Insight Newsletter
WINTER 2024

Litman Gregory
WEALTH MANAGEMENT

Investment Commentary: Fourth Quarter 2024

Market Recap

What a difference a year makes. In 2022, high inflation and the Fed's commitment to tame it led to sharply rising interest rates and negative returns for both stocks and bonds. In 2023, much to the surprise of many forecasters, global stock and bond markets ignored widespread expectations that we were headed for a recession and were able to shake off a host of uncertainties to post strong gains for the year.

Aided by a powerful year-end rally, U.S. stocks (S&P 500 Index) jumped nearly 12% in the fourth quarter to finish up 26% for the year, ending within a whisper of its all-time high. Smaller-cap stocks (Russell 2000 Index), which lagged against their larger counterparts for most of the year, also rallied sharply up 14% in the fourth quarter to end the year with a respectable gain of 17%.

Developed International and emerging-market stocks also posted solid gains. Developed International stocks (MSCI EAFE) finished the year up 18%, while emerging-market stocks (MSCI EM Index) posted a nearly 10% return.

Bonds also rallied sharply in the fourth quarter aided by a significant drop in Treasury yields. The benchmark 10-year Treasury yield declined over 100bps in the fourth quarter resulting in a 6.8% return for the Bloomberg U.S. Aggregate Bond Index. Despite massive intra-year volatility, the 10-year Treasury yield ended the year exactly where it started. For the year, U.S. core bonds (Bloomberg U.S. Aggregate Bond Index) finished up 5.5%. Credit was a standout performer both in the fourth quarter and for the full year. High-Yield bonds (ICE BofA US High Yield Index) were up 7% in the quarter, finishing up 13.4% for the year.

Non-traditional alternative asset classes delivered mixed results with multi-alternative strategies (Morningstar Multistrategy Category) returning a positive 6.6% for the year and trend-following managed futures strategies (SG Trend Index) ending the year down 4.2%.

Investment Outlook and Portfolio Positioning

Since the Fed started their aggressive tightening cycle, the debate has been about the odds of a "soft landing" of "hard landing" for the economy. In other words, would the Fed be able to thread the monetary policy needle and raise interest rates enough to stamp out inflation, but not so high it slams the brakes on the economy and tips it into recession.

In November, the Fed made it clear they believe the end of the war on inflation is near, and not only are they done raising rates this cycle,

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they are anticipating interest-rate cuts in 2024. In response, interest rates declined sharply triggering a powerful rally in stocks and bonds to close out the year.

Looking ahead in 2024, all eyes will continue to be on the Fed. When will the Fed start to cut rates, by how much, and why? Will the Fed cut rates enough to meet the markets' lofty expectations? While these questions will be in focus, monetary policy is just one of many factors that will influence markets. Geopolitical risk, the U.S. presidential election, labor markets, and inflation will likely fill the headlines and all could be sources of volatility.

From an economic perspective, we enter the year on solid footing and believe a recession is unlikely in the first half of 2024. There are several factors supporting solid economic and corporate earnings growth, while inflation continues to decline. We think the biggest recession risk will come from weakness among consumers in the latter half of the year and we will continue to closely monitor economic data and adjust our views accordingly.

Within the U.S. stock market, performance in 2023 was driven by the handful of mega-cap growth stocks, dubbed the "Magnificent 7" (Apple, Microsoft, Nvidia, Facebook, Alphabet, Netflix, Amazon). These stocks had an average return in-excess of 100% for 2023 and at the end of the year represented a combined weight of more than 28% in the S&P 500 – near historic highs. However, much of the return in these stocks was driven by expanding valuation multiples leaving them expensive relative to the broader market.

In an encouraging sign, we saw a shift in market leadership and the equity rally broadened beyond the "Magnificent 7" to include areas of the market that had lagged. For example, value stocks and smaller-cap stocks both outperformed growth stocks in the fourth quarter. This trend has the potential to persist in 2024. We anticipate rebalancing portfolios to reduce excessive exposure to the big winners of 2023 in favor of higher quality, more attractively valued strategies that we expect present better opportunity.

