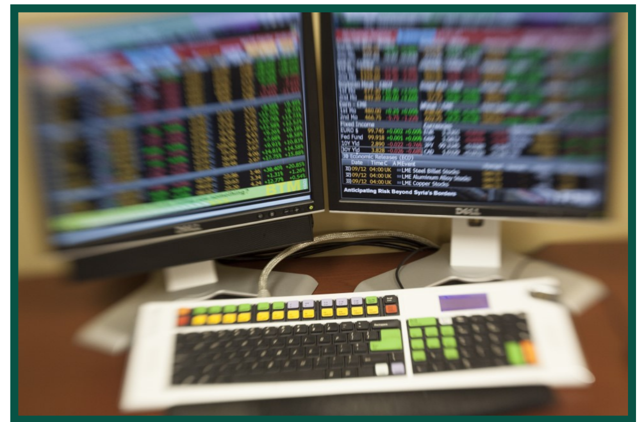
Wallington
ASSET MANAGEMENT

Quarterly Newsletter

2023: Third Quarter | **139th Edition**



"Forecasters are a humble lot with much to be humble about."
Federal Reserve Chair Jerome Powell – September 20,2023

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	**3Q23 Total Return (%)**	**2023 Total Return (%)**	**Index Characteristics**		
Domestic			**NTM P/E**	**P/B**	**Div. Yld. (%)**
S&P 500	-3.3	13.1	17.9	4.1	1.6
DJIA	-2.1	2.7	16.2	4.1	2.1
NASDAQ	-3.9	27.1	24.6	5.2	0.8
Russell 1000 Growth	-3.1	25.0	24.4	11.1	0.8
Russell 1000 Value	-3.2	1.8	13.8	2.2	2.4
Russell 2000	-5.1	2.5	19.3	1.8	1.5
International*					
MSCI EAFE	-4.0	7.6	12.6	1.7	3.3
MSCI Emerging Markets	-2.8	2.2	11.7	1.6	2.7
MSCI United Kingdom	-1.5	6.8	10.4	1.6	4.2
MSCI France	-6.9	10.8	12.3	1.8	3.1
MSCI Germany	-7.7	9.7	10.2	1.3	3.5
MSCI Japan	-1.4	11.6	14.7	1.4	2.2
Global*					
MSCI All Country World	-3.3	10.5	15.4	2.6	2.1

Fixed Income		
Indices**	**3Q23 Total Return (%)**	**2023 Total Return (%)**
Domestic		
U.S. Corp - Gov (1-3 Years)	0.8	1.9
U.S. Corp - Gov (3-5 Years)	-0.4	0.8
U.S. Corp - Gov (10+ Years)	-9.3	-5.5
U.S. Treasuries Master	-3.3	-1.8
U.S. Corporates Master	-2.7	0.4
U.S. Municipals Master	-3.8	-1.1
U.S. High Yield Master	0.5	6.0
International*		
Developed Markets Sov Bond	-4.6	-4.1

Commodities		
Resource	**3Q23 Total Return (%)**	**2023 Total Return (%)**
Precious Metals		
Gold	-3.8	1.6
Silver	2.7	-3.6
Industrial Metals		
Copper	-0.4	-2.1
Aluminum	10.1	-2.2
Energy		
Brent Crude Oil	27.9	15.1
WTI Crude Oil	28.5	13.3
Natural Gas	4.7	-34.5

Key Rates				
Rates	**9/30/2023**	**6/30/2023**	**12/31/2022**	**9/30/2022**
U.S. Target Fed Funds Rate	5.50	5.25	4.50	3.25
2-Year U.S. Treasury	5.03	4.87	4.41	4.22
10-Year U.S. Treasury	4.59	3.81	3.88	3.83
30-Year U.S. Treasury	4.73	3.85	3.97	3.79
10-Year German Bund	2.82	2.41	2.53	2.13
10-Year Japanese Bond	0.76	0.39	0.42	0.24
30-Year Fixed Mortgage	7.20	6.71	6.36	6.11

Currencies				
Indices/ Exchange Rates	**9/30/2023**	**6/30/2023**	**12/31/2022**	**9/30/2022**
ICE U.S. Dollar Index	106.22	102.91	103.52	112.12
USD per EUR	1.06	1.09	1.07	0.98
USD per GBP	1.22	1.27	1.20	1.12
JPY per USD	149.23	144.54	131.95	144.75
CAD per USD	1.35	1.32	1.35	1.37

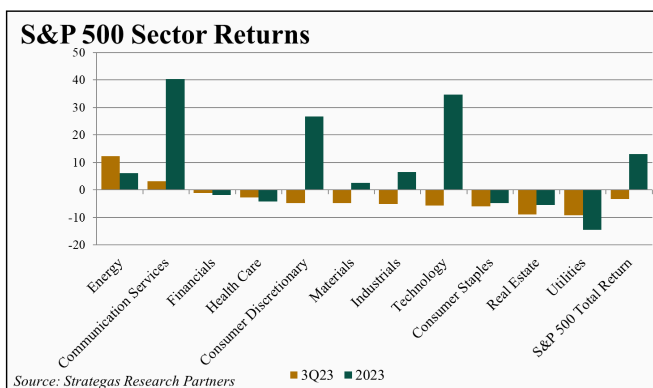
*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

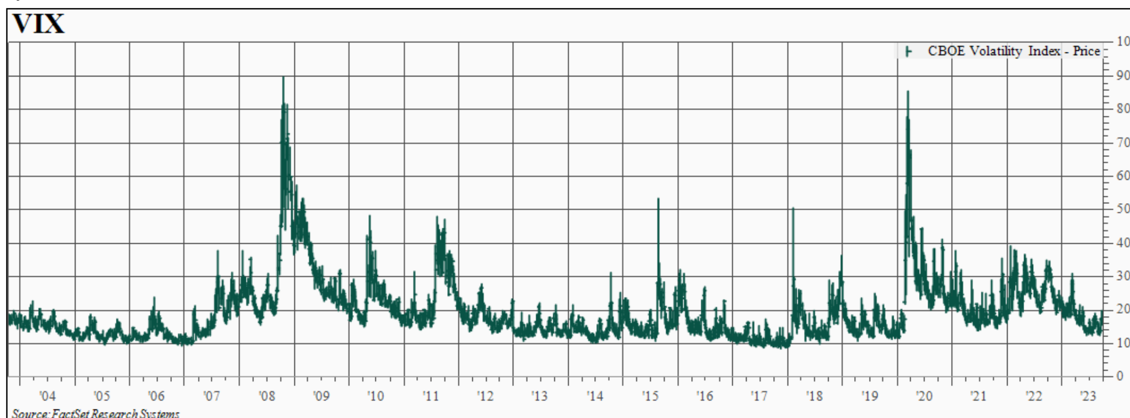
EQUITIES

- In the third quarter, major domestic equity indices experienced notable shifts from the momentum witnessed in the year's first half. The Standard & Poor's 500 (S&P 500) index recorded a total return (price change plus dividends) of -3.3% for the quarter, though its cumulative return for the year remained positive at 13.1%. Similarly, the NASDAQ experienced a pullback with a quarterly return of -3.9%, yet the index maintained its strong year-to-date (YTD) performance of 27.1%. Small capitalization stocks faced the most significant headwinds this quarter, as the Russell 2000 Index returned -5.1%, bringing its annual gain to a modest 2.5%. International stocks posted similar negative quarterly returns with developed markets (as measured by the MSCI EAFE Index) declining by 4.0% and the MSCI Emerging Markets Index dropping by 2.8% when denominated in U.S. dollars (USD). On a YTD basis, these broad international indices are in positive territory through the end of September, posting returns of 7.6% and 2.2% respectively.

