Insight Newsletter

THIRD QUARTER 2022

Litman Gregory
WEALTH MANAGEMENT

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Market Recap

After a rough first half of 2022, equity markets rebounded in July and August on investor hopes of easing inflation and a Fed pause. The reprieve was short-lived however, as stocks tumbled to fresh lows in late September amid further aggressive central bank rate hikes and statements of further tightening to come.

Global stocks (MSCI ACWI Index) fell 6.82% for the quarter and are down 25.63% for the year. The S&P 500 dropped 4.88% for the quarter and is down 23.87% for the year. Developed international markets (MSCI EAFE Index) fell 9.36% for the quarter and 27.09% YTD. Emerging Market stocks (MSCI Emerging Markets Index) dropped 11.57% for the quarter, and down 27.16% YTD.

Foreign stock market returns were negatively impacted by the sharp appreciation of the dollar. The U.S. Dollar Index was up 7.1% for the quarter and a stunning 17.3% on the year, hitting a 20-year high. These dollar gains translate into roughly comparable losses for U.S. dollar-based investors in international equity markets. For example, the MSCI EAFE Currency Hedged Index return this year is -13.05% vs. -27.09% unhedged; and the MSCI EM Currency Hedged Index return this year is -21.53% vs. -27.16% unhedged. A reversal in the dollar would be a major tailwind for unhedged (USD-based) foreign equity returns going forward.

Core investment-grade bonds didn't avoid the Q3 carnage. The 10-year Treasury yield hit a post-2008 high of 3.97%, causing the Bloomberg U.S. Aggregate Bond Index (the "Agg") to drop 4.75%. This puts the "safe-haven" Agg down an incredible 14.61% for the year to date. In other segments of the fixed-income markets, high-yield bonds (ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index) dropped 0.69% and floating rate loans (S&P/LSTA Leveraged Loan index) gained 1.37% for the quarter. For the year to date, floating rate loans have been one of the best performers, down just 3.25%.

"Non-traditional" asset classes — non-core fixed-income market segments and alternative strategies — were positive again in the third quarter. Trend-following managed futures strategies were the standout performers once again, posting gains in the low-to-mid single digits for the quarter, and returning 23% to 32% for the year, depending on the fund.

Investment Outlook and Portfolio Positioning

The Fed's response to the sharp spike in inflation has been to aggressively raise interest rates – their only means of bludgeoning economic activity

to reduce aggregate demand and in turn bring inflation in line with their longer-term targets. This has been the catalyst for the steep declines in both stocks and bonds.

While headline CPI inflation (which includes food and energy) seems to have peaked, core inflation measures have continued to rise and are far above the Fed's 2% target. This indicates inflationary pressures have become more widespread throughout the economy, rather than driven by a few extreme outliers as in 2021.

Some of this broad-based core inflation is still due to the initial "transitory" COVID-related supply-side disruptions and production/distribution bottlenecks, which central banks can't do anything about. The good news is that many of these supply-chain disruptions are dissipating as the pandemic recedes globally. However, the demand-side drivers of core inflation in the U.S. have not yet peaked, let alone demonstrated the consistent month-over-month declines that Fed Chair Jerome Powell says the Fed is looking for as "clear evidence" inflation is headed to their 2% target. As such, and as expected, the Fed has continued its path of aggressive rate increases and has signaled there is more to come.

The Fed's policy hammer of higher interest rates will eventually pound down GDP growth and increase unemployment. The odds the Fed can engineer an economic soft landing — where the U.S. economy slows sufficiently to tame inflation but does not fall into a deep recession with much higher unemployment — are increasingly slim. In fact, historically reliable indicators, including the Leading Economic Index and an inverted yield curve, point strongly toward a recession, and that is now our base-case scenario for the next 12 months.

Our focus is on longer-term fundamentals and valuations, and we are not in the business of making shorter term bets on the markets. However, our analysis tells us that at current valuation levels, stocks may not be adequately discounting the potential for further earnings declines, and that has led us to revise some of our underlying assumptions and reduce the return we expect from stocks over our five-year horizon.

At the same time, the sharp increase in interest rates this year has driven bond yields up to more attractive levels — more attractive than they have been in about a decade. On a relative basis, core investment-grade bonds now look much better versus stocks than at the start of the year. Further, core bonds provide good downside protection, which would be especially helpful if conditions turn out to be worse than currently anticipated. For these reasons, we are making a modest shift to our target allocations to increase core bonds and reduce equities (generally from 2% to 5% depending on the portfolio). It is possible stocks will decline further and reach levels that make them highly attractive for the long-term, and as always we will be looking at adding to equities at that time.

Closing Thoughts

It's been a tough year, with most investors (ourselves included) braced for more to come. But all bear markets come to an end, and it is worth remembering that the bottom is by definition the point at which things collectively feel worst. We think long term and remain confident in our ability to deliver the long-term returns required to meet financial objectives while balancing risk.

While stocks and core bonds — the building blocks of our portfolios — have had a rough year, the way that we balance risk is by creating diversified portfolios, and many of the investments we own for this purpose have been bright spots. Managed futures, which were frustrating to own while stocks persistently climbed, have delivered significant positive performance. And private investments in real estate and private equity have held up well relative to traditional stock and bond asset classes.

