Insight Newsletter

FIRST QUARTER 2022

Litman Gregory
WEALTH MANAGEMENT

What's Inside

Investment Commentary

Market Recap

A lot has happened since our year-end letter just three months ago. The biggest macro event is Russia's brutal invasion of Ukraine. While the human impact has been devastating and tragic—and our hearts and support are with the Ukrainian people—our job here is to focus on the economic and financial market impact of this event.

It was a rough first quarter across the board, with stocks, bonds, U.S., international and emerging markets all hurt by rising interest rates, inflation and the war in Ukraine. Global stocks (MSCI ACWI Index) fell 5.4% for the quarter. Among major global markets, the S&P 500 was a relative outperformer, dropping 4.6%, compared to developed international markets (MSCI EAFE Index) down 5.9% and Emerging Market (EM) stocks down 7.0%. The relatively mild declines for the full quarter masked the intra-quarter volatility. At its low point on March 8, the S&P 500 was down 13% from its high on January 3. The developed international and EM stock indexes had drawdowns in the 16-17% range during the quarter, before rebounding roughly 10% by quarter-end.

Unusually, the damage was worse in the U.S. core bond market than the U.S. stock market. The benchmark Bloomberg U.S. Aggregate Bond Index (the "Agg") fell 5.9% for the quarter. This was the second-worst quarter for the Agg since Q1 of 1980, when Paul Volcker's Fed was in full-bore tightening mode. In the fixed-income markets outside of core bonds, high-yield (lower credit quality) bonds lost 4.5%, while floating-rate loans had just a 0.1% decline.

A period of rising inflation and rising interest rates creates challenges for both bonds and stocks, and in turn for a traditional balanced portfolio comprised only (or largely) of core bonds and stocks. Diversification into other asset classes, market segments and alternative strategies can be particularly valuable in such an environment. To that point, trend-following managed futures strategies were the standout performers with the benchmark SG Trend Index gaining 17.9% for the quarter and posting gains in each month. Trends in interest rates and bonds have been a powerful contributor to their performance this year, a sharp contrast to the losses in investment-grade bonds.

Investment Outlook and Portfolio Positioning

The past two years have seen a difficult-to-imagine series of major macro events and responses that are still in the process of playing out. Going into 2020 we had low interest rates and a strong economy. The emergence of the global COVID pandemic resulted in lockdowns and restrictions that in turn led to layoffs and supply chain disruptions. The global policy response was to provide economic stimulus including keeping rates ultra-low and increasing government spending to support affected businesses and workers.

After a sharp initial downturn in growth, the global economy recovered impressively, but the stage was set for a new challenge in the form of sharply rising inflation. The short version is that supply chain disruptions led to shortages in a wide swath of products where demand was high, and when demand outstrips supply the result is higher prices. At the same time, a shortage of workers led to rising wages as businesses competed to attract and keep workers. That combination – rising wages and rising inflation – can become a self-reinforcing spiral that is damaging to the economy. The Fed (and Central Banks around the globe) recognize this risk and have committed to preventing it by increasing interest rates to whatever extent is required.

Enter the next macro wildcard, which was Russia's invasion of Ukraine. The war in Ukraine has had wide-ranging but diverse impacts on the global economy and individual regions. Besides Ukraine itself, the most direct and damaging economic impact is on Russia. Given that Russia's economy is less than 2% of global GDP and that the Litman Gregory Strategies had close to zero exposure to Russian stocks or bonds, the Russian invasion has had an immaterial performance impact on the Litman Gregory Strategies.

However, Russia is a major producer and exporter of oil and natural gas—to Europe in particular, accounting for roughly 50% of Europe's natural gas imports and 25% of its oil imports—and certain agricultural commodities and base metals. As such, the war and the sanctions imposed on Russia by the West are having, and for the foreseeable future will continue to have, a material impact on global economic growth and inflation.

In a nutshell, the war is a "stagflationary" supply-shock: it fuels higher inflation via sharply rising commodity prices (especially oil) while also depressing growth via negative impacts on real disposable income and consumer spending. It is also triggering various government and central bank policy responses, which create additional risks and uncertainties for the economy and markets, given already-high inflation and decelerating growth coming into the year.