Our overall equity allocation continues to favor another unloved segment of the market – foreign stocks. Heading into 2024, the valuation discount for developed international and emerging-market stocks versus the U.S. is the widest it's been in decades. All else equal, lower starting valuations imply better long-term expected returns and provide more of a valuation cushion should multiples contract in a stock market sell-off.

We remain positive on Core Investment Grade bonds (Bloomberg U.S. Aggregate Bond index). Overall, credit fundamentals remain relatively healthy and current yields are attractive at 4.5%. In addition to core bonds, we continue to have meaningful exposure to higher yielding, actively managed, flexible bond funds run by experienced teams with broad opportunity sets. There are several fixed-income sectors outside of the traditional parts of the bond market that provide attractive risk-return potential, and we access them through active managers. Some of these funds are currently yielding in the high single digits, while maintaining an eye on capital preservation. We continue to own managed futures and multi-strategy marketable alternatives as remain confident in their long-term diversification benefits and ability to provide non-correlated returns relative to traditional stock and bond holdings.

Looking Ahead

It is quite possible that 2024 will be a year where investors again enjoy some of the classic underpinnings of investing, where stocks and bonds are less correlated and provide diversification benefits to portfolios. This was not the case in 2022 and 2023, when stocks and bonds both declined meaningfully and then posted gains.

While there are likely to be bouts of volatility, these inevitably create opportunities. Currently, we see opportunities within the stock market, particularly as we expect a broadening out into areas of the market

that have lagged. Within fixed income, we believe that rates have peaked, inflation is under control for now, and that interest rates will decline though not back to zero. In this environment we continue to take advantage of the inverted yield curve, capturing higher yields from shorter-term securities, while also benefiting from more attractive yields across the bond market. We will also look for any opportunities that arise as a result of the Fed not meeting market expectations around the timing and magnitude of rate cuts.

As 2024 unfolds, all of us at Litman Gregory Wealth Management thank you for your continued trust and confidence. We wish you and your loved ones peace, happiness, and good health in the new year. (Written 1/9/2024)

—Litman Gregory Wealth Management

What We Can Learn from the "Magnificent Seven"

The Magnificent Seven, a group of stocks given the nickname by the financial media for their dominant performance in 2023 and their outsized weighting in U.S. and global market indexes, provide a helpful lesson in risks and rewards of concentration. The Magnificent Seven are Apple, Microsoft, Alphabet (Google), Amazon, Nvidia, Tesla, and Meta Platforms (Facebook). As of 12/18/2023 approximately 28% of the S&P 500 index is comprised of these seven companies. In this post we share a few interesting observations about the magnitude and impact of this concentration, some historical context from similar periods in the past, and how this influences our ongoing portfolio management.