As always, we thank you for your trust and welcome questions you may have.

—Litman Gregory Investment Team (10/5/22)

With Inflation Rising, Why Have Inflation-Protected Bonds Declined?

Treasury Inflation Protected Securities, aka TIPS, provide investors with a return that is indexed to inflation over the life of the bond. With the sharp rise in inflation that began in 2021 *(see our recent* **post:** *for more detail on the causes and investment impact)* many investors who own TIPS expected to see gains as a result. But actual TIPS' performance during this span has disappointed them and for some become a source of confusion. We'll do our best to explain what's going on with TIPS performance and set appropriate expectations for the future.

How TIPS Work

A quick reminder of TIPS basics is a necessary starting point.

- TIPS are issued by the U.S. Treasury in 5-, 10- and 30-year maturities with the initial interest rate set by auction. In other words, the market decides what it is willing to pay for the inflation protection built into TIPS (e.g. if investors expect higher inflation they will pay more for the bonds and thus receive a lower interest rate, and vice versa).

- Once issued, the value of a TIPS bond is adjusted twice a year in accordance with changes in the Consumer Price Index (the CPI). If prices increase (aka inflation) the principal value of the bond increases commensurately, or, more rarely, if the CPI is negative (deflation) the TIPS value declines by that amount.

- While the interest rate or coupon is fixed at the time the bond is issued (per the auction), that rate is applied to the principal value of the bond, which increases along with inflation. The result is that changes in inflation result in increases (or decreases) in both the value of the bond and the interest payments it generates over time.

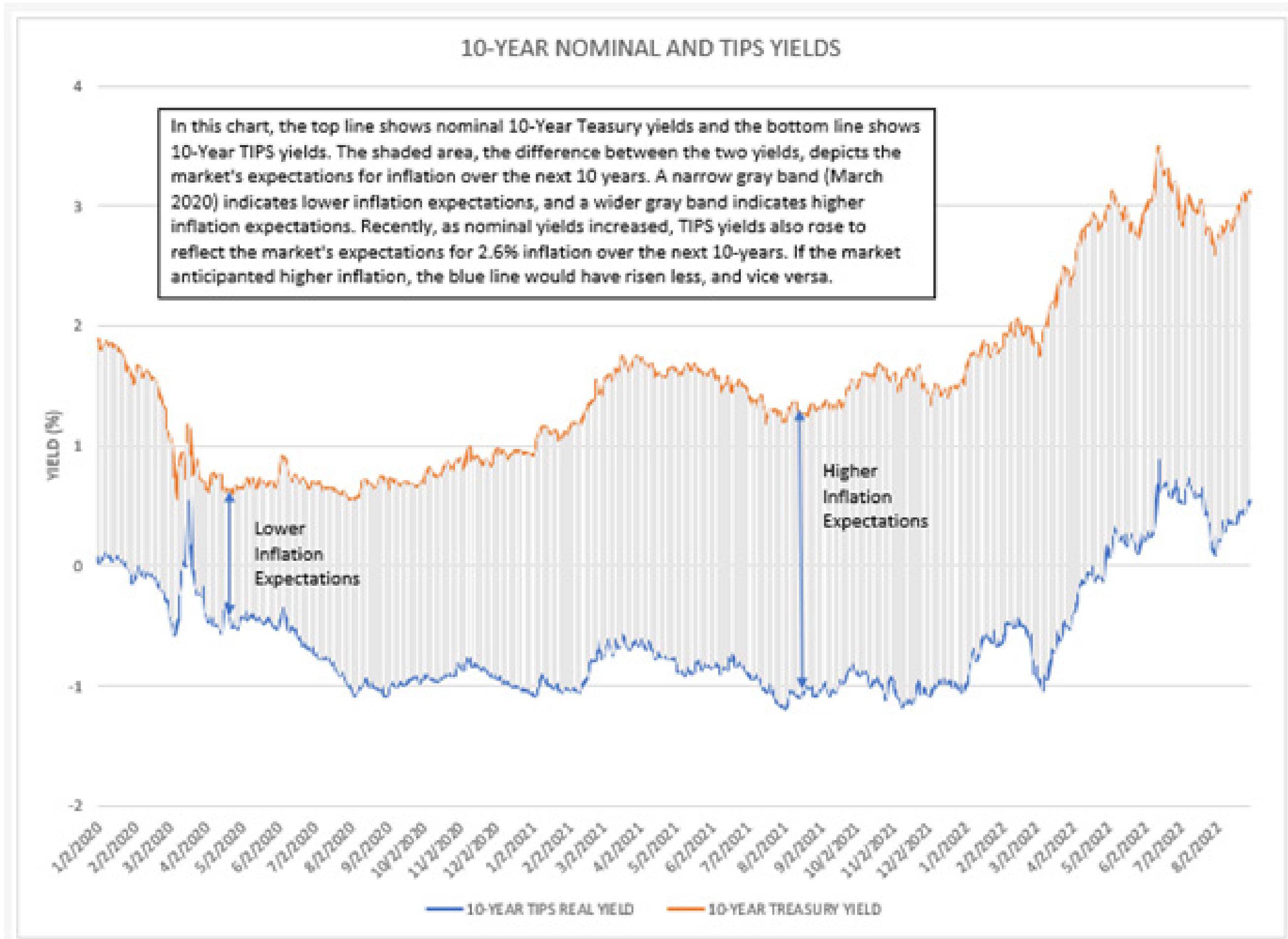
- While the price of a "conventional" bond changes with changes in nominal interest rates (meaning the "regular" rates we see quoted every day which are gross of inflation) the price of TIPS are affected by changes in "real" rates, which are net of inflation expectations. (More on this shortly.)

