Key Points

- We believe the issues that matter most for investors have not changed much in recent months, so the message below will rhyme with the last two *Overviews* we distributed.
- One issue we consider to be important is the current level of interest rates in the mid-single digits.
- There are numerous real-world investment objectives that can be achieved with a high-quality return stream in the mid-single digits.
- For example, the annual spend rate for many retirement portfolios falls within the 4%-6% range, as does the spending policy for most charitable foundations and endowments.
- Within the framework of a diversified portfolio, the current interest rate environment may present an opportunity to narrow the range of outcomes for the portfolio without dragging the expected return below a useful investment objective like retirement spending…a refreshing change from the era of interest rate suppression that prevailed from 2009 to 2022.
- Another important issue right now is the expected pivot to easier monetary policy from central bankers in the U.S and elsewhere in 2024.[1]
- Historically, stocks have performed best when policy makers were lowering borrowing costs or leaving them unchanged after lowering them.[2]
- There is an important caveat to this hopeful observation that stems from the third issue we think matters for investors: The current economic cycle is unlike any other in history, so past patterns may be less dependable for anticipating the future.
- For example, the policy transition from raising to lowering interest rates typically occurs during a recession, when corporate profits and stock prices are depressed, neither of which is the case today.
- The final carryover from recent market commentaries is geopolitical risk.
- Hot wars continue to burn in Eastern Europe and the Middle East; the strategic rivalry between the U.S. and China remains intense; the fiscal position of the U.S. government is unsustainable; and a disruptive reaction to a viscerally polarizing presidential election cannot be ruled out later this year.
- As in past commentaries, we remind investors there are always risks in the world, and it is usually counter-productive to trade in and out of sound investments in the hope of avoiding the troubling what-ifs of the moment.
- This reality justifies a balanced asset allocation for most investors with at least a portion of the portfolio committed to high quality fixed income and a healthy allocation to thoughtfully selected stocks.

[1] Source: Wall Street Journal; "The Powell Pivot Begins," Dec. 13, 2023
[2] Source: UBS, "Global Investment Returns Yearbook: 2024;" Wall Street Journal

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Don't Just Do Something…Stand There

One topic that carries over from every *Overview* we have ever distributed is risk. There are always problems in the world that lurk in plain sight. When the risks of the moment seem particularly daunting, the nagging possibility of suffering an investment loss due to a known risk that could have been avoided drives many investors to step aside and wait for things to clear up. Such behavior is almost always counter-productive.

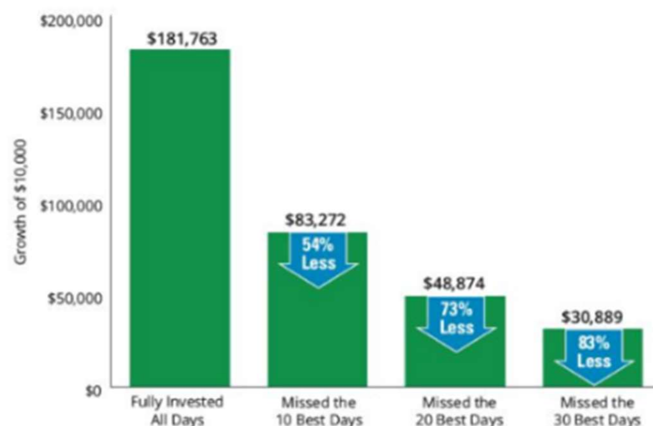
The graphic below represents a modern rendition of a study that has been conducted countless times throughout the decades. The outcome is always the same: Short-term stock market returns are devilishly unpredictable, and missing just a handful of the best moments can eliminate most of the upside from owning stocks in the first place.

Good Days Happen in Bad Markets

S&P 500 Index Best Days: 1994–2023

Missing the Market's Best Days Has Been Costly

S&P 500 Index Average Annual Total Returns: 1994–2023



Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. For illustrative purposes only. Data Sources: Ned Davis Research, Morningstar, and Hartford Funds, 1/24.

As we said in this report in January, we do not believe sound investments in the stock market should be abandoned for fear of geopolitical what-ifs. Financial markets are always looking forward, which means the risks that are visible to everyone are already reflected in current market prices to some degree. This dynamic describes the proverbial "wall of worry," whereby the stock market climbs whenever a risk that is discounted in stock prices today turns out better than feared with the passage of time.

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But What About the Problems That *Don't* Turn Out Better Than Feared?