- After a solid start to the quarter, many sectors experienced a slowdown in September. The Technology Sector declined 6.9% in September and finished the quarter with a -5.6% return. Despite the drawdown, the sector still boasts an impressive YTD return of 34.7%. The Communication Services Sector experienced a 3.1% third quarter gain and has provided a 40.4% gain YTD. Conjecture over higher interest rates for longer than previously anticipated pulled down traditionally high dividend sectors. Utilities and real estate stocks declined 9.2% and 8.9% respectively. Among cyclical sectors, energy stocks performed well, rallying with a three-month return of 12.2%. This brought the sector's YTD total return to 6.0%.



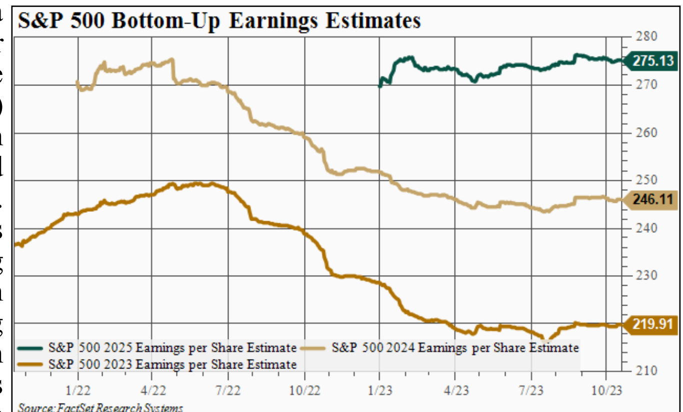
- Before the slump in September, the S&P 500 provided a reminder of the strength in the U.S. consumer, with the index posting more than one hundred consecutive sessions without a decline of 1.5% or more. The last time the index achieved this feat was in 2018. Similarly, the CBOE Volatility Index (VIX) has not exceeded a threshold of 35 this year. Should this trend continue, it would mark the first calendar year the VIX has not crossed 35 since 2019. Although labelled the "fear gauge," and while many investors remain on edge, the VIX has historically moved concurrently with equity market volatility. The YTD high for the VIX coincided with the bottom of the largest S&P 500 drawdown through the first nine months of the year on March 13.



EQUITIES

- On a price-to-earnings (P/E) basis, S&P 500 valuations closed the quarter above their historical average, trading at 17.9x next twelve months expected earnings compared to an average of 16.5x since 1996. Normally, investors are willing to pay higher valuations when risk or interest rates are low. This environment is very different, as equity investors are facing elevated levels of uncertainty stemming from geopolitical tensions, monetary policy (increasing interest rates), and many macroeconomic variables. Looking beyond the surface of the S&P 500, concentration risk has had a major influence on the valuation of the index itself. The top 10 stocks in terms of market capitalization (size) boast a well-above-average P/E ratio of 25.9x while the remaining 490 stocks trade at 16.8x, highlighting a stark disparity in valuation and earnings contribution between the top-tier stocks and the rest. The weight of the top 10 stocks in the S&P 500 also finished the quarter at a record high of 31.9%, despite only contributing 21.9% of the index's earnings.

- According to FactSet, analysts are projecting a subtle yet crucial 0.5% rise in third-quarter profits for S&P 500 companies after three consecutive quarters of year-over-year (Y/Y) declines. CEOs appear more optimistic than in recent quarters, as fewer companies cited "recession" in their second-quarter earnings calls. Despite prevalent discussions around "earnings troughing," management teams are still bracing investors for potential negative impacts on earnings and profit margins from continuing labor dilemmas and a surging USD's impact on overseas operations. On the labor front, wages are feeling upward pressure as baby boomers retire. As the dollar makes products and services more expensive for foreign clientele, firms such as Getty Images and UPS are already reporting reduced sales and slimmer profit margins.

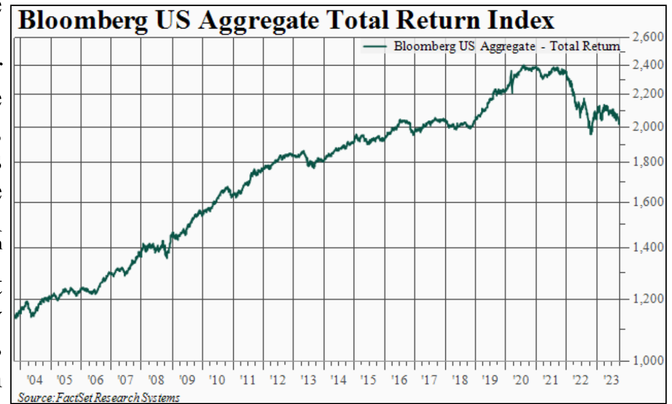


- At the micro level, many retail companies are feeling the impact of persistent and increasing shoplifting, organized retail crime, and employee theft on their bottom lines. The consequences of increasing "shrink," the industry term for theft and damaged inventory, are having a broader societal impact, affecting local communities and the overall retail environment. According to the National Retail Federation's (NRF) National Retail Security Survey, retail shrink has more than doubled since 2015 as rising self-checkouts and fewer checkout employees have collided with the pinch of inflation on consumers. Companies such as Dick's Sporting Goods, Dollar Tree, Home Depot, Walgreens, Macy's, and Walmart have all cited shrink's impact on income, pricing, and even the closing or relocating of stores. Target's CFO, for example, noted $400 million in gross profit margin impact for 2022 and estimated its cost of shrink rising to $500 million this year. Target also noted a 120% increase in theft involving violence or threats in the first five months of 2023.

