Investment Update

Q1 2024: JUST AS WE EXPECTED…

Don't be fooled by the title…we didn't predict the more than 10% return for the S&P 500 in the first quarter…but our year end update said **not to bet against anything**. **That sentiment remains in tact!** With the markets sitting at a point of maturity and relatively full value, what remains to be seen is how well they can absorb the next round of uncertainty.

Momentum is a funny thing…it can last longer than most expect and dissolve quicker than most are prepared to handle! So far, the momentum for Q4 of 2023 has carried into 2024. Equities have broadly pushed higher despite a few of last year's darlings having fallen behind (AAPL and TSLA to name a couple). It was once again Large Cap growth that led the way among equities and a few familiar mega-cap tech among its main leadership (NVDA, AMZN).

As we flip the page on Q1, later in this newsletter we will tackle the questions below, questions we hear in some form or fashion nearly every day.

- So how long can the rally last?
- Should I overweight Value or Growth?
- Aren't valuations extended/expensive?
- Is the AI hype overdone?
- Is this the late 1990's all over again?

While equities continued their banner run, Q1 saw bonds post a modest loss (AGG -0.8%) on fears of "higher for longer" as rates reversed a portion of the massive yield plunge seen in Q4. While bonds outpaced cash in 2023, some investors are still reeling from the 2022 losses in bonds. Below are questions we will tackle:

- Why move out of cash when my money market pays more than a 10-year US Treasury?
- Aren't credit-sensitive bonds expensive?
- Why add duration now given that even the Fed doesn't have a concrete path forward?

Despite the encouraging economic data, a Fed that so far has remained data-dependent, and geopolitical events that haven't escalated to involve the US further, a patient and steady hand is still prudent. We DON'T believe this environment is conducive to an "all-in" risk approach.

On a recent call a portfolio manager offered a sentiment I've heard many times before when he said **"a lot of money has been lost buying great companies at the wrong price."**

We believe it prudent to stay diversified and disciplined as the tide lifts many boats. In the pages ahead, we will further expand on what discipline means for investor positioning in today's markets.

TACKLING THE TOUGH QUESTIONS: EQUITIES

Unlike politicians of the last 60 years, below we look to directly answer questions on our readers' minds. Each is thoughtfully spelled out to make it both meaningful and actionable. We believe a big challenge among investors in 2024 will be the temptation to fix what isn't broken. Markets ebb and flow and often come back to us if we are patient enough.

So how long can the rally last?

While this is unknowable, rallies almost never die of old age! When we hear comments like "it can't go any higher" we pause…because it can. It may defy logic at times, but markets can always surpass the laws of what it "should" do.

Uptrends often persist longer than the skeptics prognosticate and the fearmongers write about. Missing the last legs of a sustained bull market can be both frustrating and have meaningful financial consequences. One doesn't need to capture it all….but trying to time the top has proven a fool's errand for over a century.

For example, the stock market in 1995 was fairly valued at a 15 P/E. In 1998 levels reached a 30 P/E. By 1999 prices were at nosebleed levels…and another year plus of the rally remained. It ended poorly, but for a prudent investor who continued to rebalance and stay disciplined, the late 1990's and early 2000's were quite rewarding.

Year	Returns w/ Dividends
1995	37.20%
1996	22.68%
1997	33.10%
1998	28.34%
1999	20.89%

S&P 500 over its best 5-year stretch ever

There's little to suggest that the current rally will reach the 1990's scale. We sit far from the euphoric sentiment of that era. Nonetheless, too much skepticism and pessimism can prove costly. Maintaining a disciplined approach to both equities and bonds is imperative whether this rally is sustained or reverses course in the coming quarter.

Should I overweight Value or Growth? Aren't valuations extended/expensive? Is this the late 1990's all over again?

Tactically overweighting parts of the market can be equally rewarding and frustrating. An asset class being fundamentally cheap isn't always a precursor to immediate investment reward. Likewise, assets that are overpriced can sometimes sustain that character for much longer than anticipated.

