

Investment Update



FEAR, ANXIETY, AND A RISING MARKET...

Any honest assessment of 2024 YTD must begin with the apprehension surrounding the beginning of this year. In the ensuing nine months, only a fraction of fears has been allayed, yet equities have paraded higher. Many experts have termed this the least-loved bull market on record.

Unlike the euphoria of the late 1990's, this bull market has been met with the most skepticism and apprehension on record. **And deservedly so!** History provides few parallels to the sequence of events that brought us to this point. A quick refresher:

- Growth concerns surfaced in late 2019
- Covid paralyzes the world
- Market selloff is sharp and deep
- Fiscal stimulus and Fed cuts rates to 0%
- Market Recovery begins
- More fiscal stimulus
- Fed hikes at fastest clip in 4 decades
- Equities (especially tech) selloff & bonds plunge
- Equity markets recover again, led by AI
- Bonds begin to recover as hints of economic slowing and Fed cuts emerge
- The Fed Cuts 50bp in September 2024

This list doesn't include these additional stressors:

- 2020 Presidential election
- Russian invasion of Ukraine
- Hamas attacks Israel and repeated counterattacks ensue
- 2024 election cycle solidifies its claim as one for the ages

The third quarter of 2024 provided yet another in the long list of surprisingly good markets. Despite an 8% selloff in early August as the Japanese Carry trade was partially unwound, markets pressed forward to end the month higher. September started out like it was destined to mimic

August, only to reverse course to post the best September since 2013.

As the month of September concluded, more than 25,000 union dock workers went on strike. Here we go again! That same day, Iran fired another barrage of missiles upon Israel. It seems enough to make one want to hunker down and hide.

From a purely economic standpoint, impact of the attacks on Israel primarily will be reflected on whether oil prices move higher. From the dock worker strike (like all work stoppages), this is viewed by market participants and lawmakers as a temporary event. Any inflation created will likely dissipate equally fast.

So why are markets higher?

Despite the unrelenting assault on both consumer and investor confidence, Corporate America and most of Main Street America remain healthy. Corporations seized the moment in 2020 when rates plunged, refinancing record amounts of debt at generational low rates. Homeowners did the same as they refinanced or bought homes with rates below 4%.

Americans are employed (near record low unemployment), wages are higher, and inflation is slowly falling back to normal levels. The Federal reserve began the rate cutting cycle a couple of weeks ago with a 50bp reduction. This will begin the process of lowering costs of home and auto purchases, as well as lower rates on credit cards for many Americans.

As we wind down the first $\frac{3}{4}$ of the year, we enter a new phase where the talk will be less focused on what the Fed will do and when it will do it and more focused on the health or corporate earnings, China, and the rest of the

developed world. We arrive at the door of Q4 with the S&P 500 up +21.9%, the Bloomberg Aggregate Bond index +4.6%, and with equity markets around the world decisively positive YTD. Even small cap stocks gathered a bit of momentum in the final 45 days of the quarter (up

over 9% in Q3). These are spectacular returns that far exceed the averages of history. ***To us, the key is what comes next!*** Will equities continue at a double-digit clip? What about bonds now that rate cuts have been aggressively priced into the markets?

EQUITIES: ARE WE FINALLY BEARISH?

From the tone of the intro, it sounds as if you're bearish on stocks...is that correct?

NO!

Allow us to elaborate. In general, stocks are fairly or fully valued. There are a few stocks that are mathematically "cheap" and a longer list that will need to deliver on every promise to justify current prices. Therein lies the crux of what we are watching...EARNINGS.

During a month or quarter, momentum and news headlines can drive the markets (and drive investors into fits of euphoria and depression). Over longer stretches of time, however, stock prices are determined by the earnings production of the companies. With credit to Adam Sandler's Billy Madison, "Innovation is good, profitability is better!"

As mentioned earlier, most great American companies have debt locked in for many years at historically cheap levels. Post-election, corporations will unveil a capital allocation plan based upon its results. Once again, they will know the lay of the land and the likely rules of the road. If history is any indication, once again betting against stocks could be counterproductive.

So, are you suggesting we ignore valuations because statistically stocks are likely to go higher?

Not exactly.

Valuations matter over time and tend to revert to historical averages given enough time. Price paid for stocks matters. Nonetheless, stocks (and the entire stock market) can resolve seemingly expensive valuations more than one way. Prices can move lower, or earnings can catch up over time. Recognizing that the second scenario is equally probable to the first, we recommend using a

combination of common-sense analysis and structural defensive equities in the mix.

Please explain...

The common-sense analysis refers to owning high quality, resilient businesses that have either (a) proven the test of time or (b) offer leadership in newer areas that are unlikely to shrink regardless of prevailing economic conditions (i.e., cybersecurity). This can be done by allocating to managers whose discipline targets companies with high free cash flow, growing dividends, or both.