The path, timing, impact and ultimate outcome of the war remain highly uncertain. Russian and Ukrainian commodity exports could be further disrupted forcing prices even higher, or we may see a quicker resolution than the current consensus (to give just two examples out of many possibilities). As we've often said about shocking events such as this: the truth is no one knows, and if they think they know, they're fooling themselves. As Nobel Prize winner Daniel Kahneman put it: "The correct lesson to learn from surprises is that the world is surprising." In short, we want to build portfolios that are resilient in the face of surprises rather than ones whose success depends on predicting them.

The disheartening events in Ukraine came as the COVID-19 pandemic news was getting better. There has been a recent uptick in new cases globally—in China (leading to full lockdowns in the affected areas under China's "zero-COVID" approach), other Asian countries and Europe—and the U.S. has started to see a similar uptick. But over time, with continued rising immunity rates, vaccines, medical advancements, and social and business adaptation, the economic damage and disruption should continue to recede. That is our base case.

If so, this should both support economic growth via consumer and business spending and mitigate some of the inflationary pressures the U.S. and global economy experienced last year caused by widespread supply-chain bottlenecks, supply/demand mismatches for consumer durable goods (e.g., autos) and the subpar recovery in the U.S. labor force participation rate, which has contributed to higher U.S. wage inflation and increased the risk of a self-reinforcing wage-price spiral taking hold.

That said, Jerome Powell and the Federal Reserve are in a tough spot. They know they need to tighten monetary policy to prevent a wage-price spiral from taking hold. If they fail, it will require even more drastic policy tightening down the road increasing the likelihood of recession. Yet, much of the current inflation is driven by exogenous supply-side disruptions due to COVID and the Ukraine war that the Fed can't control. Raising rates is intended to crimp aggregate demand and should eventually have a downward impact on inflation. But it also raises the risk of driving the economy into recession.

We have long positioned our fixed income portfolios in anticipation of eventual rising rates, mainly because with rates so low there is limited downside protection from bonds (there's little room to go lower which is what drives bond prices higher) and longer-term bond return forecasts are poor, for the same reason. In other words, we're happy with our fixed income positioning away from core bonds through our diversification into flexible fixed income and alternative investment strategies.

Another important consideration is the impact of rising rates on stocks. A handful of U.S. large-cap growth stocks (e.g., the tech-heavy FANMAG* group) account for an historically large proportion of the overall U.S. stock market. These companies can be thought of as "long-duration" investments – in that they require a longer time period for company performance to eventually justify their high current valuations relative to the broader market. Low interest rates are a strong factor in supporting these high valuations and as rates have risen the toll on those stocks has been significant.

Here too diversification is key as simple large-cap stock index exposure is likely to remain vulnerable in a world of rising rates. Our equity positioning is broadly diversified, both through our use of active managers, in many of our portfolios, who can avoid areas of the market they find unattractive and through dedicated exposure to smaller-cap and value-oriented domestic companies as well as developed international and emerging market stocks. In addition, our portfolios have benefited from the uncorrelated performance of alternative strategies, including distinct areas that have had positive performance so far this year.

Closing Thoughts

The war in Ukraine has caused massive human suffering. From an economic and investment perspective, it has added to already-high uncertainty, degraded the near-term growth outlook, and added additional fuel to the inflationary fire. Crises, as painful as they are, often create opportunities. However, the equity and fixed-income markets have reacted quickly to the headlines, and as currently priced aren't offering any compelling new top-down tactical asset allocation opportunities, in our view.

Our balanced portfolios remain positioned with (1) a small overweight to global equities, coming from our tactical overweight to EM stocks; (2) a large overweight to flexible, actively managed, credit-oriented fixed-income and floating-rate funds; (3) core positions in lower-risk and diversifying marketable alternative strategies; and (4) a large underweight to core bonds, but still meaningful allocations in our most conservative portfolios. In many of our Litman Gregory private client accounts, we also have core holdings in private equity and private real estate funds run by skilled managers with strong track records and reasonable fees. These investments offer attractive long-term return potential plus additional portfolio diversification benefits relative to publicly traded securities.