- Uncertainty regarding the pace of Federal Reserve (Fed) rate hikes all but shut down initial public offerings (IPOs; the mechanism private companies typically use to enter the public markets) in 2022. Recently, the IPO market has shown signs of resurgence, underscored by the high-profile listings of British chip designer Arm Holdings, grocery delivery service Instacart, and marketing automation platform Klaviyo. The upcoming listings of brands like Birkenstock and potential entrants like Waystar indicate that there is still momentum, albeit with investors increasingly focusing on financial stability and growth catalysts.

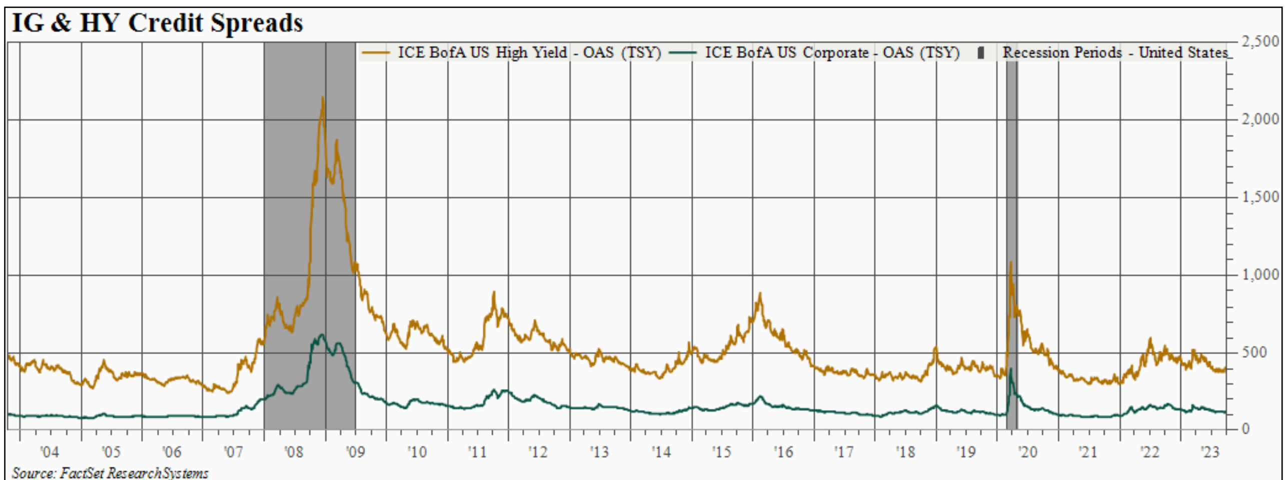
FIXED INCOME

- Interest rates across the U.S. Treasury (UST) curve marched upwards in the third quarter, with most USTs trading at yields not seen since 2007. The 2-year UST yield rose 0.16%, 10-year yield rose 0.78%, and 30-year yield rose 0.88%, leading most segments of the fixed income market to have negative total returns. As measured by BofA-ML indices, 1- to 3-year corporate and government bonds returned a positive 0.8% in the quarter. Longer maturities fared worse, with the 3- to 5-year and the 10+ year indices returning -0.4% and -9.3%, respectively. YTD, the Bloomberg U.S. Aggregate bond index is down 1.2%. September was the unprecedented 37th consecutive month the index had gone without setting an all-time high, and it remains well below its high watermark. The longest prior periods without an all-time high were roughly 16-month stretches beginning in 2017 and 1980. There is potential for U.S. bonds to provide three consecutive years of negative returns for the first time in history.



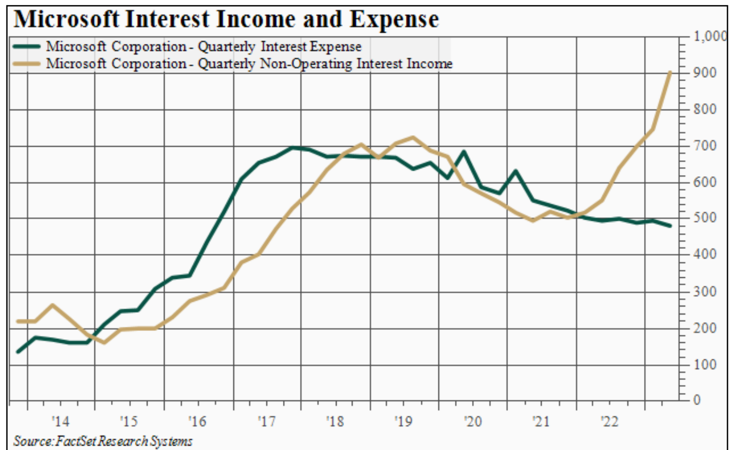
- The move in yields has worked to partially unwind the yield curve inversion which has persisted for nearly a year. The 3-month/10-year inversion hit a low of -1.89% in the second quarter. The curve rose through the third quarter, finishing at -0.96%. This steepening was driven by long-term yields rising more than short-term yields. It is historically rare for the yield curve to un-invert as a function of long -term yields rising above more stable short-term yields. This is due to curve inversions typically preceding a recession, causing the Fed to cut short-term rates in turn.

- Despite the yield curve continuing to flash a recessionary signal, credit spreads (the yield differential between corporate and government bonds) remain low. The lack of movement in spreads allowed corporate bonds to outperform USTs for the fourth consecutive quarter, returning -2.7% compared to -3.3% for USTs. Investment grade corporate bonds are fighting to stay positive on the year with a YTD total return of 0.4%. After spending most of the quarter below 4%, high-yield spreads finished the quarter at 4.03%. This level is well below where spreads have been during past recessions and allowed high-yield bonds to return 0.5% for the quarter and 6.0% through the first nine months of the year.