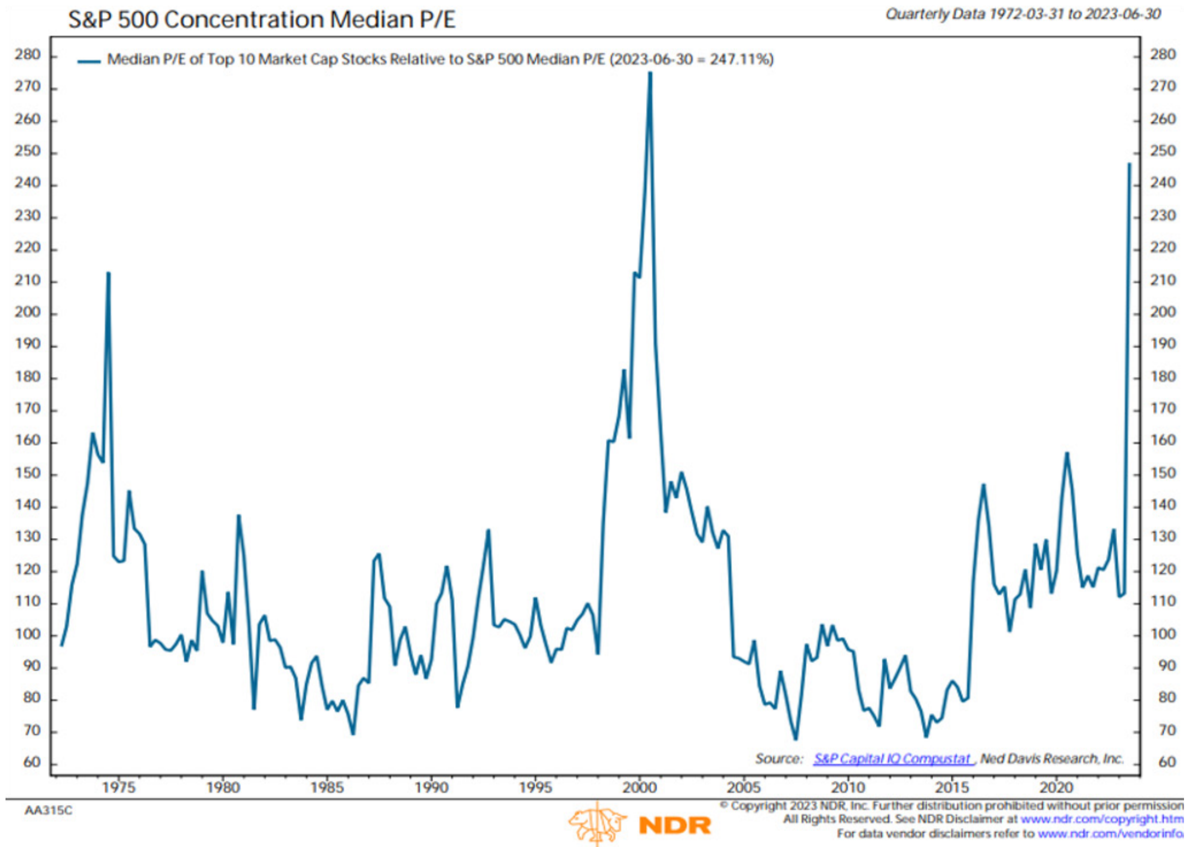
In considering concentration versus diversification, very strong performance by each of the Magnificent Seven stocks so far in 2023 (ranging from 52% for Apple to 240% for Nvidia) has boosted their collective market cap relative to the rest of the S&P 500. In aggregate the group accounted for nearly 60% of the S&P 500's 26% year-to-date return, which has driven their combined market cap to $13.8 trillion, and that is nearly one-third of the total S&P 500 market cap. Not surprisingly in the context of concentration versus diversification, the contribution to S&P 500 risk (in the form of volatility) from the Magnificent Seven is even greater than their contribution to market cap, as measured by research firm Qontigo.

Historically there have been a few similar cycles in which a small number of stocks accounted for outsized percentage of the total S&P 500 market cap. The two most recent are the early 1970s, when the "Nifty Fifty" (Polaroid was a member) was all the rage, and in 2000 as the tech bubble approached its popping point. The chart on the next page shows the percentage of total S&P 500 market cap accounted for by the 10 largest stocks going back to the early 1970s.

The S&P 500 is Highly Concentrated

Source: Ned Davis Research. Data as of 11/30/2023.