We dislike market declines and periods of high uncertainty as much as anyone, but both are an inevitable part of investing. While uncomfortable, these stretches remind us of the fundamental principles that define our approach: invest for the long term because the short term cannot consistently be predicted, stay disciplined, diversify, and remember that disruption creates investment opportunities for those with the research skill and conviction to take advantage of them. As always, this is what we will to do in managing our client portfolios.

We appreciate the trust that our clients place in us to guide their investments through both volatile and steady times. We encourage you to reach out to your Litman Gregory Advisor to review your portfolio, individual situation, and any questions.

—Litman Gregory Investment Team (4/5/22)

Enhancements to Our Firm's Investment Strategy

Litman Gregory is pleased to share details on enhancements and updates to our long-term investment strategy that take into account the evolving investment landscape.

While our ongoing portfolio management involves regular rebalancing back to our target allocations, making occasional tactical shifts in response to risks and opportunities, and replacing managers with better options when appropriate, we periodically engage in a deeper and systematic strategy review that considers changes in the overall investment landscape and focuses on construction of the baseline portfolios from which our ongoing portfolio management is applied.

These deeper dives happen about once a decade, or sooner if we believe changing conditions warrant. The changes described below reflect work that began almost two years ago and that was completed last year.

We want anyone with an interest to have insight into how our investment process works and how it has evolved, so in this short article we offer a high-level overview on the foundation of our investment approach as context and then describe the changes and our rationale for making them.

Litman Gregory Investment Strategy Overview

Litman Gregory's investment strategy begins with the creation of globally diversified long-term ("strategic") portfolios, each of which is matched to a short-term (12-month) downside threshold –meaning that in the significant majority of 12-month periods we expect losses won't exceed that threshold (though building them never to exceed it would lead to hyper conservative portfolios unlikely to achieve satisfactory long-term returns).

The short-term loss threshold is an understandable way to express risk but selecting a suitable portfolio involves deep consideration for a client's circumstances including long-term goals, financial security, and temperament.

The second part of our process draws on the enduring principle that financial markets are usually, but not always reasonably efficient. This means it is usually better to build sensible, diversified, risk-matched portfolios and simply hold them for the long term. But inevitably there are periods where greed or fear drive markets to excess: the tech bubble and the financial crisis giving examples of each. These periods create potential to detract value by selling at depressed levels and conversely to create value by buying when prices are cheap.

It is imperative that clients are able to stay the course during difficult periods. Owning diversified portfolios that are unlikely to experience sustained declines beyond expected levels, along with understanding and accepting downside risk in advance, helps clients ride out these periods.

And selectively taking advantage of opportunities created during down markets can help us generate higher long-term returns for clients. We call this our "fat pitch" tactical approach, a term borrowed from the legendary Warren Buffett that gets at the importance of being patient and selective in waiting for an easy pitch to hit.

A final point is that clients are our partners in achieving their success. We work hard to set realistic expectations, communicate honestly, and reinforce their trust through our work on their behalf.

How and Why We Modify Our Strategy

The recent changes made reflect several client-focused goals that are more easily attainable today than when we last did a deep dive strategy assessment about ten years ago. These are: reduce expenses, reduce variability in how our portfolios perform relative to broad market indexes, increase after-tax returns, and be more systematic in how we "spend" our risk budget in pursuit of return. We'll give brief details on each.

On expenses, we still believe strongly in active management, but must nonetheless objectively consider the now-larger hurdle an active manager must clear to beat a low-cost index given how inexpensive index funds have become. We have concluded that greater use of low-cost index vehicles makes sense in asset classes where we believe it is already tougher for active managers to outperform (such as large cap U.S. equity). The higher return that results from reducing expenses is a rare "sure thing" in the investment world.

Using index vehicles also reduces the performance variation active managers experience. This matters because all active managers have periods of underperformance that can lead investors to want to act. Unfortunately, most emotion-driven investment decisions hurt rather than help performance and reducing those triggers helps ensure long-term success.

Index vehicles also contribute to tax efficiency, generally speaking, and are better-suited to other strategies to reduce taxable gains such as "loss harvesting" where an index vehicle that has temporarily declined can be sold to offset gains elsewhere and replaced with a nearly equivalent index (in other words a certain benefit is achieved–less taxes–with no real change to how we want the portfolio allocated).