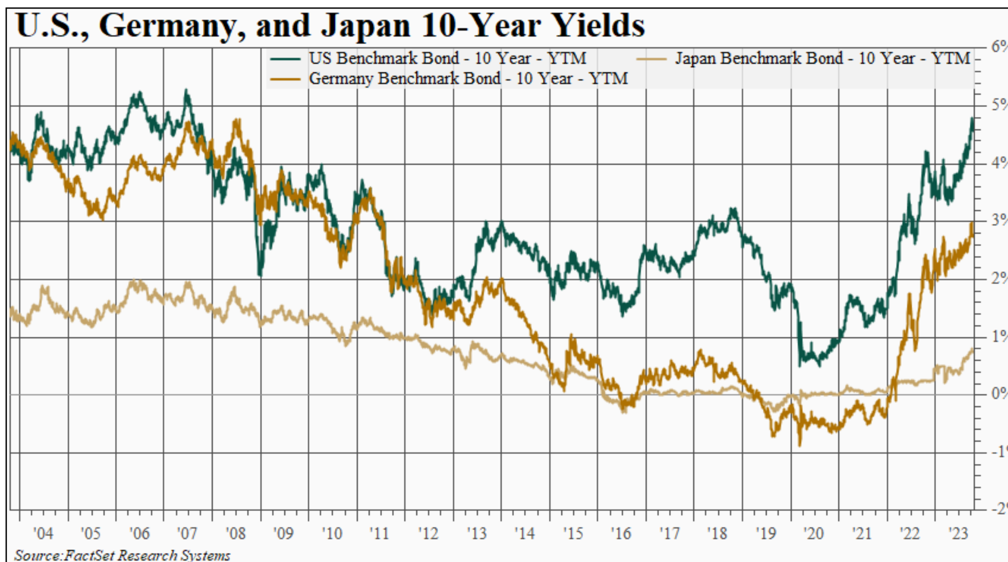


FIXED INCOME

- Corporations were a beneficiary of the past decade of low interest rates, allowing them to finance their balance sheets with cheap debt. By locking in long-term, low interest rate debt, corporations have avoided the immediate impact of the Fed's rate hiking cycle. Like a homeowner with a 3% mortgage, companies can watch interest rates rise and see little to no increases in their debt payments. For example, Microsoft has paid roughly the same $500 million per quarter in interest expense since the start of 2022. However, they have seen the interest earned on their cash increase rapidly over the same period, with their most recent earnings report showing they made over $900 million in interest income in the second quarter. Large corporations with easy access to public debt markets have seen little movement in the effective interest rate paid on their debt. Société Générale reported that ex-financials, the effective interest rate on debt paid by the largest 10% of firms in the S&P Composite 1500 was only 3.37% as of August 2023. The rate is up from the pandemic-recovery low of 2.92% recorded in March 2022, but it is still much lower than the over 5% return they can earn on their cash.

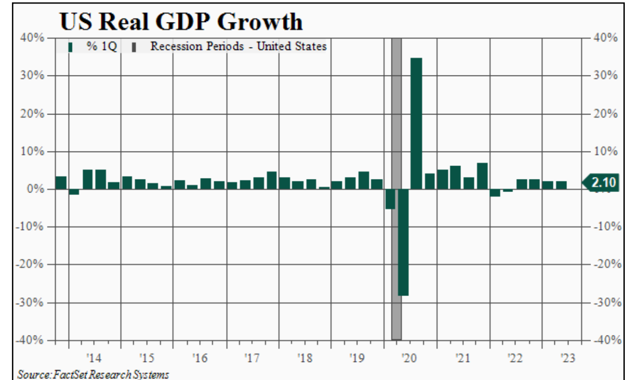


- While almost all government yields globally have risen due to inflation, Japan has continued to enact stringent yield curve control measures. The Bank of Japan (BOJ) has had these policies in place since 2016 amidst a decades-long fight against deflationary pressures. While the BOJ loosened its policies and allowed 10-year rates to rise in December and again in July, the 0.76% yield to end the quarter remained well below most of the world. These policies have come at a cost to Japan, as the government has needed to spend tens of billions of dollars a week on bond purchases to stabilize rates. The differential in yields has also caused the yen to fall to its lowest level versus the dollar since the early 1990s, as investors have sought higher income elsewhere.

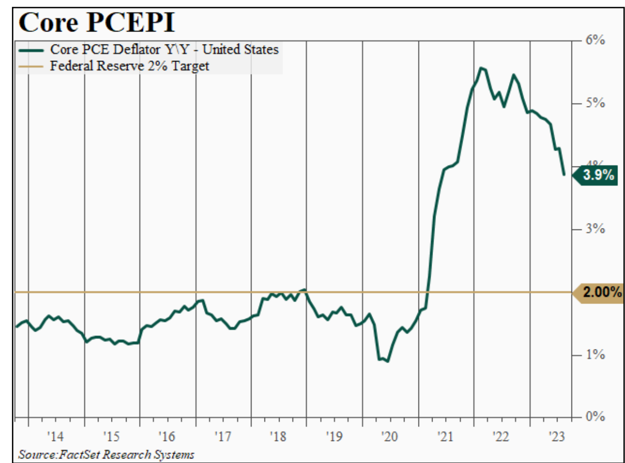


ECONOMICS

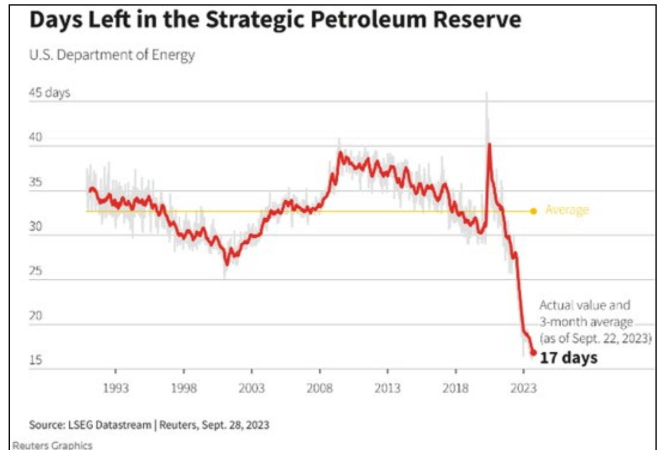
- The U.S. economy is slowing but still shows resilience. Annualized gross domestic product (GDP) growth was 2.2% in the first quarter and 2.1% in the second quarter. There appears to be some momentum building for the third quarter with expectations calling for growth over 3%. Consumer cash and savings balances above pre-pandemic levels, stimulative government fiscal policy, and the delay of fed funds rate hike impacts have all contributed to economic resilience. However, in addition to lingering inflation and higher rates, the potential government shutdown, auto union strikes, student loan payments restarting, and higher gasoline prices all represent headwinds for continued consumer strength.