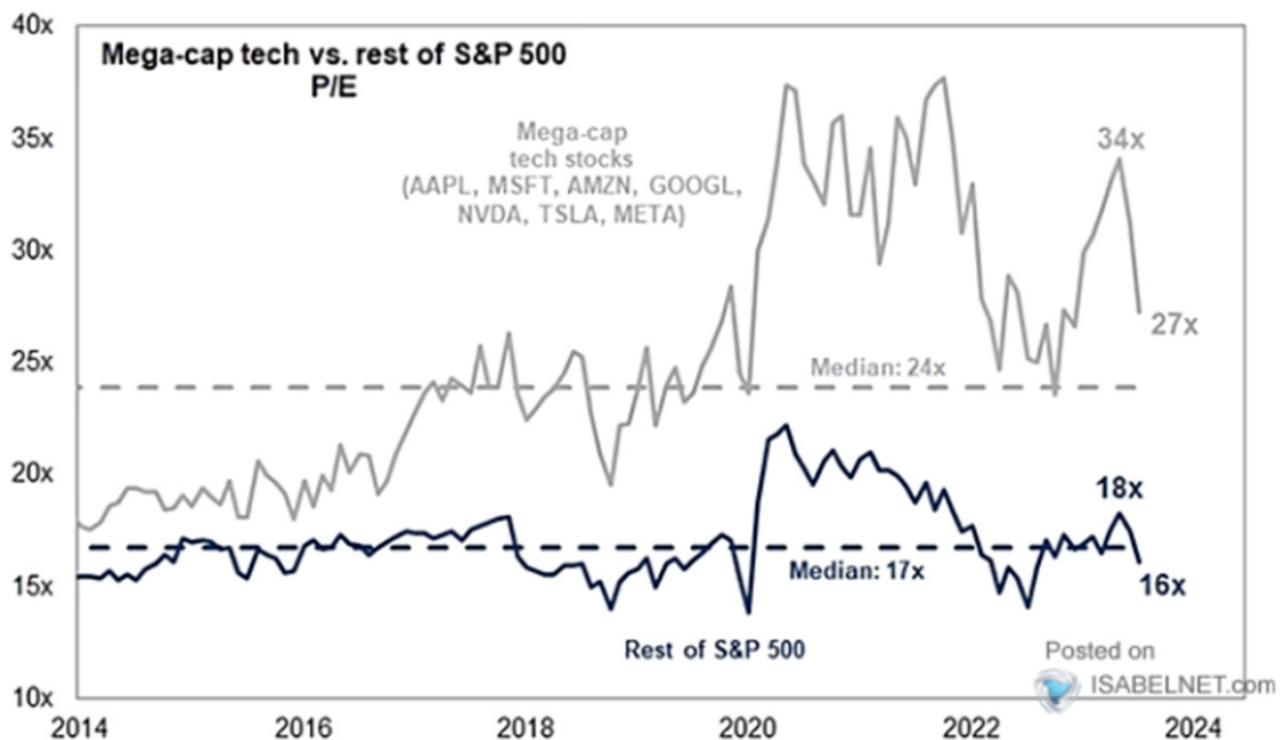
The S&P 500 is Pricey at the Top



A hallmark of these periods where a smaller number of companies commanded an outsized market-cap share is that they also carried above-average price-to-earnings valuations, as the next chart makes clear. In the charts on the previous page, we can clearly see the points when valuation spiked for the 10 largest stocks in the S&P 500. While there's not a perfect correlation between valuations and stock prices, it is true that valuation tends to inflate when the stock price climbs faster than actual earnings. Similarly, a falling stock price, or even one that climbs at a slower rate than earnings, brings valuations back down. So the peaks in valuations have generally followed periods of outsized returns, and the drops show that trend reverting.

Taking a closer look specifically at the Magnificent Seven, in the chart below we can see the valuation expansion they experienced in recent years relative to the rest of the S&P 500. The greater volatility relatively to the broader index is also plain to see in the more dramatic ups and downs of the light grey line reflecting the price movement of the Magnificent Seven.

Rich Valuations for a Few, Fair Valuations for Many



Source: Goldman Sachs Global Investment Research.

What this means for investors in the cap-weighted S&P 500 index is simple: they have enjoyed generous returns thanks to the Magnificent Seven's influence, but looking forward investors have more risk now by owning a large stake in a handful of expensive stocks with varying dependencies on difficult-to-predict technology developments.

Taking a step back to consider how this market trend affects our portfolio decisions, we first recognize that our investment process involves building portfolios to address defined risk and return objectives. This requires assessing potential risk within each investment we own as well as how various investments correlate so that we can create effective diversification and help our clients stay the course across full market cycles. When it comes to concentration, we have always favored investment managers we believe are highly skilled and who take larger positions in their highest-conviction investments. But in contrast, for capitalization-weighted market indexes, we know that portfolios become more concentrated simply when an individual stock's price increase by a greater amount than the rest of the index.