How TIPS Behave, And Sometimes Seem To Misbehave

- TIPS are reliable in delivering on expectations if held to maturity. You know the bond's cost and interest rate up front. You know those values will increase with inflation and that if held to maturity you will receive that value (making any volatility along the way of little consequence). For more information on bond pricing while interest rates change, please see our recent **post on "bond math**."

- Over shorter periods, though, TIPS can be volatile. TIPS with long maturities are more sensitive to changes in real rates (which is the mashup of nominal rates and inflation expectations) and investor expectations on those variables affect prices. Generally speaking, TIPS can be expected to perform well when unexpected inflation emerges, and real rates don't spike, as was the case in 2021. During that year, inflation rose from 1.4% to 7.0%, a level well above expectations, while 10-year real yields ended the year virtually where they started.

- This takes us to this year, in which we saw TIPS fall in value during a period of higher inflation. While TIPS' investors benefited from higher principal and interest payments, investors have expressed their collective belief that inflation won't remain at today's high levels. At the end of August, investors are anticipating inflation to be 2.6% to 2.7% in five to 10 years, a far cry from today's elevated levels. The result of nominal interest rates spiking higher at a time when investors believed longer-term inflation would come back down was effectively an increase in real rates. (The chart on the next page illustrates this.) And as we know, TIPS prices move inversely to changes in real rates just as conventional bond prices change in accordance with nominal rates. That is what drove the decline this year; interest rates rose by enough to more than offset the benefit that TIPS received from the inflation adjustment.



Source: U.S Department of The Treasury. As of 8/15/22.

One way of thinking about this is that the normally reliable "bond math" around rates and prices that we see with conventional bonds is less definitive for TIPS – especially in volatile periods – because there is more for investors to anticipate with both interest rates and inflation rates. Just as investors would pay less for the stock of a company if they had a strong belief its earnings were going to fall, TIPS buyers are paying less than what current inflation numbers suggest in anticipation of inflation coming down from elevated levels. In fact, this is consistent with our own belief on inflation, as we've written many times.

Our Take on TIPS

We understand that some are disappointed in TIPS performance this year, but it's worth the reminder that disappointment or happiness is always a function of expectations. We aren't concerned or surprised by TIPS performance. When we initially added TIPS in 2021 as part of the periodic revision of our long-term "strategic" allocations, we wrote "we will initially be underweighted to TIPS given their negative real yields, and the current implied level of inflation."

But TIPS are part of the long-term strategic allocations for most client portfolios and we are confident they will do the job we drafted them to do: mitigate the impact of long-term higher inflation, outperform core bonds during rising-rate environments (which they've done), and provide diversification through their low correlations to the other types of investments we own.

We appreciate the opportunity to answer any additional questions. Please feel free to reach out to your advisor to discuss this and/or your individual situation.

I Savings Bonds Currently Offer a Generous Yield

The Portions May Be Small But It's Still Pretty Close To A Free Lunch.

Update as of November 2, 2022: This article was originally published on our website in August 2022. On November 1 the interest rate on I Bonds was reset and now stands at 6.89% for the first six months for bonds purchased from November 1, 2022 through April 30, 2023. The new rate, though lower, is still attractive and doesn't affect the general points made in the article below. As we review I Bonds going forward, we will provide an additional update if our opinion changes.

With a current yield of 9.62%,[1] no credit risk in that they are U.S. Government bonds, and no interest rate risk since their principal value cannot decline, Series I Savings Bonds are an attractive option for most investors and savers. The only "downside" is that they are limited to a maximum investment per person of $10,000 per calendar year for electronic purchases, with an additional $5,000 available to purchase paper bonds with your tax refund — if you have one.

Series I savings bonds ("I" stands for "inflation") also referred to as "I bonds" are issued by the U.S. Government and their interest rate is linked to current inflation rates. Their yield is comprised of a fixed rate, which for these issues is zero, and a semiannual inflation rate, which is 4.81% (9.62% annualized) on bonds purchased between May and October 2022. Six months after purchase, the I bond's yield will be reset based on the latest inflation rate (from readings done on November 1 and May 1), as measured by the non-seasonally adjusted Consumer Price Index for all Urban Consumers (CPI-U). So, if inflation eases over time the yield will reset lower.