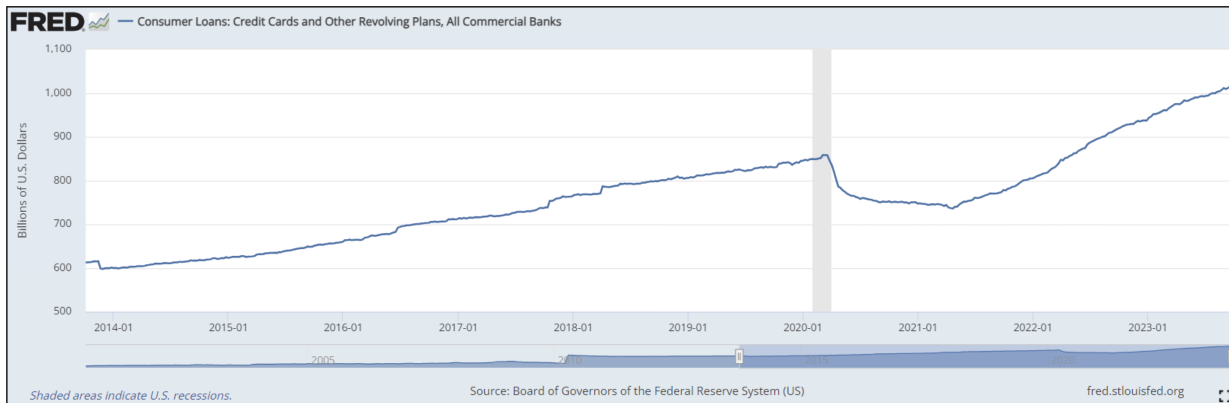
- The fight against inflation is making slow progress. The Consumer Price Index (CPI), which measures broad inflation faced by households, was up 3.7% Y/Y in August versus 3.2% in July, mainly due to higher energy prices. Core CPI, which excludes food and energy, was up 4.3% in August versus 4.7% in July. The Fed's preferred inflation measure, the personal consumption expenditure price index (PCEPI), showed similar trends. The good news is that monthly core PCEPI for August was up only 0.1%, its smallest monthly increase since September 2021. Annualizing the past three months of core PCEPI growth results in an inflation rate of 2.2%, close to the Fed's target of 2%. The Fed continues to walk the "soft landing" line between inflation reduction and significant economic damage.



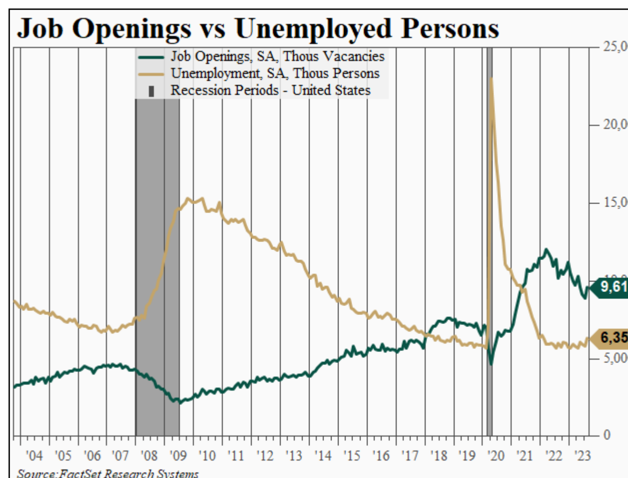
- Energy prices have been a focus of recent inflation reports. Oil prices rose from under $70 per barrel in July to more than $90 in September as the Organization of Petroleum Exporting Countries plus Russia (OPEC+) extended two prior production cuts of 1.6 million barrels through 2023. Global oil demand has grown to 102 million barrels per day. With demand up and supply constrained, prices increase. Oil above $90 per barrel will continue to put upward pressure on inflation. Although U.S. oil production is near a record at 12.8 million barrels per day, domestic reprieve is unlikely with the Strategic Petroleum Reserve depleted to its lowest level in four decades and the Biden administration's recent proposal of the most restrictive oil and gas leasing program in history.



- Surveys show that consumers are feeling the effects of inflation, and the Census Bureau has just provided evidence. Median family real (inflation-adjusted) income peaked in 2019 at $78,250 and has fallen for three consecutive years; real median income had declined $3,670, or 4.7%, by the end of 2022. This should change in 2023. Average annual hourly earnings rose 4.2% in September, down from 4.3% in August and 4.4% in July, but still above inflation for the fifth consecutive month. Consumer spending represents about two-thirds of the economy. While initially consumers maintained their spending in the face of real wage erosion with the assistance of pandemic stimulus programs, more recently habits have been supported by a rebound in credit card debt to a record of over $1 trillion. As this debt has been added at an unsustainable pace, consumer health and real wage growth will be crucial for continued economic growth.



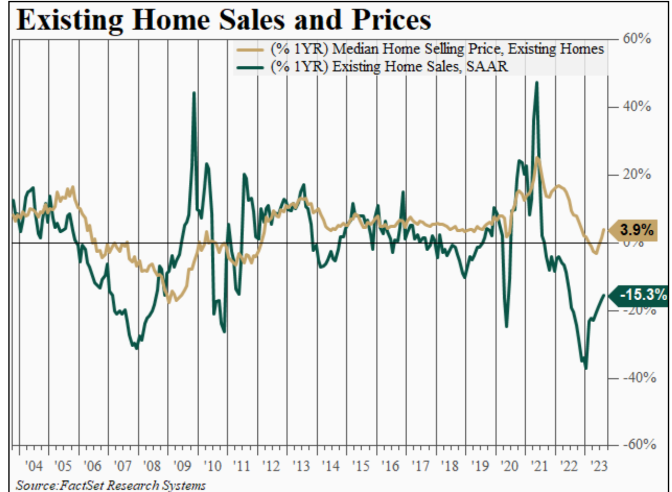
- A cooling labor market helps the fight against inflation and boosts the chances of a "soft landing." The labor market is cooling, but far from freezing and still tight as represented by 336,000 jobs being added in September. However, for the three months ending in August, job gains averaged 189,000 monthly, versus 238,000 for the prior three months. The unemployment rate rose to 3.8% in September and August from 3.5% in July, but the increase was due to more workers entering the labor force, not job losses. The labor force participation rate rose, especially in the prime working-age group of 25-54. Job openings were 9.6 million in August, up from 8.9 million in July. The layoffs and discharges rate was 1.1% in August, and the quits rate was finally back to 2019 levels at 2.3%.



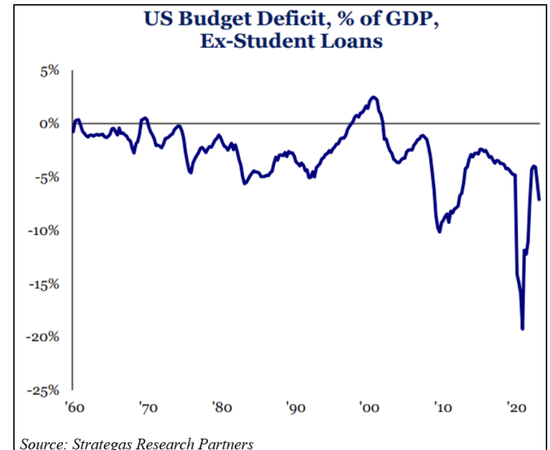
- Following the COVID pandemic, American workers walked off the job at a rate not seen in 23 years due to several factors including: (1) wages not keeping up with inflation since 2019; (2) income inequality; and (3) the tight labor market allowing workers to substantially raise pay by changing jobs. Through August, 7.4 million days of work have been lost YTD due to strikes and other labor issues. And this was before the United Auto Workers (UAW) strike started. This will end up being the largest strike year since 2000, driven largely by public favor of workers over management and pro-union government rhetoric and policy. To put the UAW strike in perspective, there are approximately 1 million people employed in the U.S. auto industry, from parts manufacturing to assembly to distribution. The UAW represents 160,000, of which 146,000 are at Ford, General Motors, and Stellantis. A prolonged strike will significantly impact economic growth.