Our final objective was to include alternative asset classes (which we have owned tactically) as dedicated long-term positions in our strategic allocations to add diversification and address challenges with ultra-low bond yields, which reduces bonds' downside protection while exposing us to inflation-driven interest rate risk. The recent rise in interest rates and resulting poor performance from core bonds makes clear the importance of this. Fortunately, we have been well diversified away from core bonds for a long time and have benefited accordingly.

While our strategy reassessment was underway prior to joining iM Global Partner in June 2021, their additional global research capabilities have been helpful. Working together we reaffirmed both the strong foundation of our enduring investment approach as well as the enhancements we implemented in our portfolios.

We want to reiterate that the foundation of our portfolio management approach is unchanged and draws on the same timeless principles that have served us and our clients for more than three decades. At the same time, we always want our clients to understand what we do on their behalf and why, and this communication is issued in that spirit.

Business Updates

iM Global Partner signs UN PRI and announces proactive ESG strategy

We are pleased to announce that iM Global Partner, and Litman Gregory Wealth Management as part of the organization, is now a signatory of the **Principles for Responsible Investment** (PRI), the world's leading proponent of responsible investment promoted by the **United Nations**. This commitment is part of iMGP's ambitious global ESG (Environmental, Social, Governance) strategy for 2022.

The need for positive sustainable action across all sectors of business has never been more prevalent. Becoming a member of PRI is another example of iMGP's efforts to play our part in a sustainable future for us, our clients and our partners. We believe it is time for the world of investments and finance to join the collective realization for the need for urgent action in incorporating sustainable development through a proactive ESG strategy. With this commitment, iMGP hopes to aid in spreading the message on the important role finance can play as an agent of change in meeting today's global challenges.aid in spreading the message on the important role finance can play as an agent of change in meeting today's global challenges.

You can read more in iMGP's **corporate social responsibility (CSR) brochure**.

Wealth Management Team Updates

We are committed to providing a deep team of experienced professionals to support our clients' financial success in the decades and generations to come. Below, we share news of the recent advancements within the Litman Gregory Wealth Management team.

Teresa Hatcher joins Litman Gregory Wealth Management as Associate—Client Services

Teresa joined the team in January 2022 as a Client Service Associate, and brings over 16 years of commercial banking and customer service experience. Her role at Litman Gregory directly impacts the client experience, as she focuses on providing personalized service to clients and ensuring that client-related goals and milestones are delivered efficiently and effectively.

Please join us in welcoming Teresa as the newest member of our team.

Gretchen Hollstein & Monica Muñoz Named as 2022 Forbes Top Women Wealth Advisors Best-in-State

We are thrilled to share that Gretchen Hollstein, CFP® and Monica Muñoz, CFP® have been named by Forbes as two of America's Top Women Wealth Advisors Best-in-State for 2022. This year's list spotlights 1,377 advisors nationwide who collectively manage $1.9 trillion for clients.

Gretchen has previously been recognized by Forbes as one of the Top Women Wealth Advisors and Best-in-State Wealth Advisors in both 2020 and 2021. Gretchen has been providing advisory services for over 25 years and working with Litman Gregory clients since 2005. Her experience includes extensive work in personal financial analysis, asset allocation, retirement planning, and multi-generation family legacy planning.

"We are grateful to Forbes for shining a light on top women wealth advisors," said Gretchen. "It's very rewarding to be in a role where I can help guide clients through scenario planning and help them make decisions that create positive impact. I know this work wouldn't be possible without the entire team at Litman Gregory, and I feel honored to be included and represent our firm."

Monica has previously been named as one of Forbes' Top Next-Gen Wealth Advisors in 2021, and has been serving Litman Gregory clients since 2007. Monica provides wealth planning and investment advisory services to individuals and families, with a specialty in next generation wealth.

"It is an honor to be recognized by Forbes alongside the other esteemed top women wealth advisors," said Monica. "We are incredibly grateful for the trust and confidence we receive from our clients and remain committed to helping them gain more financial peace of mind through the wealth planning and investment management work that we do."

The Forbes ranking, developed by SHOOK Research, is based on qualitative and quantitative data, rating thousands of wealth advisors with a minimum of seven years of experience and weighing factors like revenue trends, assets under management, compliance records, industry experience, and best practices.

Contact

Contact our team for more information on our services

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