As we enter Q2 of 2024, the cheapest parts of the market are as follows (cheap both relative to their own historic ratios and the broader markets as well): Small Cap Value, Small Cap Growth, and European Large Cap Value. These "cheap" areas also carry with them fundamental reasons many investors remain underweight. Small cap companies are the most affected by higher borrowing costs and higher interest rates. Smaller banks are especially sensitive to what's happening in the office real estate markets. Europe has lagged the US in many ways for over a decade and a half and has been cheap for most of that period.

On the other hand, Japan was "cheap" for nearly 3 decades…and then a policy pivot has made their markets rise to new all-time highs. Active management can uncover such opportunities. Rather than a timing decision, active management can look to uncover companies whose price and fundamentals are underappreciated.

Time rewards the patient investor. ***Fundamentals and earnings growth are the ultimate drivers of price over time <u>even if they are not at a given moment in time</u>***. Today's valuations of growth stocks are not cheap, but nowhere near the excesses of the late 1990's. Today's most growthy names trade at 35-50x 2025 earnings. In the late 1990's there was a twofold issue: (1) many of the fastest growing companies had no earnings and (2) P/E levels were often in the triple digits.

Is the AI Hype overdone?

Perhaps a bit in the short-term…but don't sleep on what COULD materialize. AI is more than Chat GPT! AI is likely to transcend industry and lead to breakthrough innovation in pharmaceuticals and biotechnology, space exploration, telecommunications, and more.

The great news about AI is that nearly every portfolio has exposure to AI without making any changes. Some of the largest benefactors of AI are likely the companies listed as your Top 10 of the biggest funds you own. Names like Microsoft, Meta, Google, Nvidia are front and center, but the list of companies leveraging AI grows daily. JP Morgan is among the most active in the financial world. Your next mortgage will likely be AI reviewed.

TACKLING THE BOND MARKET...METHODICALLY

Before the calendar year 2022, many bond investors knew little of the potential for loss in fixed income portfolios (especially outside of credit exposures). Fast forward to today, as the yield curve remains inverted for the longest stretch ever…what's an investor to do? We tackle a few of your questions below…

Why move out of cash when my money market pays more than a 10-year US Treasury?

For every investment there is a risk and reward. Even for cash, there's a risk and a reward. The comfort of cash has ratcheted up considerably in the last 2+ years as the Fed raised rates and money market yields soared.

Sitting in a money market account is **not** riskless. An overweight to a cash alternative exposes an investor to buying power risk and reinvestment risk. When yields begin to normalize and the Federal Reserve begins cutting (or before, as the markets anticipate such actions) the return on bonds again becomes a math equation with two components: yield from the portfolio and the price movement of the bonds themselves. As yields fall, bond prices rise. This doesn't happen with a money market asset…by its very nature its price remains static.

Is that price movement meaningful? Duration is the industry term we use to measure this move. YES, it can be meaningful. For example, a portfolio with a 4-year duration would recognize a 4% appreciation in price if prevailing rates dropped 1%. Couple that with a 5-6% yield and you have a recipe for bonds returning 8-10%. For money markets to return 8-10% the Fed would have to raise rates another 300bp+. The halves of risk for bond investors are, in our opinion, decisively favorable over the next couple of years!

Why add duration now given that even the Fed doesn't have a concrete path forward?

As mentioned above, duration is a measure of interest rate sensitivity. The larger the number, the more your portfolio is expected to move based on changes in prevailing rates. The Bond Index (AGG) trades with a duration of over 6 years, meaning that for every 1% move in rates the portfolio's bonds move ~6%. With a yield of just over 5%, this means a 1% move higher in rates would result in a negative year of performance. On the flip side, a 1% drop in rates would correspond to a +11% result.

That band of -1% to +11% is wider than we would prefer for our "core" bond positioning. Nevertheless, when the "duration move" begins, it often moves much faster than investors are prepared for. Rather than try to time such a move, we have been easing in more duration over the last 6 months.

Below we will elaborate on where we seek returns in bonds today.

How is HIP beating the AGG so significantly and consistently since the start of 2023?