As an example, portfolios that have been in capitalization-weighted index investments during recent years have experienced this increased concentration as the weighting of the Magnificent Seven grew and shifted the S&P 500 toward the mega-cap and growth ends of the style and size spectrum. During this time, mid-to-smaller-cap companies and value companies have become comparatively less of the market cap of the index and are now more attractive on a relative value basis as shown in the chart on the next page. The degree to which this impacts diversification and potential downside risk for a particular portfolio is something we consider in our analysis.

Growth Stocks Take Up a Larger Share of The S&P 500

- The S&P 500 has over 40% in the growth bucket
- Value stocks mark up less than 25% today
- Historically, the growth/value mix is more equal

While we appreciate the strong contribution to performance from the Magnificent Seven (as we have from other strong growth companies in the past) we also understand how cycles work and the degree to which a major performance run can affect the balance and diversification in the portfolios we manage. For that reason, we are regularly looking for opportunities to rebalance and better align the equity allocation within our client portfolios. In the end, we do not try to predict and bet on short-term trends, but instead construct portfolios so they take on the appropriate levels of risk and potential return to meet our clients' goals.

Growth Stocks Take Up a Larger Share of the S&P 500

12/31/2018

	Value	Blend	Growth
Large	28.1	29.6	32.4
Mid	4.2	3.6	2.1
Small	0.0	0.0	0.0
	32.3	33.2	34.5

12/31/2020

	Value	Blend	Growth
Large	18.0	37.5	28.5
Mid	6.3	7.5	1.9
Small	0.2	0.1	0.0
	24.4	45.2	30.4

11/30/2023

	Value	Blend	Growth
Large	15.8	30.7	35.4
Mid	5.6	9.3	3.0
Small	0.2	0.1	0.0
	21.6	40.0	38.4

Source: Morningstar Direct. Data as of 11/30/2023.

Our Team is Prepared for the Gender Wealth Shift

According to a **McKinsey & Company** report, men are the primary financial decision-makers in two-thirds of affluent American households. This male dominance extends to the industry itself, where women constitute only 15% of financial advisors across various channels.

However, the landscape is changing rapidly. Women typically outlive men by about five years, often inheriting their spouse's financial assets. By 2030, it's projected that American women will control a substantial portion of the $30 trillion in financial assets currently held by baby boomers.

There's also a noticeable shift in the younger, affluent female demographic. Compared to five years ago (2015), there's a 30% increase in married women actively making financial and investment decisions. (You can read the full McKinsey report **here**.)

This evolving dynamic is a pivotal moment for wealth management service firms. When women assume control of household finances, they frequently seek new wealth management relationships that align more closely with their needs. Notably, 70% of women change their wealth management provider within a year of losing their spouse.

Many leading companies have started to shift gears by offering new products, hiring more female advisors, and launching financial literacy and community outreach events. At Litman Gregory Wealth Management, we're ahead of the curve, with women making up 50% of our team. Two of our senior advisors, **Gretchen Hollstein, CFP®** and **Monica Muñoz, CFP®**, have been named by Forbes as **Top Women Wealth Advisors Best-in-State** for the past two years.

Our entire wealth management team strongly believes in forging deep relationships with our clients to understand and cater to their long-term financial needs. We also understand that women have distinct financial needs and goals and require unique solutions tailored to their specific requirements.

Thank you to all our senior women advisors at Litman Gregory Wealth Management; **Cynthia J. Morris, CFA, CFP®**, **Lesley E. Cannan, CFP®, CPWA®, AIF®**, **Gretchen Hollstein, CFP®** and **Monica Muñoz, CFP®** for their hard work and dedication.

—Jeff Seeley, CEO Litman Gregory Wealth Management

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.

(from left to right):

Jennifer Ceccarelli: promoted to Managing Director, Chief Operations Officer

Lesley Cannan: promoted to Director, Senior Advisor

Pratik Kumar: promoted to VP, Client Services

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Index Disclosure

Any reference to a market index is included for illustrative purposes only, as it is not possible to directly invest in an index. Indices are unmanaged, hypothetical vehicles that serve as market indicators and do not account for the deduction of management fees or transaction costs generally associated with investable products, which otherwise have the effect of reducing the performance of an actual investment portfolio.

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 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.

Contact

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