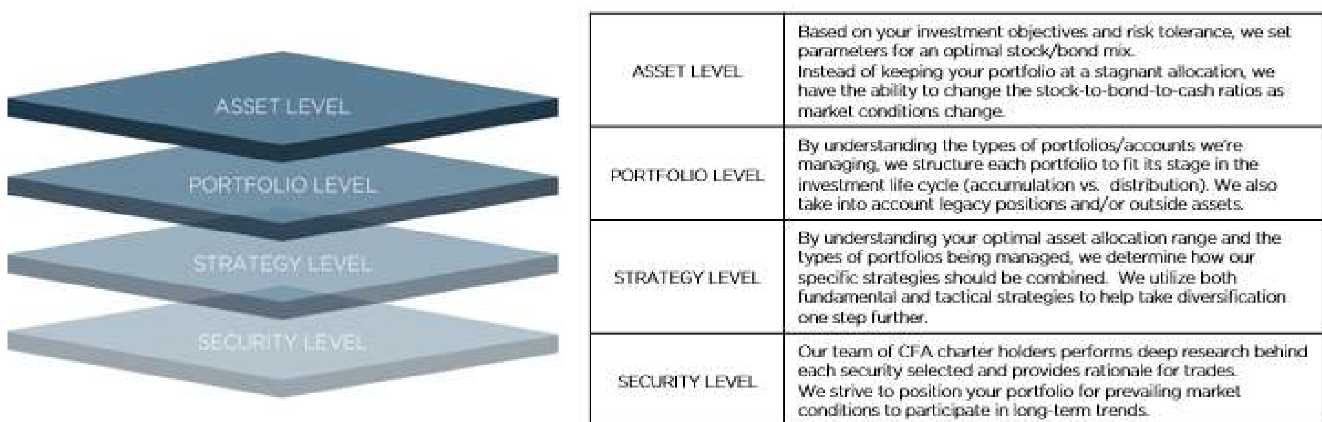
To be sure, not all investor worries turn out to be unfounded. Even more annoying is the tendency for the most damaging downturns to be triggered by problems that no one was focused on the first place…think Covid, toxic mortgages and the collapse of Lehman Brothers, 9/11. Even if nothing like these events ever happens again, something else will come along to deliver a similar gut-punch to the stock market.

We believe the best way to prepare for this inevitability is through asset allocation, rather than market timing. The ratio of stocks vs. bonds in a diversified portfolio will have a material impact on the *range of outcomes* the portfolio delivers over short-term time horizons. The higher the allocation to bonds, the narrower the range of outcomes, and vice versa.

The current level of interest rates makes this foundational principle of asset allocation particularly relevant. In the bond market today there are attractive, mid-single digit yields available in high-quality securities with moderate duration. Unlike most of the past 15 years, investors can use fixed income to reduce the risk profile of their portfolio without sacrificing the expected return of the portfolio below real-world investment objectives like retirement income. Although the optimum mix of stocks vs. bonds is different for everyone, we believe *most* investors should employ a balanced approach to investing in the current market climate, with at least a portion of the portfolio allocated to high quality fixed income.

Current Design of Our Investment Strategies[3]

The remainder of this report addresses the current positioning of each of our investment strategies under current macro conditions. The specific design of *your* portfolio is customized to match your return objectives and risk tolerance. **For a refresher on how your portfolio is designed, and why, please reach out to your Wealth Advisor any time.**



ASSET LEVEL	Based on your investment objectives and risk tolerance, we set parameters for an optimal stock/bond mix. Instead of keeping your portfolio at a stagnant allocation, we have the ability to change the stock-to-bond-to-cash ratios as market conditions change.
PORTFOLIO LEVEL	By understanding the types of portfolios/accounts we're managing, we structure each portfolio to fit its stage in the investment life cycle (accumulation vs. distribution). We also take into account legacy positions and/or outside assets.
STRATEGY LEVEL	By understanding your optimal asset allocation range and the types of portfolios being managed, we determine how our specific strategies should be combined. We utilize both fundamental and tactical strategies to help take diversification one step further.
SECURITY LEVEL	Our team of CFA charter holders performs deep research behind each security selected and provides rationale for trades. We strive to position your portfolio for prevailing market conditions to participate in long-term trends.

[3] The portfolio strategy discussions in this section are supplemental to a compliant GIPS Report. A complete list of Capital Advisors' portfolio models and compliant presentations are available by contacting Capital Advisors.