The reference to structural defensive equities refers to two components that play a prominent role in our portfolios today: Buffered ETFs and Covered Call ETFs. Buffered ETFs use options to offer downside protection against principal loss (typically 9-15%). Covered ETFs, on the other hand, provide an element of protection through enhanced cash flow generation from selling of call options. Many such strategies distribute 7-9% cash flow on an equity-based portfolio.

With both buffered ETFs and covered call ETFs, the objective is reduced sensitivity to market drawdowns. Neither requires us to try to tactically time when to move in and out of equities, but instead allows us to dial up or down our risk exposure based on how much of our equity exposure is in such strategies. In 2022, for example, prominent holdings in our Covered ETF mix posted losses of -1.47% (DIVO) and -3.52% (JEPI). We aren't bragging about losses but recognize that losing less in a year like 2022 helps allow an investor a quicker recovery than feeling the full brunt of an 18% correction.

For example, in the Spring of 2009 (after a nearly 50% market correction) we would NOT have wanted to own anything that limited our upside exposure to a recovery.

Today, given full valuations and a 15+ year equity bull market, allocations that trade unlimited upside for risk mitigation make more sense.

So, what types of equity returns lie ahead?

Prognosticating forward returns is (thankfully) not the role we play for clients. As mentioned earlier, many have bet against equities at their own peril over the last 15 years. Rather than focus on what markets will do, our primary focus is on how best to allocate to equities during different regimes. *When has there been a year that hasn't surprised investors in some way?*

We believe it is appropriate for most investors to always have an allocation to equities, but the HOW can and should vary over time. By adjusting HOW we maintain the exposure, we become far less sensitive to HOW MUCH and WHEN.

Having said all of that, it is logical to conclude (given current valuations and empirical historical evidence) that the returns in the coming 5-10 years are unlikely to mirror the last decade. (see chart below) We believe our approach will add significant value if this proves true!

What about Gold, the US Debt and two wars? Do those not matter either?

All the above matter. By in large, however, none are actionable in scale for most portfolios.

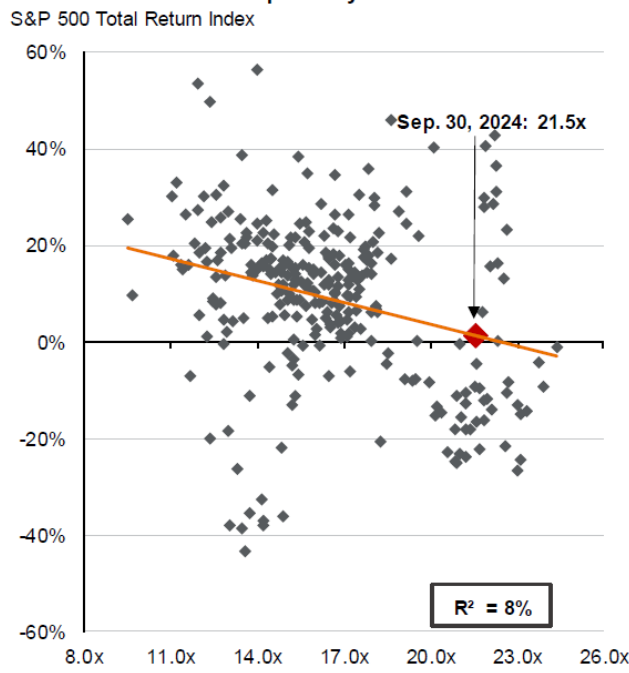
Why would we say that?

Gold has posted enormous gains in 2024 but is debatable as a portfolio diversifier or hedge. In 2022, when inflation skyrocketed and the Fed acted aggressively, GLD posted a loss. We are evaluating a trading position in GLD but aren't targeting it as a core holding.

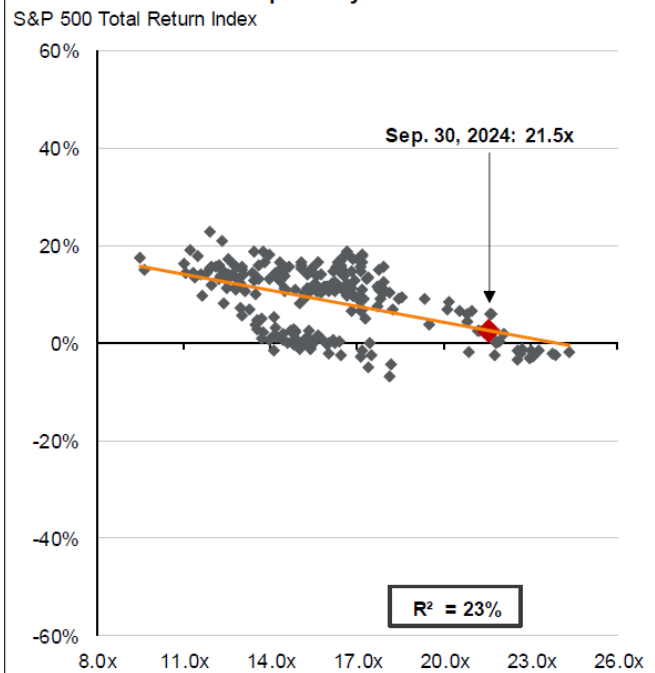
While hugely concerning, the US Debt obligation is likely one that will be a case of "kick the can" for many years to come. Some estimates suggest 2032 as the most probable timing for serious discussions about entitlement program funding and the national debt structure.

