APPLETON PARTNERS, INC.

Diversification & Risk: A Deeper Look Can Be Revealing

Atisa Dipamkara, a revered 11th century Buddhist philosopher, once said, "The greatest wisdom is seeing through appearances." His insight into looking beyond first impressions resonates in today's investment world. While diversification has long been touted as a means of mitigating risk, we recognize that it is far from solely determined by the number of securities held in an index or portfolio. In a media landscape consumed by daily market performance updates, we thought it would be useful to look beneath the surface of common stock market indices.

Risk Analysis Ought To Be Personalized

As private wealth managers, we seek to develop risk efficient asset allocation strategies in a manner that addresses our clients' unique financial goals. The liability side of that equation involves personal circumstances and needs, whereas the composition and mix of investment assets in a client's account reflect portfolio management decisions. For many years, stock investors have embraced index investing, whether through mutual funds, ETFs, or direct indexing. Low costs and defined market exposure are certainly valuable attributes, and at times we complement our own active management with index ETFs that deliver specific sector or asset class coverage.

What's Behind Your Index?

Our commentary often references factors such as breadth and style when discussing market conditions, as widely reported market performance would benefit from greater context. For example, the largest components in a capitalization weighted index such as the S&P 500 can have a disproportionate influence on aggregate returns, as do the highest price stocks in a 30-stock price weighted index such as the Dow Jones Industrial Average (DJIA). When looking at equity market proxies, a relatively small subset of names often drives a considerable amount of overall performance and accompanying risk exposure. In fact, only 8 names, 1.6% of the stocks in the S&P 500, accounted for 75% of the index's YTD return as of June 30th. Turning to the DJIA, information technology has produced more than 100% of the overall YTD return. In other words, the DJIA would be down this year if excluding that single sector.

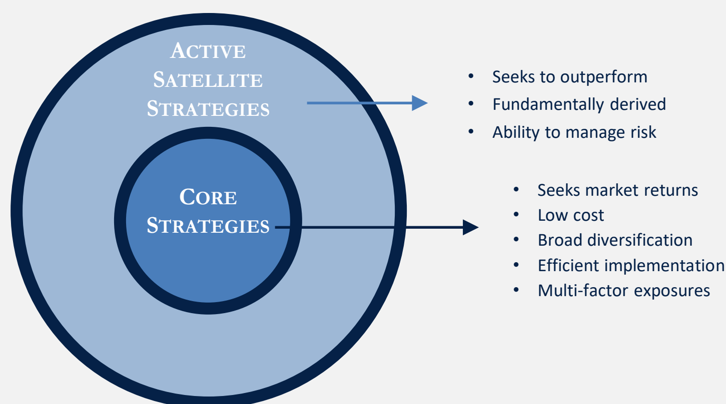
By no means does that mean owning popular mega cap names or others with strong momentum is a bad thing. The point is that the risks an investor assumes, whether derived from individual stocks, sectors, or styles, can be more concentrated than may be apparent at face value. Portfolio returns can be heavily influenced in either direction by narrow, not readily transparent exposures even when holding a seemingly highly diversified index, and simultaneously owning those same stocks in individual accounts or through mutual funds further concentrates risk.

Finding the Right Asset Allocation Fit

When evaluating a client's risk profile and asset allocation strategy, we take a holistic approach grounded in individual circumstances. Variables such as cash flow requirements, long-term liability planning, time horizon, and ability to withstand downside volatility all weigh heavily. For many investors, an investment approach that combines the potential of active management to add diversification and excess returns with the ability of passive indices to deliver broad, low-cost exposures may have considerable appeal.

Furthermore, more narrowly focused strategic beta ETFs offer access to risk factors such as size, value, quality, profitability, and momentum that may be beneficial in an asset allocation context. Our proprietary BetaCore asset allocation models were developed with those characteristics and attributes in mind. Through a "core and satellite" investment approach, BetaCore aims to deliver tailored asset allocation solutions that efficiently address long-term performance objectives while carefully managing risk.

There is no single optimal investment solution given the unique nature of individual needs. At its core, we view asset allocation strategy as a roadmap to pursue an investors' financial goals in a risk conscious manner. Developing and implementing such a gameplan greatly benefits from first knowing what you own, including where performance drivers and risk exposures lie, as managing volatility is more challenging than merely holding an index fund or other portfolio with many stocks. Because "the market" may not always be what it appears at first glance.