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Managed Equity Strategies

Equity Market Outlook

The pace of "enabling" innovations remains historically strong, market liquidity remains historically high, and the global economy remains generally healthy. In such an environment, lower interest rates are supportive of asset valuations, and the Fed's next interest move is expected to be in that direction.

Volatility around the election, but not just because of the election

We highlight four key factors that could increase volatility in the equity markets as the year matures. For one, the Fed's behavior appears likely to inflect. As we near the Fed lowering rates later this year, the stock market should increasingly anticipate what the next big monetary policy trend will be.

This period could coincide with a second source of volatility as the political cycle heats up for the U.S. Presidential election, which might shed more light on the policies that may be necessary to address unsustainable federal debt levels.

Certain economic areas could also come under the stress of having to refinance debt at appreciably higher rates. For example, debt maturities in the commercial real estate sector accelerate later this year into next.

Lastly, as investors better understand the near-term impact of artificial intelligence (AI), we believe they are increasingly likely to define winners *and* losers, instead of just winners.

Earnings growth is expected to accelerate

Earnings per share (EPS) for companies in the S&P 500 Index were down 1% last year, but are expected to jump 9% this year, followed by 13% growth in 2025 (see the bar chart below). Forward expectations for earnings eight-to-18 months out are often the most important for stocks, so the anticipated earnings ramp is particularly key to the market's direction.

Enabling Innovations remain key

The proliferation of enabling innovations like AI facilitate greater optimism in the longer-term earnings outlook. "Enabling" innovations add value not only to the markets from which they originate, but also promote value creation throughout the economy. Key examples include electricity and the internet, both of which not only boosted the utility and technology sectors, but also enabled value creation in every other sector. Such innovations tend to increase economic productivity, as reflected in the chart below that shows a material acceleration in earnings in recent decades facilitated by the internet, global supply chain, wireless connectivity, certain robotics technologies and molecular medicine innovations.

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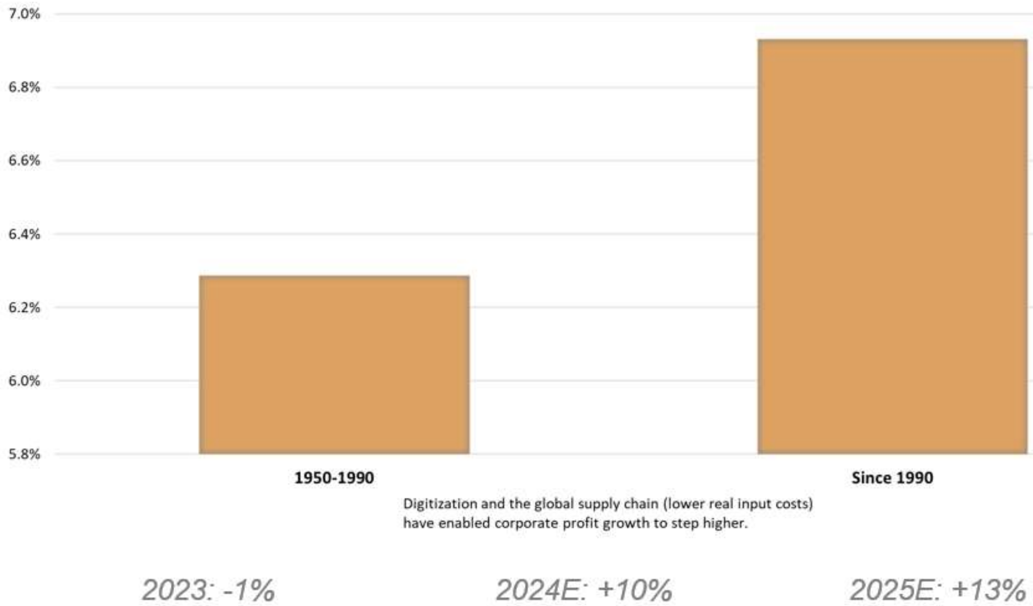
Earnings Growth
Median Annual S&P 500 EPS Growth Rates
Through Dec. 2023



Source: Bloomberg. Uses actual operate earnings per share (EPS) for historic results and Bloomberg consensus EPS estimates for 2024 and 2025.

We are at the approximate one-year anniversary of AI coming into popular awareness. The process began in January 2023 when **Microsoft (MSFT: ~$421)** announced a significant expansion of its partnership with OpenAI, and it accelerated into public consciousness last May when **NVIDIA (NVDA ~$900)** posted its first major AI-fueled new order jump.