Let's begin by sharing our preferences in fixed income: we prefer high quality credit in high yield, preferred stocks, and securitized credit. For tax-sensitive clients of those where we are looking to extend duration, municipal bonds are quite appealing. We like closed end funds that own these exposures and seasoned active managers. We believe navigating fixed income in 2024 is as much about what you don't own as what you do!

Currently, our yields generally exceed the bond index by 1-2% and our duration sits at less than half of the index. Said another way, we'd prefer to take less duration risk and a little credit risk than pretend we know exactly the path the Fed will take from here.

In 2023 our fixed income portfolios posted double-digit gains for most clients and, so far in Q1, we have sustained that pace of outperformance. In Q1 most clients saw gains of 2-4% in fixed income, despite the index being slightly negative. Our managers continue to be selective, disciplined, remain highly liquid, and seek to "pounce" on opportunities that come their way. In the meantime, we are concentrating on making our fixed income assets as productive and resilient as they can be [until the path forward for rates is abundantly clear].

JEROME, JOE, AND DONALD…

We mean no disrespect to any of the above-listed civil servants, but Jerome Powell, Joe Biden and Donald Trump garner more headlines in the context of the markets than they warrant.

The Federal Reserve is likely to cut rates from current levels at some point…but the timing and pace remain uncertain. They are [rightly] data-dependent. Neither Mr. Biden nor Mr. Trump make laws nor pass budgets. They can veto policies, talk about policies, and propose policies, but Congress enacts laws. ***That's by design!***

We will continue to see eye-catching headlines the remainder of 2024. It's an election year and it's perfectly normal to hear more negativity than ever in the media. Their job is to draw eyes and sell ads. Elections are part popularity contest and part test of willpower.

Don't be distracted as an investor. Stay focused on what really matters to your portfolio: the earnings of the companies you own and the creditworthiness of the entities of whom you have debt holdings. **Buckle up!**

Panic Attacks and the S&P 500

Year	Panic Attacks	S&P 500 Max Drawdown	Cumulative S&P 500 Price Return*
1999	Y2K	-12.1%	248.8%
2000	Tech Bubble Bursts	-17.2%	191.9%
2001	September 11th, 2001 Recession	-29.7%	224.8%
2002	Final Tech Bubble Flush, Corporate Scandals (Worldcom)	-33.8%	273.5%
2003	Iraq War	-14.1%	387.4%
2004	Oil Price Breakout	-8.2%	285.6%
2005	Hurricane Katrina	-7.2%	253.8%
2006	Fed Culminates Hiking Cycle	-7.7%	243.5%
2007	Subprime Cracks Emerge	-10.1%	202.3%
2008	Global Financial Crisis, Bank Failures, Auto Bailouts	-48.8%	192.0%
2009	Global Financial Crisis Culminates	-27.6%	374.7%
2010	European Debt Crisis, Flash Crash	-16.0%	284.5%
2011	S&P Downgrades U.S. Debt, Greek Debt Writedowns	-19.4%	241.0%
2012	Euro Crisis, 2nd Greek Bailout	-9.9%	241.0%
2013	Taper Tantrum	-5.8%	200.7%
2014	Ebola	-7.4%	132.0%
2015	Chinese Slowdown, Yuan Devaluation, Deflation Scare	-12.4%	108.3%
2016	Brexit, Global Negative Rates	-10.5%	109.8%
2017	North Korea Tensions Escalate	-2.8%	91.5%
2018	Trade Wars, Short Vol Unwind	-19.8%	60.4%
2019	Repo Crisis, Yield Curve Inversion	-6.8%	71.1%
2020	Covid-19 Pandemic	-33.9%	32.7%
2021	Covid Variants, Chinese Regulatory Crackdown	-5.2%	14.2%
2022	Russian Invasion of Ukraine, Fed's Hawkish Pivot	-25.4%	-10.0%
2023	Regional Bank Crisis, Debt Ceiling Drama	-10.3%	24.2%

*Cumulative S&P 500 price return is calculated from day prior to the new year (ex. 1999 looks at 12/31/1998) to present. Data as of Dec. 31, 2023. Sources: Bloomberg, Federal Reserve, S&P. Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

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