A few noteworthy facts are that I bonds pay interest for 30 years, and you can cash them in at any time after holding for one year. But if the bond is redeemed during the first five years after purchase, the seller foregoes the last three months of interest. At six-month intervals interest is added back to the bond's principal value. Another attractive feature is that interest from I bonds is not subject to state and local taxes, and although they are taxable at the Federal level, that tax can be deferred until the year the bond is sold (or matures) or paid annually (as might make sense if a child is the owner). Eligible education expenses can also be used to offset the taxable interest.

Series I bonds are available through the government's TreasuryDirect website, where you can buy and redeem securities directly from the U.S. Treasury in paperless electronic form with the annual cap of $10,000. You can purchase an additional $5,000 of paper bonds by using **IRS form 8888** (complete Part 2) to direct the IRS to use all or part of your tax refund to purchase paper I bonds. Although your Litman Gregory advisor is not be able add these I bonds to your investment portfolio (you must purchase them on your own) we are happy to guide you through the process. With a 9.62% current yield, this "free lunch" is worth consideration, even if the portions are small. **Here is a Q&A** from the TreasuryDirect website that walks through the basics, including how to purchase.

Please feel free to reach out to your advisor if you have any questions.

[1] (9.62% annualized, 4.81% semi-annual) on bonds purchased between May and October 2022.

3 Tips for Protecting Yourself Against Cybersecurity Risks

October is "Cybersecurity Awareness Month" — therefore it's a great time to revisit important safety reminders to protect yourself against common fraud and cyber-attacks, especially around finances.

The first step is to be aware of how to identify fraud attempts, so we have compiled a few visual examples **here**.

But in addition to knowing what to look for, there are three key steps that you can take to protect yourself.

1. Protect your personal information

- **Enroll in an identity theft protection service.** Do this proactively to safeguard personal data.
- **Be wary of any unsolicited inbound phone calls.** These include unexpected calls from potential tech support, government agencies, banks or other financial services firms, software companies, utility companies, or even supposed Litman Gregory employees. Never give information over the phone unless you are able to verify the caller is legitimate, which you can do by hanging up and calling back using the official number you have on file. (Or visiting their website and calling via their listed number.) The IRS and the Social Security Administration will not call you.
- **Protect information on social media.** Sharing too much information can make you susceptible to fraudsters and allow them to quickly pass a variety of tests related to the authentication of your personal information. Do not share details such as birthdates, home addresses, phone numbers, or social security numbers. And, consider whether to post pictures or comments that make it obvious you are away from your home.

2. Protect your accounts and passwords

- **Protect your email account.** Do not click on any links or open any attachments whatsoever unless you're expecting the communication and you're completely sure they are coming from legitimate sources. When in doubt, review the full email address in the "from" field to help determine if it could be from a fraudulent source.
- **Safeguard account access.** Use two-factor authentication when available. Do not reveal personal or financial information in an email. Deliver sensitive information through a secure means. If sharing with a Litman Gregory team member, you can use our secure client portal.
- **Secure and use strong passwords.** Use strong passwords (or passphrases) and do not use the same password for different accounts. (A strong password includes letters, possibly both caps and lower case, along with numbers and symbols.) Regularly reset your passwords, and do not store your passwords in email or other folders on your computer. Consider using a password manager program such as LastPass or 1Password.

3. Protect your devices

- **Manage your devices.** Always use the most up-to-date antivirus software and update software regularly. These programs are most effective when users set them to run regularly rather than just running periodic scans, which may not provide maximum protection to your device.
- **Surf the web safely.** Do not connect to the Internet via unsecured or unknown wireless networks, such as those in public locations like hotels, airports, libraries or cybercafés. These networks may lack virus protection, are highly susceptible to attacks, so should never be used to access confidential personal data. Litman Gregory's Polices to Protect Clients' Financial Information

Litman Gregory's Polices to Protect Clients' Financial Information

- We have established policies and procedures for **handling suspected/confirmed compromises** to client accounts, which include:
  - We train our team members regularly on cyber fraud topics and test employees using cyber fraud simulations.
  - Our team will call our clients to verbally confirm and verify money transfers instructions and information.
  - We may need to disable the ability for fund transfers or establishing new account numbers.
- We have established security policies and procedures to **protect client sensitive data** that include:
  - Minimizing authorized access to the data
  - Plan appropriate handling of data, device and network management
  - Plan for physical security of data

For many years, we have aided clients as they navigate the threats of cybercrime and work to protect themselves from attempted security breaches. We remain focused on staying abreast of new ways that we, and our clients, can work to protect their identity and finances.

Please reach out to your advisor if you have any questions about how we can help you, or to better understand the steps that we're taking to protect your information.