ECONOMICS

- The housing market continues to bear the brunt of higher interest rates. Existing home sales fell 2.2% in July and 0.7% in August. Sales are down 15.3% for the 12 months ending in August and 36.3% since January 2022. But supply constraints have kept prices high, with existing home prices up 3.9% in August from a year earlier. The highest mortgage rates since 2000 have locked homeowners in their existing homes, restricting the supply of homes for buyers and making affordability the worst in 38 years. As an example, consider someone who bought a $500,000 home two years ago, putting 20% down and taking out a 2.86% 30-year fixed-rate mortgage. The monthly mortgage payment would be $1,656. Since then, home prices are up 13.6%, and mortgage rates are over 7%. The monthly payment to buy that house is now over $3,000. The new home market has alleviated some of the supply shortages, selling homes at an annual rate close to 2019 levels of 700,000. New home prices averaged $430,300 in August, down from a record $496,000 in October 2022. Builders are building smaller homes with an average square footage of 2,420, down 10%, to accommodate demand.



- The government also continues to lose from rising interest rates. Total government debt has surpassed $33 trillion, of which more than $26 trillion is held by the public and Fed. Half of this debt comes due within the next two years and will need to be refinanced. After 15 years of issuing debt at historically low interest rates, refinancing old, low-rate debt at higher rates will drive interest costs up rapidly. The average interest rate of public federal debt has already increased from 1.4% in early 2022 to 3.0% today. The Congressional Budget Office estimates the interest cost of federal debt at $745 billion this year and forecasts that to double in the next decade. Interest costs currently take up 20% of revenues and are projected to rise to more than 30%. Federal budget deficits have run high since the pandemic, and a $1.7 trillion deficit (6% of GDP) is forecast for fiscal year 2023. Ballooning interest costs will have a major impact on annual deficits and will receive much attention in coming years as austerity measures become increasingly important.



The Intuitive Nature of Forecasting and The Potential Cost to Investors

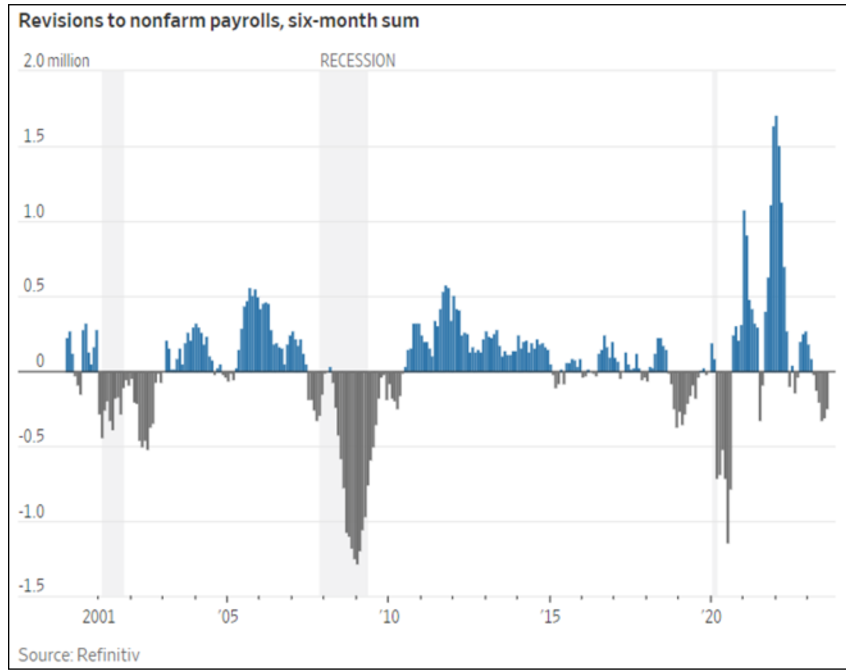
Human beings have always had an inherent desire to foresee and plan for the future. Ancient civilizations relied on omens, divination, and astrology to make predictions. Since the 1700s, the art of forecasting began to increasingly include a more systematic and data-driven approach. Whether for personal use or for the benefit of an organization, company, or government, individuals analyze historical data, consider trends, and rely on perceived relevant factors to attempt to predict future events or make decisions that hopefully result in the best possible outcomes. Forecasting has always been an inherent component of investing, and those who place capital at risk in the financial markets are some of the most intense in trying to predict future outcomes. That intensity has grown in recent times due to an extreme amount of uncertainty faced on many fronts, including but not limited to economic growth both domestically and globally, Fed (monetary) policy and inflation, and geopolitical events. Unfortunately, many of the historical references utilized in forecasting in this uncertain environment, including those with near 100% causality, simply have not worked.

For many, decisions are intuitive, no doubt harkening back to earlier times when life and death decisions had to be made many times a day. As David Kahneman points out in his book, "Thinking Fast and Slow," this process can be fast, unconscious, and intuitive, or slow and deliberate using conscious reasoning. The attributes of a robust forecaster are the consideration of many variables, competing views, and an array of facts and data. They are modest, open to self-criticism, curious, and avoid behavioral biases such as confirmation bias, recency bias, and others. To wit, Phillip Tetlock, a Canadian-American political science author, has analyzed thousands of forecasts and has written several books on the topic. His work suggests an inverse relationship between fame and accuracy; the more feted by the media, the worse a pundit's accuracy. The media's favorite pundits are not tentative and balanced. They are forceful, confident, and decisive – and mostly wrong in their forecasts.

In an attempt to forecast future variables more accurately, more formal processes, typically at institutions, are often utilized in economics and the financial markets (and many other fields). This involves the development of forecasting models using empirical data as inputs. The foundation of these empirical models is the concept of causality. Most empirical forecast models try to demonstrate that variations in some underlying causal variable X have a predictable and statistically significant effect on some outcome Y. These forecast models can be very complex, involving numerous variables. Yet, many of the forecasts employing these more complex models often prove sub-optimal or simply wrong.