This natural progression from when AI burst into public consciousness last year to when corporations broadly prosper from the technology will likely fuel an important stock market rotation, in our view. Through 2023 and into early 2024, AI fueled a record investment concentration into the technology's leaders. As the cycle matures, we expect flows to spread out, with the focus remaining on companies that can shape the development of AI's economic impact. The latter stage includes technology leaders as well as platform business model innovators. Platform models gather and benefit from the innovations (and investment expenses) of many other companies.

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The chart below shows how enabling innovations have contributed to economic value creation throughout history, using corporate valuations as a proxy. Note the concentration at the current time.

"Innovation is at the Heart of Value Creation"

...and is additive

S&P 500 real returns Jan. 1927-Feb. 2023

Source: Bloomberg. The S&P 500 Index is shown on a logarithmic scale

<u>Three Enabling Innovation Leaders in Each Managed Equity Strategy</u>

Managed Equity Growth

NVIDIA: A technology leader currently shaping <u>AI</u>'s market development curve. The visionary management team is attempting to move the company in the direction of a platform business model.

Uber (UBER ~$76) & DoorDash (DASH ~$138): Global leaders in the "<u>Gig Economy</u>" which has already significantly impacted the labor market, personal mobility, and economic convenience.

Intuitive Surgical (ISRG ~$383): A key global leader in the development of medical <u>robotics</u>.

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Managed Equity Dividend

Eaton (ETN ~$312): A leading global energy management company that is key to enabling the electric grid conversion and the ability of data centers to absorb AI's increased energy requirements.

Broadcom (AVGO ~$1310): A key supplier of technologies that transport significant data flows among computer networks, including AI.

IBM (IBM ~$190): One of the AI pioneers with its Watson computing system, and a major facilitator for other companies seeking to implement AI throughout their organizations. IBM is also among the companies at the forefront of quantum computing.

Fixed Income

Following the historic move lower in rates at the end of last year, the bond market gave back some of the rally, rising between 0.3% and 0.4% in yield across the maturity spectrum.[4] Much of this coincided with the market's fading outlook of six rate cuts of 1.50% in 2024, and moved more in line with the Fed's year end messaging of approximately three cuts, or around 0.75% lower by year-end.[5] At these elevated bond yields, we remain steadfast that "locking in higher yields for longer" in our clients' bond strategies is a prudent investment. However, we are very cognizant of the nation's financing concerns, and are currently focused on overweighting interest rate risk on the short-to-intermediate part of the yield curve, with limited exposures too far out the maturity spectrum.

Managed Credit Strategies

Within our *Managed Credit Strategies*, we are orienting the portfolios toward better credits, with roughly 70% of our clients' exposure in companies currently rated A- or better, on average.[6] We believe our BBB exposure has better balance sheets than the broad market, but we are willing and able to further reduce this allocation should we see specific situations worsen. We also hold a modest allocation to U.S. Treasuries, as applicable, to provide further credit diversification from any potential slowdown in the economy.

Our overweight to investment grade corporate credit outperformed Treasuries in the first quarter and our slightly defensive duration posturing protected portfolios on the downside. With interest rates still materially higher than in years past, we will look to add interest rate risk, but not go out much past 10-years. On a go-forward basis, portfolios are now yielding around 4.8%-5.0%, depending on one's yield curve positioning.[7]

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[4] Source: Bloomberg, Two-year treasury to Ten-year Treasury Note yields, 3/28/24
[5] Source: Bloomberg, World Interest Rate Probability as of 3/28/24
[6] Source: ORION
[7] Source: Bloomberg, ORION