Planning for One Thing That's Certain: Taxes

As we enter the final months of this year, which has been full of uncertainties, we wanted to share some of the timeless strategies that we focus on in our discussions with clients around one thing that is certain this year – taxes:

- **Maximize the use of tax-deductible retirement plan contributions** each year to lower your tax liability as much as possible. The SECURE Act now permits savers to continue contributions to IRAs even after age 70½.
- **Make annual or one-time gifts to family members** to transfer taxable income and future gains from your portfolio to others, potentially reduce family-wide tax liability, and reduce your taxable estate during your lifetime.
- **Gift appreciated securities held for more than one year directly to charities or to a charitable donor-advised fund (DAF).** The tax deduction is based on the value of the gift, and tax liability for you on any built-in capital gains are eliminated.
- **Concentrate multiple years of charitable deductions into one year** to maximize the tax benefits of giving, using the technique of "charitable bunching."
- **Consider qualified charitable distributions (QCDs) from IRAs for those over age 70½**, especially if you would not otherwise receive as advantageous a tax deduction for gifting taxable assets. If you're over 72, QCDs also count towards your required minimum distributions.
- **Consider a Roth IRA or Roth 401(k) conversion or even discretionary distributions of IRA assets**, especially if this will be a low-income-tax-rate year for you and/or when asset values are down. If you have not begun taking required minimum distributions from IRAs, one strategy we often recommend is to reduce or eliminate your pre-tax traditional IRA assets before they kick in.

Throughout the year, we regularly look for opportunities to maximize after-tax portfolio returns beyond investment selection, allocation, and periodic rebalancing. As part of our tax sensitivity in managing investment strategies **we utilize some of the following techniques in our client portfolios:**

- We aim to **hold investments in taxable accounts for more than one year** before selling them so that long-term capital gains tax rates will apply. The tax difference can be significant. (However, we always assess the potential risk and return tradeoffs that result from any decision to extend an investment holding period.)

- When raising cash in your portfolio, we do so by **selecting securities or individual lots of a security that have the lowest taxable gain** consequences.

- We **consider carefully before selling investments with large built-in gains**, unless the sale is justified by a higher expected return from another investment or is necessary to maintain portfolio asset allocation objectives.

- We seek to **place the interest-earning portion of portfolios in tax-deferred accounts** given interest income is taxed at the top marginal rate, unlike long-term capital gains.

- For portfolios without significant tax-deferred assets, we will generally recommend **holding tax-exempt bonds** in lieu of taxable bonds, depending on the client's marginal tax rate

- We **look for opportunities to "harvest" capital losses** if there is market volatility throughout the year, as well as during our year-end review. These realized losses can then be used to offset realized gains elsewhere within or outside the portfolio, either in the same tax year or rolled forward to future tax returns. Proceeds can then be placed in comparable investments so the portfolio allocation remains intact.

- We **consider any anticipated taxable year-end distributions** from investments within a portfolio when rebalancing, raising cash or harvesting taxable losses.

As always, we welcome the opportunity to discuss these planning topics with our clients and to coordinate with their tax advisors to determine the best techniques for each client's individual tax situation. Please contact your Litman Gregory Wealth Management advisor for more information and to review your situation.

Note: As with all tax planning, every person's situation is different. We suggest consulting with your tax advisor before implementing any of these tax planning techniques.

Key Tax Changes in 2022

In 2022, several changes went into effect that may impact your tax situation. Here are a few key highlights:

- **401(k), and other employer-sponsored plan contribution limits:** The annual contribution limit for 401(k)s and similar plans increased to $20,500 (up from $19,500 in 2021). Those age 50 or older can make an extra "catch-up" contribution of $6,500, for a total of $27,000.

- **IRA contribution limits:** Traditional or Roth IRA contribution limits (combined) remain at $6,000, or $7,000 if you are age 50 or older. However, the modified adjusted gross income limitation to make Roth IRA contributions increased to $144,000 for those filing single, and $214,000 for those filing joint tax returns.

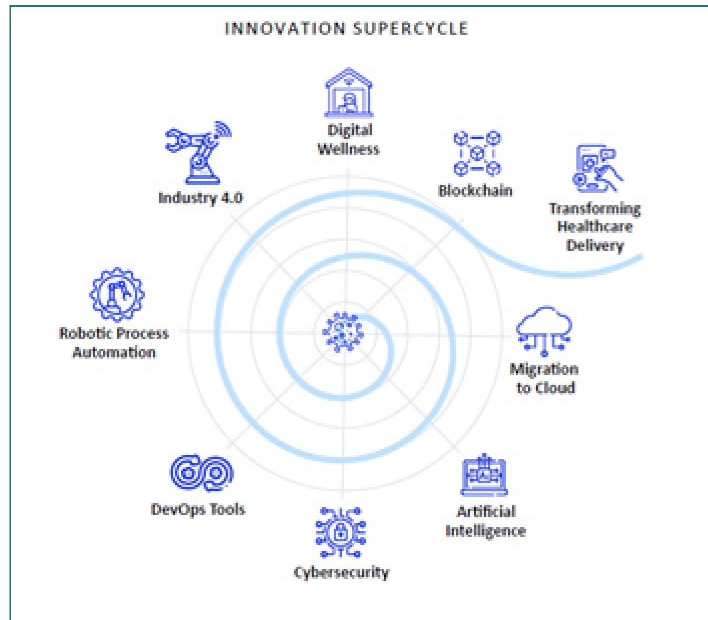
- **Annual gift tax exclusion limits:** The annual amount that any individual can give to another individual without having to report the gift to the IRS (or use some of their lifetime estate tax exemption) is now $16,000, up from $15,000 where it has been since 2018.