Since World War II, geopolitical events have garnered scary headlines but few lasting consequences for stock investors. We will never dismiss any specific episode, but the consequences of the current two wars is likely far greater in human tragedy than stock market consequence.

Forward P/E and subsequent 1-yr. returns



Forward P/E and subsequent 5-yr. annualized returns



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Historical EPS levels are based on annual pro-forma earnings per share. *2024, 2025 and 2026 EPS growth are based on consensus analyst estimates for each calendar year. Past performance is not indicative of future returns. *Guide to the Markets – U.S.* Data are as of September 30, 2024.

BONDS: WHAT HAVEN'T WE ALREADY SAID?

Many investors are aware of it, but not all bonds are created equal. Even George Orwell would agree.

Why does this matter? Why care about the nuances of fixed income?

The answer to this lies at the root of how our team continues to decisively outpace the Bloomberg bond index by more than 3% per annum for more than 2 years. Below are a few components of bonds that truly matter:

- Coupon
- Price
- Issuer
- Credit rating / worthiness
- Maturity
- Tax treatment of income

Given the above information, a manager can make an informed decision about risk and reward for a bond portfolio.

What are the types of bond risk?

The bond risk most familiar to investors is credit risk. The creditworthiness of the US Government is higher than that of Iran or Haliburton or a pool of car buyers. Accordingly, to compensate the lender (bond holder) for the additional risk taken, such securities pay a higher income than that of the US Treasury Bond.

A second risk that has become a prominent point of discussion in the last 12 months is duration risk. In essence, this is a measure of the interest rate sensitivity of a bond portfolio. When prevailing rates are at 2%, other bonds price based upon some yield over that number. In a year like 2022, when rates went up aggressively, other rates moved accordingly higher. With rates moving to 4%, those credit-sensitive bonds must yield something more.

So how does a bond with a 4% coupon yield 7%? Its price falls! When yields rise, prices fall. When yields fall, prices generally rise.

The third risk is a variation of the first listed (credit) that also factors in market volatility and economic conditions. Spread is what describes the relationship of a Haliburton bond to a US Treasury of the same maturity. In a

calm/normal market that excess yield might be 2.5%. When stresses in that sector or the broad market prevail (and buyers of such bonds become scarcer) that spread could widen to 6-8%. ***Recall again that the way yields go higher is bond prices fall.***

I will term the final risk “the risk of guessing what the Fed will do.” While not industry accepted terminology, this has been among the biggest reasons we have garnered exceptional results in bonds in recent quarters. Too many “professionals” have advocated adding to areas of the market that have failed to deliver over the last two years. Specifically adding duration (expecting yields to fall) has caused a lot of paper losses. Owning spread and short duration has worked. Only recently has this trend been rewarded (we believe it could be short lived).

You just listed a lot of ways to lose on bonds. Now what?

It's true, bonds can lose value based on changes in creditworthiness, economic conditions, interest rate policy, and supply and demand dynamics. Thankfully, active management and active portfolio allocation can navigate risk reward dynamics through all these factors.

Rather than aggressively betting on Fed cutting, we have chosen to own a larger allocation of consumer-focused bonds (i.e., mortgages) whose sensitivity to economic conditions is far greater than their sensitivity to Fed policy. Their coupons tend to be considerably higher than US Treasuries and US Agency paper. We are not locked into any stance, however. We have recently been actively adding to areas that we were underweight over the last 2 years as the markets evolve.

Any call to action?

Our #1 ask is a two-parter. ***First, please get out of excess cash and money market sooner than later ...rates are likely heading much lower. Secondly, we would love to have this conversation with your friends who have been hoarding cash in the bank/credit union, etc.*** The difference between 5-6% and 3% on a \$1 Million CD or bank deposit is worth a conversation!

PEEKING AROUND THE CORNER...

In the coming weeks our team looks to debut a new educational series. The initial focus will center around two timely and differentiated investment topics:

- **Hedging Risks in a Volatile World**
- **Fixed Income: Beyond the Basics**

Rather than create content in a vacuum and miss the mark, we welcome your feedback on what additional topics are of interest to you and your friends. Give us a call or e-mail your thoughts.

We anticipate offering a virtual option for those who may be unavailable to attend in person. As soon as

content is approved and a schedule is created, we will communicate how to reserve your seat.

With uncertainty seemingly lurking around every corner, we believe education about risk management techniques and strategies is more important than ever. Furthermore, if the next decade proves more challenging than the last, an alternative approach could prove invaluable!

Your help in getting the word out is most appreciated!

2024 CLIENT APPRECIATION EVENT...

December 11th

6:00 PM – 9:00 PM

Chesapeake's Seafood Restaurant

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