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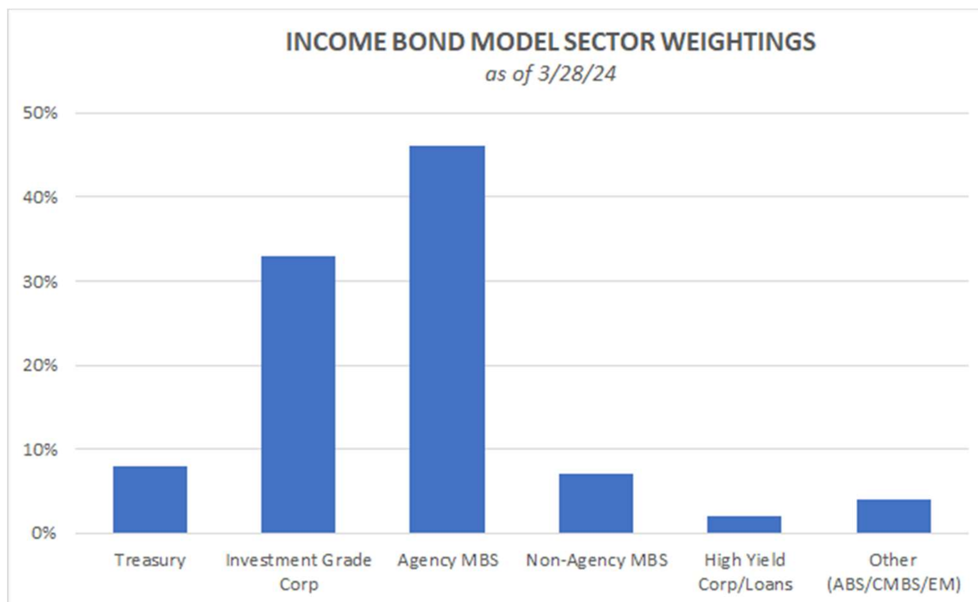
ETF Bond Models

Our *Aggregate Bond* ETF strategy remains 100% invested in "defined maturity," investment-grade corporate bond ETFs, which positively impacted the model's outperformance relative to the benchmark in Q1. Today, there is a relatively conservatively positioned laddered maturity structure of ETFs ranging between 2025-2029, and the model carries an average net acquisition yield of approximately 5.0%.[8]

The *Income Bond* ETF strategy has focused on maximizing cash flows within the construct of balancing risks, most notably through sector diversification (see chart below). In Q1, the model's relatively defensive interest rate posturing provided some downside protection versus the benchmark. Looking forward, "AAA-rated", Agency Mortgage-Backed securities remain the model's largest weighting, as relative yields versus both corporates and Treasuries look attractive on a both an absolute and historic basis.[9] The potential for stable to declining interest rates could bring back incremental buyers of this high-quality asset class (i.e. insurance companies, banks, etc.) over the course of the year. Today, the strategy carries an average net acquisition yield of approximately 5.3%[10].



Source: ORION, iShares, State Street, Doubleline, Janus Henderson

[8] Source: Bloomberg, iShares, State Street, as of 3/28/24
[9] Source: Bloomberg, as of 3/28/24
[10] Source: Bloomberg, iShares, State Street, as of 3/28/24

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Municipal Bonds

Our *Municipal Bond* portfolios continue to be focused on "A" and above credits with strong debt coverage and liquidity profiles. We have also intentionally over-weighted essential service revenue bonds (water & sewer, utilities, etc.), and general obligation bonds with an average portfolio credit quality of "AA." Our conservative posture provided some downside protection with municipal bond rates marching higher in the quarter. This move is not overly surprising as we head into tax season, when sellers tend to overtake buyers until taxes have been paid. High-quality municipal bonds may provide some stability going forward, especially as we move toward the national election where rhetoric about a larger federal budget deficit and a possible higher tax rate regime may make the asset class more attractive. Municipal bond portfolios are now yielding between 3.0% and 3.1% tax free *(between 5.1% and 5.3% at the highest marginal federal tax rate)*[11] depending on one's yield curve positioning.

Tactical Global Growth Strategy

The *Tactical Global Growth* strategy is off to a solid start in 2024, led by an overweight position in domestic large-cap growth stocks during the first quarter. The tactical positioning of the portfolio was beneficial during the quarter, as demonstrated by a higher return for the strategy, net of fees, relative to a simple average of the nine investment vehicles included in the portfolio during the period.

The portfolio will enter the second quarter with an overweight position in international equities and emerging markets relative to common benchmarks for the global equity asset class. These markets are currently trading at one of the widest valuation discounts in multiple decades relative to U.S. stocks.[12] We believe there are structural reasons for U.S. stocks to trade at a premium compared to international equities, but the magnitude of the current discount is extreme within the historical range, allowing ample opportunity for reversion to the mean in favor of international markets, in our opinion. On this score, it is not necessary for the valuation gap between international and U.S. stocks to close completely. Even a modest narrowing should support the relative performance of international markets if/when it occurs.