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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- As the Q1 flight to quality trade simmered in early April, signs of economic strength drove UST and ultimately municipal yields higher over the remainder of Q2 and into early July after hawkish post-Fed minutes were released.
- Front-end municipal curve inversion steepened with the spread between 1-year AAAs and 5-year AAAs reaching -43 bps. Inversion is driven by expectations for more Fed rate hikes, although we feel that the terminal rate is only 1-2 hikes away.

	3/31/23	6/30/23	QTD change
2Yr AAA Muni	2.38%	2.93%	+55 bps
10Yr AAA Muni	2.27%	2.56%	+29 bps
30Yr AAA Muni	3.30%	3.49%	+19 bps

- Strong technicals have driven municipals valuations higher relative to USTs and taxable. This is perhaps best measured by the 10Yr AAA Muni/UST ratio which ended Q2 at 66.67%. We expect valuations to be sustained over July and August but anticipate some back off in September with a 65-75% range likely in the foreseeable future.
- Municipal issuance in 2023 is still trailing 2022 levels and dealer expectations have been reduced to $350-375B from $425-450B at the start of the year. YTD issuance of $174.8B is off 20% vs. 2022.
- Strong demand and limited issuance is fueling new issue oversubscription. Bid-wanteds for high quality specialty state names such as CA, MA, and NY are trading very tight.
- With yields drifting higher in Q2, longer duration bonds began to hurt recent performance, although for the year duration and credit have outperformed. The “BBB” rated segment of the market has returned +4.45% YTD, while the “AAA” rated segment returned +2.08%. Resource Recovery, Tobacco, Hospital and Lease bonds are the best performing sectors YTD.
- In Intermediate portfolios, we are finding value in the 9 to 12-year part of the curve, while front-end inversion has also made 1 to 3-year bonds attractive.
- Our UST trading range for the remainder of 2023 is 3.25%-4.00% with current levels at the upper end of that range. We maintain a duration target on Intermediate portfolios of 4.60-4.70 years.

Investment Grade Corporates & Treasuries

- After a relatively benign start to Q2, IG Credit spreads began to compress in mid-May. An 8bps rally over the last few trading days of June allowed OAS to close at 123bps, not far off the YTD low of 115bps.
- Vibrant market conditions reflect consumer resilience, healthy economic data, and rebalancing after an extended equity rally. We feel that spreads have likely settled in close to a near-term bottom.
- Volatility kept many IG primary market issuers on the sidelines in Q2, although a strong finish allowed June’s $91B of issuance to beat expectations. We expect tight net new supply to remain a factor in keeping spreads range bound during Q3 and Q4.
- Several factors have allowed the US IG Corporate market to remain on firm footing. Most notably, corporate balance sheets are generally quite healthy, and a strong labor market has helped bolster consumer spending. A market that was pricing in an imminent recession at the start of the year now has a much more sanguine outlook.
- Although High Yield has been a strong performing asset class, we believe a high-quality focus is still warranted. Our IG bond selection emphasizes large issuers with the financial strength and trading liquidity needed to weather a potential downturn.

Equities

- Stocks continued to rally in Q2 as all major indices added to their Q1 gains. The S&P 500 closed at a 52-week high and with a +8.3% quarterly gain that increased YTD total return to +16.9%.
- Nasdaq returned +32.3% over the first half given its concentrated exposure to mega cap tech winners. The FANG+ Index, comprised of companies such as Apple, Microsoft, NVIDIA, Tesla, and Meta, has returned a whopping +74.2% YTD.
- Only 3 out of 11 S&P 500 sectors (Technology, Consumer Discretionary, and Communication Services) outperformed the index in Q2, leading a historic style tilt towards growth. The Russell 1000 Growth outperformed its Value counterpart by 8.7% (+12.8% vs. +4.1%), extending the YTD gap to nearly 24% (+29% vs +5.1%).
- In aggregate, all of 2023’s gains can be attributed to valuation expansion as forward EPS estimates have only modestly contracted despite the value of the index increasing 15.9%. This leaves the S&P 500 trading at ~19x forward earnings, more than 2 points higher than at the start of the year. We are closely monitoring earnings as they must justify current valuations.
- Equity market tailwinds include a better-than-feared Q1 earnings season, growing hopes for a soft economic landing, disinflationary pressures, depressed sentiment, and optimism surrounding artificial intelligence.
- Risks clearly remain though, such as the potential for Fed policy error, declining money supply, yield curve inversion, lingering recession risks, corporate margin pressure, and ever-present geopolitical concerns.

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