- **Estate & gift tax exemption limits:** The federal estate and gift tax exemption amount is now $12.06 million, up from $11.7 million in 2021. (It is important to note that as the law currently stands, this amount will sunset after 2025 and revert to the 2016 limit of $5 million indexed for inflation.)

Research Update: Opportunities in Private Equity

In managing client portfolios, we focus on finding opportunities for long-term growth, while also keeping an eye on shorter-term risk. In seeking long-term growth, we focus on strategies that invest in companies whose earnings and valuations are expected to increase over time. These investments are often in companies that trade on the public stock market exchanges, but they can also be made in privately held companies. We have found that carefully chosen private equity (PE) investments can add meaningful value to a diversified portfolio. Further, we consider our ability to identify PE investments to be an important value we add for our clients, where suitable, and in this piece we set out to demystify the space and explain how and why we selectively use PE.

Venture and growth capital strategies seek companies with potential to transform an industry.



Source: Adams Street Partners 2022 Global Investor Survey; Private Markets Insights: Optimism in an Age of Change, published March 7, 2022.

To some, the term "private equity" may suggest a realm of exotic early-stage investments or aggressive restructuring from corporate raiders that bring high levels of risk and potential reward to elite investors. While there are a range of PE strategies employed, and we'll walk through them briefly in a bit, a helpful foundation in understanding the space and the opportunity it affords is to start with the term itself. Private equity simply refers to equity ownership in private rather than publicly traded companies.

When it comes to raising capital to finance expansion or other objectives, companies can borrow money or sell a portion of their stock. Borrowing entails risk because the financial burden of debt payments can damage or bankrupt a business if it encounters a severe downturn. By selling stock, a company can raise capital to fund expansion or a turnaround – or to allow existing owners to exit the business – without the risk to the business that debt brings. (However, the "cost" of equity, in the form of dilution to existing owners, is significant as well, and at times can be prohibitive.)

While going public through an initial public offering (IPO) can create access to the large amounts of capital available in the public markets, it comes at a cost of a heavy regulatory burden and excessive investor focus on short-term earnings. For these reasons, over the past two decades more private firms have opted to stay private, raising capital from various private market investors including venture capital (VC) and growth equity funds rather than go public. In fact, the number of publicly traded U.S. companies has dropped by almost half since the late 90s and the investable universe of private companies is now significantly larger.

Investing in PE is done through private investment funds that are offered and managed by firms with expertise in specific industries and strategies. These funds are often structured as Limited Partnerships (LPs) in which the PE managers are the General Partners (GPs) who are responsible for investing the fund's assets and managing the overall fund, and Limited Partners (LPs) provide the bulk of the capital but are passive and have no involvement in the fund's operations. GPs typically look to build teams with strong networks within specific industries that can help identify attractive opportunities and provide a source for operational experts and consultants that can help improve a portfolio company's performance. GPs sometimes even place their own "operating partners" inside portfolio companies to help accelerate improvements.

The time horizon for typical PE funds is lengthy – usually 10+ year terms – and during that period there is little opportunity for liquidity. An investment in a PE fund involves a total dollar commitment that is invested in increments (over time) when the GP makes "capital calls" to the investors as needed to fund the investments it identifies.

PE funds generally have high minimum investments, and there are regulations that usually restrict investment in these funds to Qualified Purchasers. (QP) Qualified Purchasers are sophisticated investors that meet requirements around total investable assets, annual income, and/or investment experience.

The limitation on eligibility to invest in private equity isn't an issue for most of our clients; rather, the more difficult issue for incorporating PE into our clients' portfolios has been the high required investment minimums for many of these funds. For example, some PE vehicles have a minimum of

$1 million (and most established firms now have minimums higher than this), which can be more than an investor would like to allocate to just one PE fund. Further, this high minimum can make it challenging to implement an appropriate allocation to PE within a portfolio. For example, an investor with a maximum desired allocation of 10% would require a total portfolio value of $10 million (and this example doesn't provide for the diversification we would like to see within an allocation to PE – see more on that below).

One of the reasons for high minimums has been the high operational complexity and cost involved in administering PE vehicles, which include complex accounting, capital calls, etc. that can make it uneconomical for PE vehicles to take smaller investments. And if the investment opportunities that meet their criteria are finite and they are easily able to attract investors – as is the case for many established PE firms with long and successful records – there is no incentive to take on smaller investors.

Increasing availability of high-quality, lower-minimum fund-of-funds expands the ability to include PE in diversified portfolios.

Fortunately, in recent years there have been increasingly more fund-of-fund vehicles offered by PE investors we believe to be highly skilled and who – through a combination of technology and broader distribution – are able to offer high-quality underlying PE investments at more accessible minimums in the six- rather than seven- or even eight-figure range. Additionally, they provide more diversification among PE investments, which is also important. This in turn broadens the profile of clients where we feel confident including PE in their portfolios.

Of course, there are other important factors in allocating to PE, including time horizon, liquidity requirements, risk tolerance, etc. and all of these are taken into account in our guidance to clients as to whether or not we recommend including PE in their portfolios. But for those where it makes sense, PE brings a number of advantages relative to the liquid stocks and bonds we use to build client portfolios.