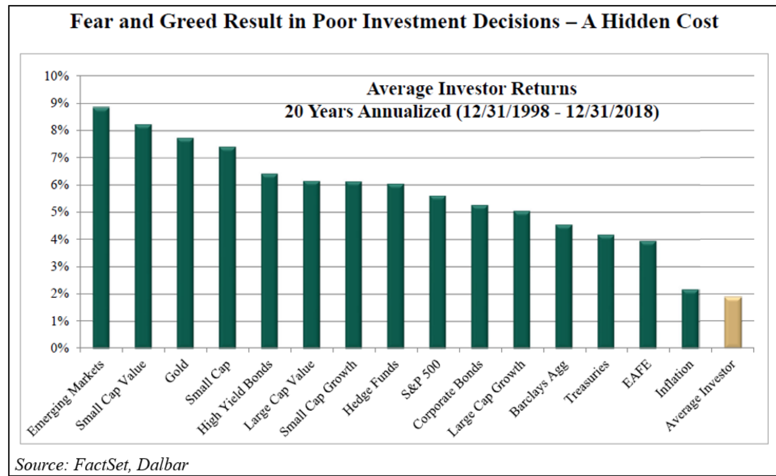
There have been so many famous wrong forecasts one could write a book about them. Irving Fisher, a famous economist, stated in September 1929 that the stock market was at a "permanently high plateau." He died a poor man. The forecast of Dewey defeating Truman in the 1948 election was one of the worst political forecasts of all time. Thomas Malthus forecasted in the 1700s a doomed civilization because of its inability to feed itself. Surprisingly, this was repeated over 200 years later in the 1972 book "The Limits of Growth" by the Club of Rome. The book argued that economic growth was doomed because of non-renewable resource depletion and population growth. The forecast model examined 19 commodities and said 12 would be in short supply by the end of the century. The book sold 12 million copies, and those 12 commodities remain in plentiful supply.

Most forecasts deal with known unknowns, but what disrupts many forecasts are unknown unknowns – often referred to as "black swan events" in financial markets. Before the discovery of Australia, people in the Old World were convinced all swans were white, as confirmed by empirical evidence (confirmation bias). Once black swans were discovered in Australia, a belief based upon hundreds of years of observations was shattered. In today's vernacular, a black swan event is a low-probability outlier, outside the realm of expectations because nothing in the past convincingly points to its possibility. It also causes a significant impact on markets or society. But, after the event, explanations are often concocted to explain its occurrence, making us believe it was explainable and predictable. What black swan events point out to forecasters is that "what you don't know is more relevant than what you do know." According to Nassim Taleb, author of "The Black Swan," black swan events have been increasing since the industrial revolution and a small number can explain most of history.

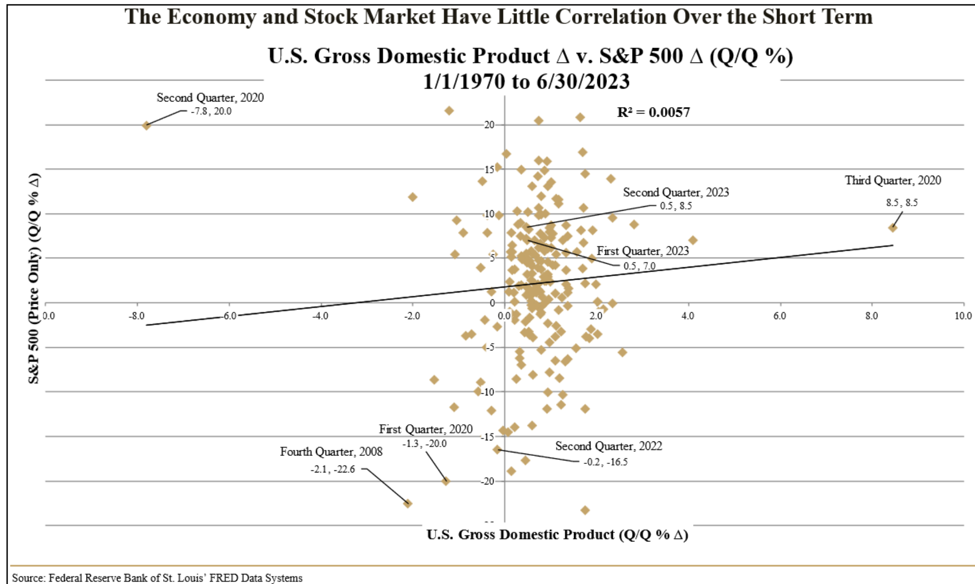


The most recent black swan event, the COVID pandemic, has muddled the gathering of economic data to the point of destroying the reliability of some critical financial information, making accurate forecasting even more difficult. As an example, the Bureau of Labor Statistics (BLS) estimated job growth of 209,000 in June and 187,000 in July, but in August, the BLS had to revise those numbers down by 110,000. The Federal Reserve Board and its 12 regional banks employ hundreds of economists with Ph.D.'s, but that does not seem to help provide accurate forecasts. In June, Fed officials forecasted economic growth of 1.0% for 2023, but they raised that forecast to 2.1% in September. The Commerce Department just recalibrated the trend line for household savings. Previously, they estimated $346 billion of excess savings at the end of the second quarter; that has now been revised to $1.3 trillion. Such a wide differential has a big impact in forecasting future economic growth. A recent Wall Street Journal survey found that as of the end of the third quarter of 2023, approximately half of economists forecast a recession and the other half a soft landing. This means that two broad groups of economists have confidence in their forecasts even though both sets have analyzed similar information on interest rates, inflation, economic growth, earnings, and a multitude of other variables, yet come up with significantly different forecasts.

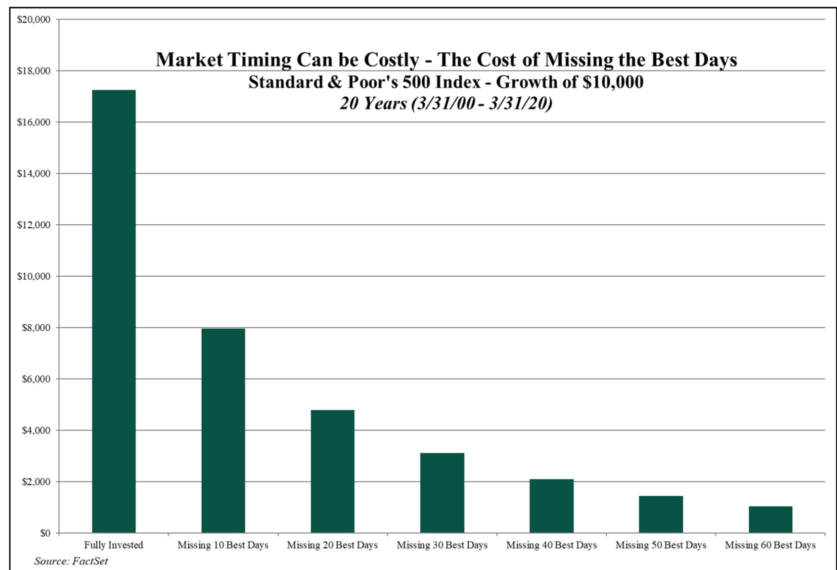
Forecasting is an inherent component in any investment decision since there is some level of uncertainty involved when investing capital. Even with Certificates of Deposit (CDs), deciding on the term of the instrument involves some type of forecast, albeit minor compared to investing in other instruments with greater uncertainty. An investor in a CD either implicitly or explicitly must decide on the term (maturity) of the instrument, and in so doing is faced with the unknown as to how interest rates will move once the investment is consummated. Purchasing or holding an individual stock, the gain or loss of which depends upon the future results of the company, also requires some type of forecast to be made. However, it is not the mere existence of a forecast but the framework by which the forecast is made and the magnitude of the response that can put an investor at risk and undermine results. Anyone can be successful in making a forecast or two accurately, even if the theme or idea that is utilized has little or no proven causality (a broken clock is right two times per day). From a wealth management standpoint, though, *sustainable success* requires a *series of those forecasts* to be made accurately over extended periods of time, the odds of which are very slim when a management philosophy incorporates high-magnitude responses (a.k.a. making big bets). This is implied in the accompanying Dalbar chart and supports why some of the most successful investors in history (Buffet, Price, Lynch, Davis, to name a few) do not attempt to manage capital with that type of philosophy in mind. The cost of a significant miss due to making a big bet is too substantial, and the human tendency once behind is to attempt to make up lost ground, which is dangerous in managing wealth.



