably B of A reducing their 2023 target from $500B to $400B. Reduced issuance and persistent oversubscription has created a need to find bonds via bid lists and in the secondary market.
- Curve inversion has led us to increase selling in the 4 to 7-year maturity range given higher 1 to 3-year yields. Our front-end exposure is greater than is typically the case and we are balancing some short positions by buying more 9 to 12-year maturities.
- Q1 performance was driven by duration and lower grade credit spread "carry." The 22+ year index was the top performer at +5.92% while the 1-year index returned only +1.26%. Credit outperformed as the "BBB" rated segment returned +4.85% QTD.
- Our 2023 UST yield expectation is 3.25%-4.00% and our Intermediate portfolios are being managed with a 4.60 to 4.70-year duration target.

Investment Grade Corporates & Treasuries

- The Fed remains laser focused on battling inflation without creating too much damage to the labor market and overall economy. Both show signs of slowing although the Fed Funds Rate rose again by 25 bps in March to 4.75-5.00%, just shy of our 5.00-5.25% target for the remainder of 2023.
- After a benign start to 2023, markets were jolted by a March flight to quality. The 2Yr UST ended Q1 at 4.02% after hitting a high of 5.07%, and investors betting on higher yields rushed to cover in a sudden "risk off" environment.
- Pressure on regional banks and concerns about liquidity created considerable spread volatility. The OAS within the sector began March at 127 bps and climbed as high as 187 bps before receding to 164 bps. Our longstanding preference for US Global Systemically Important Banks (GSIBs) rather than regionals was rewarded amid recent developments.
- IG primary market issuance lagged expectations by $30B in Q1, with March alone ($100B of new debt) falling short by 30%. Conditions were choppy, but those willing to navigate uncertainty were rewarded with limited new issue concessions and oversubscribed deals. Secondary market performance was also largely solid.
- We view IG Credit conditions favorably outside of the areas most directly impacted by banking turbulence and are eagerly seeking out new offerings and secondary market supply that meets our credit and relative value criteria.

Equities

- Stocks closed higher in Q1 as the S&P 500 enjoyed its best January since 2019 (+6%) before closing at +7.0%. The Nasdaq, last year's laggard, got off to its best start since 2001 at +16.8%. The DJIA, 2022's leader, posted a much more modest + 0.4% gain.
- Sector performance was mixed in Q1 with four sectors in the red, including the defensive Utilities and Health Care sectors. Financials were the laggard amid March's banking crisis and Energy wasn't far behind with crude oil -5.7%. Technology, Communication Services, and Consumer Discretionary were outperformers.
- Fed Funds hikes slowed to 0.25% at the February meeting although Chairman Powell reiterated a "higher for longer" message that subsequently pushed up short rates and flattened the curve.
- Growing anticipation of a Fed pause sparked a sharp rotation into growth names, with the NYSE FANG+ Index gaining 39%. Large growth's advantage relative to large value is likely to hinge on the path of interest rates, as moderation should favor growth.
- Stocks face several risks including stubborn inflation along with the Fed's commitment to reign it in, a softening economy, and impending debt ceiling drama.
- As always, we are highly focused on earnings, and estimates are softening. The extent to which companies can beat these expectations will influence near term market performance.

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