> *****Please Note: We plan to revise important elements of the investment process for the Tactical Global Growth strategy to align it more consistently with economic and financial market cycles and improve the tax efficiency of the strategy for taxable portfolios. These changes will be described in detail in a forthcoming note to investors in this strategy.***

[11] Source: ORION, Bloomberg, highest marginal tax rate of 40.8% = 37% federal plus 3.8% net investment income tax

[12] Source: Bloomberg; MSCI

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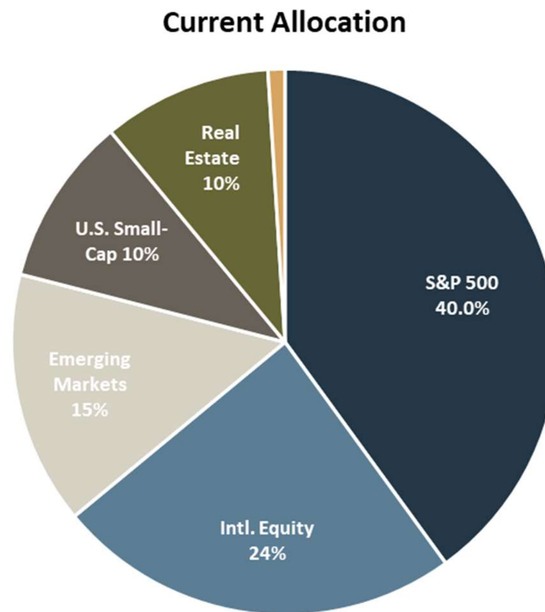
Dynamic Allocation Strategy

This strategy held at least 85% of its allocation in risk market sectors throughout the first quarter, allowing healthy participation in the strong performance of global equities during the period. As of quarter-end the portfolio was invested in all five of its risk market sectors as follows:



International Focus Strategy

International equities advanced nicely in the first quarter to enable a solid start to the year for this strategy. Of all the major risk markets globally, we believe emerging markets might have the greatest potential for positive mean reversion following several years of relative under-performance versus developed market equities, particularly in the U.S. It seems noteworthy that emerging markets have weathered the massive tightening of U.S. monetary policy over the past two years without a crisis of some kind. This is almost unheard of historically and it suggests a material improvement in the fiscal resilience of many less developed economies, in our view.

Looking forward, we believe international equities are set up nicely for the year ahead with a likely reversal of U.S. monetary policy, and a possible tailwind from a weaker U.S. dollar exchange rate. Among non-U.S. markets, we would expect emerging markets to benefit most from this combination of variables, if they happen.

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The **S&P 500 Index** is a stock market index based on the market capitalizations of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. The index is calculated on a total return basis with dividends reinvested and is not assessed a management fee.

The **Russell 1000 Growth Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit growth characteristics.

The **Russell 1000 Value Index** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit value characteristics.

MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI EAFE Small-Cap Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of small- and mid-cap stocks in the developed markets, excluding the U.S.

Vanguard High Dividend Yield ETF is an exchange-traded fund that seeks to track the performance of the FTSE High Dividend Yield Index, which consists of common stocks of companies that pay dividends that generally are higher than average.

Morningstar Dividend Yield Focus aims to track high-yielding, qualified dividend-paying, U.S. based securities screened for companies with financial health. The Index is calculated on a total return basis with dividends reinvested and is not assessed a management fee. It is not possible to invest directly in an index.

Bloomberg Aggregate Bond Index is an unmanaged index made up of U.S. Government, corporate, mortgage-backed and asset-backed securities rated investment grade or higher. The index is designed to measure the performance of the domestic investment-grade bond market.

Estimated portfolio yield represents the 12-month run-rate of interest and/or dividend payments in a strategy divided by the market value of the securities and cash reserves invested in the strategy. Estimated interest/dividend payments and market values are calculated by a portfolio accounting system from *Orion* using a single client portfolio that Capital Advisors believes to be representative of clients' portfolios invested in the same strategy. The actual portfolio yield for any single client portfolio may be lower or higher than the yield quoted. The underlying holdings of any presented portfolio are not federally or FDIC-insured and are not deposits or obligations of, or guaranteed by, any financial institution.

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The information provided is supplemental to a fully compliant GIPS Report. A complete list of Capital Advisor's portfolio models and compliant presentations are available by contacting Capital Advisors at the number listed below. The actual return and value of an account fluctuate, and at any time the account may be worth more or less than the amount invested.

Additional information, including management fees and expenses, is provided on Capital Advisors' Form ADV Part 2, available upon request or at the SEC's Investment Adviser Public Disclosure site, https://adviserinfo.sec.gov/firm/summary/104643

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