Arguably, the most widely seen and promoted forecasts of significance in the financial markets involve investors in equities making bold decisions with the allocation of their portfolios. Currently, the intuition of many investors is to avoid equities in the face of the immense amount of uncertainty that exists, especially as it relates to the economy, inflation, and interest rates. But as the accompanying chart shows, the correlation between the economy in the short-term and the stock market is very low. Often, a difficult economic environment leads investors to intuitively want to sell out of equities at the very time they should be buying, or at least maintaining exposure. There are certainly times in which it pays to reduce some risk in a portfolio, and this may be one of them. However, a reduction of risk is significantly different than avoiding or even eliminating equity volatility, which can lead to an entirely different risk exposure longer-term (i.e., purchasing power risk).

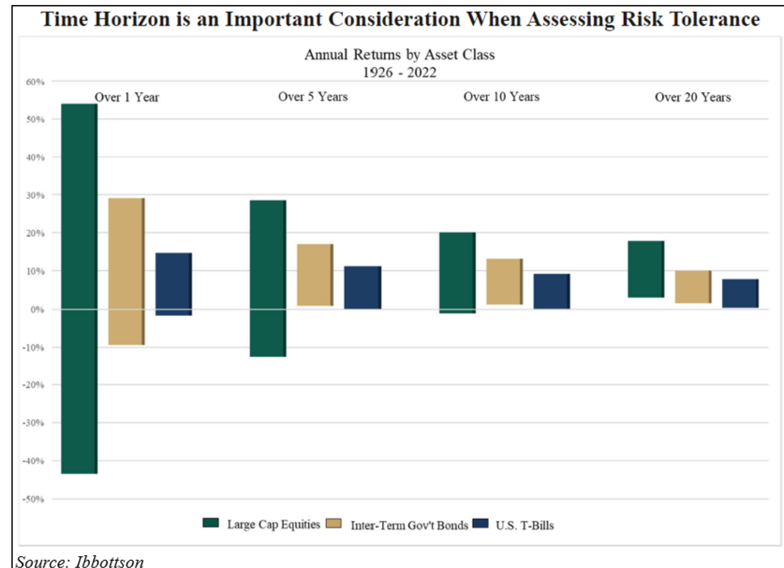


It is no surprise that forecasting plays a pivotal role in decision-making within the realm of investing, where "knowing the future" could provide an enormous advantage in wealth creation. Most often, investors' forecasts are drawn from top-down arguments deduced from one or a few big themes or ideas. The forecasts typically have significant recency bias assuming trends will continue, missing the potential for major structural or cyclical changes in the trend. Also, the forecasts are often made with significant confirmation bias, in that there is a strong tendency to look for information or interpret it consistent with an existing belief. These tendencies, along with an emotional aversion to loss, which is thought to be nearly three times greater than the desire for gain, often lead to investors making dramatic market timing allocations based on their forecasts. The results have been abysmal as investors' tendency is to sell when investments have dropped in price and buy when they have risen dramatically. The empirical data in the previous Dalbar studies chart reflects that such behavior has dramatically reduced investor returns over time. What those investors fail to understand is that time in the market is what is most important. The return generated in equities over time involves volatility, and as the accompanying chart shows, missing the best days of the market, many of which occur during bear market environments, can prove costly.



The Fed-orchestrated higher interest rate environment with enticing yields on U.S. Treasuries, CDs, and other fixed income instruments is adding further complexity for investors, and not just those who invest in equities. For fixed income investors, why extend maturities past one or two years when yields are lower and interest rate risk is higher with longer-dated bonds? It is a great question that can be answered by considering reinvestment rate risk (the risk of reinvesting at maturity if rates are lower). Should the Fed begin lowering interest rates in the future, not locking into the higher rate environment will prove a missed opportunity. So, an implicit component in choosing higher short-term yields *exclusively or almost exclusively* over longer-dated bonds is a rather significant forecast that short-term yields will remain elevated relative to their longer-term counterparts. As we have seen recently, most economists find it difficult to predict (forecast) with certainty the timing and magnitude of Fed policy decisions – rate increases, pausing, or reversing to an easing posture. Much of these decisions depend upon the evolving economy, inflation, geopolitical conditions, and consumer behavior. The Fed itself has generated many forecasts that have proven inaccurate, not a surprise due to the complexity of their work. Rather than subjecting portfolios to potentially significant errors as a result of inaccurate forecasts, investors are better served understanding and adhering to fundamentals, relying on proven principles, and maintaining discipline to a pre-determined risk and return profile – all of which allows for adopting a long-term strategic focus. As seen in the accompanying chart, it is time horizon that has historically narrowed the forecasting risk associated with asset class returns, especially equities, not market timing which by definition has a limited time horizon. Other principles paramount to managing wealth successfully over the long term are the identification of appropriate financial goals and objectives, the optimal risk and return allocation to meet those goals and objectives, and an honest assessment of the ability to tolerate risk (volatility); the latter of which can significantly impact the emotional resolve to adhere to a long-term strategy. Understanding the inner workings of these relationships dramatically reduces the tendency to unknowingly succumb to confirmation, recency, and anchoring biases, which are prevalent in forecasting, and which have often proven very costly to investors who attempt to make forecasts of great magnitude.

Time Horizon is an Important Consideration When Assessing Risk Tolerance



Source: Ibbottson

"If I have noticed anything over these 60 years on Wall Street, it is that people do not succeed in forecasting what's going to happen to the stock market."

Benjamin Graham, Economist and Author, The Intelligent Investor.
Also known as The Father of Value Investing

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