Potential Benefits of Private Equity

- **Large investment universe.** The number of private companies far exceeds that of public companies, and many companies are staying private longer, which provides more of the growth opportunity to private investors.

- **Longer time horizon with which to add value.** PE managers can help smaller companies in particular improve operations and pursue new opportunities that have a high likelihood of paying off over a multi-year horizon. This leads to the next point, which is…

- **Less distractions relative to public companies.** Management teams can focus on running and growing their businesses without the short-term pressure of earnings calls and incentives that many public companies face.

- **Strong alignment between company management teams, PE managers, and investors.**

- **Inefficient information flow.** Public markets have a very level playing field in terms of disclosure that reduces an investor's ability to gain an information edge over other investors. However, in the private space a skilled PE management team with strong industry knowledge can potentially uncover unrecognized opportunities.

- **Ability for GPs to add value.** The same network and expertise that allows GPs to source attractive deals can also help them bring value to the companies they own through operational improvements, restructuring, uncovering new growth opportunities, creating scale through add-on acquisitions, etc.

- **Diversification.** PE funds and their underlying investments are significantly affected by unique factors connected to their particular business versus broader stock or bond market dynamics. That's not to say they are immune to the broader business environment, but attributes like where they are in their lifecycle, development of innovative and sometimes transformative products, and highly specific business challenges and opportunities, for example, result in very different return drivers for PE funds, which creates a diversification benefit when added to a portfolio that includes public equities.

- **Consistent long-term track record of outperformance versus public equities.** Individual PE investments can be highly risky, and PE fund returns can be negative early on as capital is deployed that will take time to generate a benefit (and fees are paid), before turning positive as improvements are realized (the performance pattern is described as a "J-curve").

The potential advantages of PE can vary widely depending on what types of strategies are employed and how skilled the PE management team is.

Investment Strategies Employed by PE Funds

Buyout is the largest PE category and typically involves taking a controlling interest in a company and employing strategies such as restructuring to improve its growth and profitability. This can involve a private company or a public company that is then taken private. Buyout managers typically look for somewhat more mature, stable companies and use leverage to varying degrees to enhance returns.

Growth capital is also a large category and usually involves buying equity in a private firm with an established business that needs capital for growth or acquisitions. These are usually minority investments where the interests of company management and the PE investors are strongly aligned. Because these companies are typically still experiencing high growth, little if any leverage is used for growth capital investments.

Venture capital (VC) is also a significant category and involves early-stage investments in companies that can be highly innovative and/or disruptive to existing industries (think Uber versus traditional taxi companies). These companies generally carry the highest risk and the highest potential for reward. The VC model relies on a few massive winners in each fund returning multiples of their initial investment to generate performance, overcoming the higher number of companies that produce negative returns (with many being written off entirely).

Distressed involves equity or debt investments in companies facing significant financial or operational challenges that the PE manager believes can be turned around including through restructuring, often after gaining control via the debt through a bankruptcy process.

Secondaries are typically the sales of an existing interest in a PE fund to another investor, usually at a discount that reflects the lack of liquidity. This could happen if an institution becomes overallocated after public markets decline sharply but has in recent years become more common as a standard way for LPs to manage their PE portfolio for a variety of reasons (e.g., trimming the number of non-core GP relationships). Related to this is a more recent trend where PE managers raise capital from secondary investors to create a new vehicle to hold on to investments they believe still present significant growth opportunity but where the original fund is nearing the end of its planned life. Finally, secondaries can be interests in individual

companies, where an owner of private stock wants to sell a portion to raise cash for another purpose. This could be an employee of a private company needing cash and not being willing or able to wait for the IPO.

How We Use PE Investments within Diversified Portfolios

Given the lengthy commitment period, lack of liquidity and high levels of volatility and risk, successfully investing in PE requires a strong research focus and careful consideration when and how to include PE in a more broadly diversified portfolio. Our research team (through our affiliation with iMGP) has expertise in identifying and completing due diligence on suitable PE investments, and we have a clear approach for how we include PE in our client portfolios.

Client suitability is critical and is always the starting point. What does that mean? Risk tolerance is part of it, but it's more than just the degree to which someone is uncomfortable with volatility or the idea of more speculative investing. Of course we have to consider their comfort with this style of investment, but even more important is a client's overall financial position relative to their goals.

Suitability is based on a client's risk tolerance, time horizon and liquidity needs.

A client with multiples of capital more than they require for financial security can make longer-term and potentially riskier or more speculative investments without as much concern for unexpectedly needing liquidity or for the impact that an unforeseen investment downturn or setback can have on their lifestyle. A client with a high likelihood of achieving their financial objectives in the future but less margin for error may not want or need to complicate that by owning something with higher volatility and low liquidity, as it could create some potential for disrupting their broader objectives. Wherever a client falls on this spectrum we carefully consider their full financial circumstances to determine whether an allocation to PE makes sense, and if so to determine the appropriate size of an allocation to PE for their portfolio.

