Think Twice Before Changing Lanes

Traffic is an inevitable part of urban American life as those of us who frequent highways in Greater Boston or most other metropolitan areas know all too well. Apologies for raising an irritating topic, but we feel there are useful parallels to be drawn between driving and investment decision-making.

Perception in both realms is often distinct from reality as emotion can distort our interpretation of information. How often on traffic choked highways have you observed the adjoining lane appear to be less congested and changed lanes only to quickly come to a stop as those previously behind you move ahead? Social scientists have studied the phenomenon and offer a compelling rationale.

When assessing the lane to our left or right while stopped or travelling very slowly, people tend to focus their attention forward and overly emphasize a very temporary or even insignificant perception that others are advancing more rapidly. The inference is that drivers are responding to somewhat of an illusion; namely, that the next lane on a congested road is preferable even when traffic flow over a more meaningful period averages the same speed.

The punch line is that impulsive, reactionary moves are often counterproductive. As wealth advisors, we stress this to clients but fully recognize that emotion makes us human, and it isn't always easy to stay put when experiencing market related stress. Let's look at a couple of psychological explanations for why some are prone to abruptly switch lanes and/or asset allocation strategies.

Recency bias is a cognitive tendency to place much more emphasis on recent events than past ones regardless of their relative significance. When driving, you are likely to overweight the most recent thing you see, specifically cars passing you to the right or left, and believe that is likely to continue. When investing, people often overvalue short-term performance trends, which is why asset flows typically gravitate towards "hot" mutual funds, stocks, or sectors. Chasing cars or performance is not advisable as it may be illusory and risks backfiring. The reason is that more cars moving towards one lane itself generates traffic slowing congestion, just as performance chasing can introduce greater risk by inflating valuations to the point where a subsequent sell-off becomes more likely.

Whether recognized or not, many of our daily decisions factor in expectations of risk relative to anticipated benefit or return. That's why we develop asset allocation and portfolio strategies with a clear sense of both a client's goals and their willingness and ability to accept risk. Overreacting to short term developments without fundamentally based rationale, whether by joining the herd or by impulsively selling during unsettled times, can create opportunity cost (foregone market gains) or portfolio risk (loss of capital). A prominent academic study offers confirming evidence of that point, finding that over a 26-year period average 3-year forward mutual fund returns were inversely related to the same funds' prior 3-year performance decile. In other words, there is a meaningful cost to chasing what appears to be the hot performer.[1]

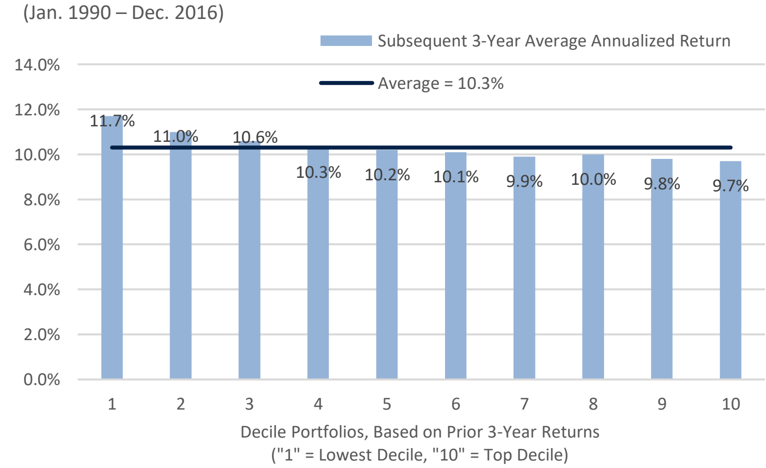
Unfortunately, risk analogies also apply to our highways as data suggests that jumping off course can result in much more severe potential consequences than traffic. Even if one is to assume that lane changers get to their destination a little sooner, is it worth the risk? Perhaps not. According to Insurance Information Institute, reckless lane changes create 9% of all US accidents and directly factor into the deaths of 6,000 drivers annually.[2]

By no means are we suggesting that asset allocation ought to be on autopilot. Active management drives our investment process, and we will make portfolio adjustments as market conditions change and opportunities present themselves. We believe that wealth management ought to be highly personalized and recognize that individual needs and objectives evolve over time. The distinction we make, though, is between impulsive and well-grounded, fundamentally sound decisions.

Think about it in terms of the difference between relying on roadside traffic intelligence provided by Waze and reacting in frustration to what you momentarily see on the highway to one side or another. When risk tolerance, income needs, tax situations, or liability planning changes, portfolio strategy may need to adjust in response. But we rely on factors of that nature to make decisions as opposed to being overly influenced by daily market prognostication. The dynamics of fear and greed that often characterize investor behavior are somewhat analogous to the frustration and envy that drivers experience when battling their way to their destination.