Turning to portfolio construction, any addition to an already-diversified portfolio includes determining which existing investments it will replace. We consider PE to be a part of our "alternatives" category, which refers to investments with different risk and return drivers than the more traditional (and publicly traded) stocks and bonds that serve as core portfolio building blocks. Alternatives are selected to reduce overall portfolio volatility and, depending on the investment, to also reduce downside risk or increase upside return potential – and in some cases both – relative to the investments they replace.

PE usually replaces publicly traded stocks in a portfolio.

In the case of PE, given its typically more aggressive risk profile, it generally replaces public equities (stocks) one-for-one in our client portfolios (though this can vary depending on the types of strategies included in each PE fund, as well as other factors). For these portfolios, owning both public and private equities, in the appropriate proportion better balances important objectives like liquidity, risk and return than can be achieved by owning either alone.

Looking specifically at the PE investments themselves, we believe it is critical to diversify across multiple criteria. First, we want to diversify our client's positions with several PE managers to increase the potential to capture returns from different managers who cover different styles, areas of expertise, and types of opportunities. Strategy diversification is important because over the long duration of a PE fund, business and economic trends can emerge that have significant impact (good or bad) on particular strategies. And, we prefer to have our clients use multiple vintages – which refers to the year in which a PE fund is launched or begins making investments. Through these vintages we can improve diversification to mitigate the risk of broad business cycles hurting performance and take advantage of different timing on new investment opportunities, both of which are impacted by the entry and exit point of fund investments.

Achieving suitable diversification is done more easily in larger overall portfolios, because the underlying PE funds have relatively high investment minimums, that must be met without resulting in a client's overall

PE allocation exceeding the target percentage. Fortunately, we have been able to identify high quality PE funds-of-funds with built-in diversification among investments and managers, offered at modest investment minimums with very reasonable fees relative to the quality of underlying GPs. These are mostly in the buyout and growth capital areas. PE investment areas like distressed and special situations can also be included during periods when opportunities are compelling, and we can include venture capital based on availability of high-quality options.

In Closing...

Through in-depth due diligence that identifies high quality investment vehicles offering potential for long-term capital growth, attractive diversification and lower minimums, we have found effective ways for our clients to take advantage of PE investments. We are happy to share more about this investment area and the long-term portfolio benefits that we believe come from the inclusion of private equity in an investment portfolio.

If you have questions or want to discuss this opportunity with your advisor, please don't hesitate to reach out.

Wealth Management Team Updates

We are committed to providing a quality 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.

Phillip Lampe joins Litman Gregory Wealth Management as AVP—Business Technology Analyst

Phillip joined the team in March 2022 as a Business Technology Analyst. He brings years of professional experience having previously worked as an investment analyst at a boutique wealth management firm, and in data/technology roles at a large, privately held corporation. Philip's main responsibilities are to build and maintain cross-functional IT solutions and automate workflow processes.

Carter Bertelsen joins Litman Gregory Wealth Management as Associate—Operations

Carter joined the team in November 2021 as a member of the Operations group. In his role, Carter provides support to the Operations and broader Wealth Management Services Teams with a focus on trade submission and execution as well as client supplemental reporting.

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The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

The MSCI ACWI Index represents the performance of large- and mid-cap stocks across 23 developed and 24 emerging markets. The index covers 2,900 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.*

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar- denominated, fixed-rate taxable bond market.

The US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada.

The ICE BofA US High Yield Index is market capitalization weighted and is designed to measure the performance of U.S. dollar denominated below investment grade (commonly referred to as "junk") corporate debt publicly issued in the U.S. domestic market.

The ICE U.S. Dollar Index is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar.

The S&P/LSTA Leveraged Loan 100 Index (LL100) dates back to 2002 and is a daily tradable index for the U.S. market that seeks to mirror the market-weighted performance of the largest institutional leveraged loans, as determined by criteria. Its ticker on Bloomberg is SPBDLLB.

The Morningstar LSTA US Leveraged Loan 100 Index is designed to measure the performance of the 100 largest facilities in the US leveraged loan market.

*The **MSCI Hedged Indexes** include all of the securities and weights of each corresponding unhedged MSCI Parent Index, enabling investors to measure the impact of hedging currency, for all the constituents of the Parent Index.*

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Estimated Returns Disclosure

Scenario Definitions –

Downside: The economy falls into a deep and sustained recession for any of various reasons, such as deleveraging/deflation, unexpected systemic shock, geopolitical conflict, Fed or fiscal policy error, etc. At the end of our five-year tactical horizon, S&P 500 earnings are below their normalized trend and valuation multiples are below-average reflecting investor risk aversion. Inflation and 10-year Treasury nominal and real yields are very depressed.

Base: Consistent with long-term economic and market history, reflecting economic and earnings growth cycles that are interspersed with recessions around an upward sloping normalized growth trendline. Inflation is at or moderately higher than the Fed's 2% target level and 10-year Treasury real yields are around zero percent to slightly positive. For the S&P 500, we now bookend our base case with a lower-end and upper-end estimate:

At the lower end of our base-case fair-value range, reflation efforts are successful and nominal economic growth is higher than the average. However, the economy overheats, and valuation multiple and some margin compression largely offset the favorable macro backdrop.

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