Traffic patterns and markets can be unpredictable, yet in both contexts a steady path is typically more effective in getting from Point A to Point B. As Portfolio Managers, we have the responsibility of developing investment strategies that give each client the best opportunity to achieve their personal financial objectives, and to do so in a risk conscious manner. Course corrections are sometimes needed, but they ought to be based on more than momentary emotion.

Average Mutual Fund Subsequent 3-Year Performance
Sorted by Prior 3-Year Returns, US Long-Only Equity Funds
(Jan. 1990 – Dec. 2016)



Source: Research Affiliates

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Yields moved sharply high over Q3 as headline inflation accelerated driven by a large jump in oil prices. Municipals followed USTs, driving negative quarterly and YTD performance.
- Front-end curve inversion steepened and shifted the trough down to 7 years (2030) from 9 years (2032). The spread between 1 and 7-year AAAs fell to -30 bps from -54bps on 6/30. The municipal curve should gradually steepen, although normalization will likely be a late 2024 phenomenon.

	6/30/23	9/30/23	QTD change
2-yr AAA Muni	2.93%	3.66%	+73 bps
10-yr AAA Muni	2.56%	3.45%	+89 bps
30-yr AAA Muni	3.49%	4.34%	+85 bps

- The Fed increased rates 25bps to 5.25-5.50% at the July meeting and then paused in September. Fed minutes indicated they would "proceed cautiously" on future rate decisions. However, "higher for longer" remains pervasive in their rhetoric.
- Municipals underperformed relative to USTs in September and the 10-year AAA Muni/UST ratio rose to 75.5%. We expect ratios to stay in the upper end of a 65-75% range in Q4.
- Municipal issuance declined 3.8% in Q3 relative to 2022 levels and the YTD figure is down 13%. Higher rates and an increased cost of borrowing have slowed new supply.
- New issue bonds have often been oversubscribed, and high tax states such as CA and MA recently traded through the AAA scale.
- Longer duration bonds underperformed in a rising rate quarter with the 20-year portion of the index trailing at -2.14%, while short-dated maturities outperformed.
- Credit has been rewarded with the BBB rated index segment off only 0.24% YTD, while the AAA component declined 2.35%.
- Yields at levels not seen since January 2008 and a Fed winding down their rate increase cycle is giving us conviction concerning municipals. Technicals remain strong with 2024 maturities, calls and coupon payments expected to exceed flat issuance.
- We are finding value in the 9 to 12-year part of the curve in Intermediate portfolios, while front-end inversion also makes 1 to 3-year bonds attractive. Our UST trading range for Q4 is 4.25%-5.00% and we are beginning to extend duration to 4.60-4.70 years.

Investment Grade Corporates & Treasuries

- UST yields climbed higher in Q3 with the 10Yr up 73 bps to close at 4.57%. A bear steepening trend caused the spread between 2Yr and 10Yr yields to fall from -102 bps to -48bps.
- Rate moves of this magnitude often have unintended consequences and we remain vigilant for cracks forming in the economy as the Fed's commitment to bring down inflation on a sustained basis is reinforced.
- IG credit spreads remain range bound. OAS on the Bloomberg US Aggregate Corporate Bond Index ended Q3 at 121 bps after hitting a YTD low of 112 bps at the end of July. Spreads remain slightly tighter than the 5-year average of 123 bps.
- The Markit North American IG 5Yr CDX index, a default protection derivative and risk proxy, hit a YTD low of 63 at the end of July before ending Q3 at 74 as a risk-off tone and a UST sell-off took hold. Credit resiliency is still evident and the CDX index is well below its YTD high of 90.
- Primary market supply of IG credit beat expectations in September with ~$124B coming to market vs. a projected $120B. Issuers have been selective about new offerings, although average concessions are lower than in 2022 and deals well subscribed.
- High Yield has been a bright spot of late with the Bloomberg US Corporate High Yield index returning -1.18% in September vs. a -2.67% return for its high-grade counterpart. High Yield credit spreads remained close to YTD tights, ending Q3 at 394 bps.

Equities

- Equities were weak in Q3 with the S&P 500 declining 3.27%. Energy and Communication Services were the only positive sectors. The Energy sector, fueled by a +35% move in Crude Oil, was up 12.22%.
- The back-up in UST yields and negative seasonal trends presented headwinds as stocks struggled with a "higher for longer" narrative. Following a strong July (+4.48%), S&P 500 returns fell to -1.59% and -4.77% in August and September.
- Due largely to a rise in energy prices, September saw headline CPI post its biggest monthly gain in 2023 at +0.6%, although Core CPI and PCE continue to trend lower.
- Volatility, as measured by the VIX Index, was muted in Q3. The VIX remained below 20 even as stocks declined.
- Earnings estimates are improving, albeit on the margin. FactSet expects a S&P 500 YoY decline in earnings of -0.3% for Q3. If realized, it would be the fourth straight quarterly earnings decline, but the smallest of that period.
- Provided interest rates stabilize, we believe Q3 weakness presents an opportunity to add to high conviction holdings ahead of a period of the year that has historically been strong.

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