BlackDiamond Financial

INVESTMENT INSIGHTS

FOURTH QUARTER 2022

Key Topics

- Increasing Interest Rates Punish Stocks and Bonds
- Fed Implements Most Aggressive Rate Tightening Cycle in Decades
- Importance of Portfolio Diversification for Long-Term Investors
- Stock Pickers Trailed Indexes During this Year’s Downturn

MARKET UPDATE

Turbulent Year Leads Market Values Lower

Increasing Interest Rates Punish Stocks and Bonds

Stocks declined 18.1% in 2022 to record their biggest annual loss since 2008. This was on the heels of stocks more than doubling over the prior three years. The year was unique as virtually every asset class declined in value. Just as the economy emerged from a pandemic, the war in Ukraine broke out and high inflation led to unprecedented monetary policy measures. Bonds, which are typically inversely correlated with stocks, experienced their largest annual decline in history – dropping 13.0%.

This was only the third year in the last 100 when stocks and bonds both lost value as investors faced a challenging investment landscape dominated by high inflation. The global investment community closely followed the Federal Reserve's aggressive rate tightening – the magnitude of which was the largest annual move since 1973. The Fed's actions and the ensuing economic impact (including a likely softening of the labor market) will continue to be the primary driver of asset prices in 2023.

Rising interest rates have started to slow economic activity and inflation has declined over the last several months. However, the impact of rising rates will not fully work through the economy until well into 2023 and perhaps 2024. While every Wall Street investment bank has a prediction on the likelihood of an impending recession, Jerome Powell said it best with his statement, "I just don't think anyone knows whether we're going to have recession or not — and if we do, whether it's going to be a deep one or not. It's just... it's not knowable."

Despite these headwinds, investors should be optimistic going into 2023. American companies remain resilient and have tremendous long-term earnings potential. Over the last 30 years, stocks produced a compound return of 1,484%, which would turn $100,000 into $1.48 million. During this period, stocks incurred back-to-back annual declines only twice. It is critical to construct an investment portfolio that is risk-appropriate, returns optimized and tax-efficient to preserve and enhance wealth. This approach will continue to be successful as it anticipates periods of market volatility such as investors experienced in 2022.

Comparative Returns

		Annualized Performance			
	Q4 2022	1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks[1]	7.6%	(18.1%)	7.7%	9.4%	12.6%
Small Cap U.S. Stocks[2]	6.2%	(20.4%)	3.1%	4.1%	9.0%
International Stocks[3]	14.3%	(16.0%)	0.1%	0.9%	3.8%
Real Estate[4]	4.9%	(25.4%)	(1.2%)	2.5%	5.2%
U.S. Bonds[5]	1.9%	(13.0%)	(2.7%)	0.0%	1.1%

1 S&P 500 index. 2 Russell 2000. 3 MSCI ACWI ex-U.S. index. 4 MSCI U.S. REIT index. 5 Bloomberg Barclays Aggregate Bond index.

Fed Implements Most Aggressive Rate Tightening Cycle in Decades

The Federal Reserve has a dual mandate that includes facilitating maximum employment and maintaining price stability. To the Federal Reserve, price stability means moderate inflation of approximately 2.0%. For the decade prior to 2021, the Fed was successful in hitting its target, averaging 1.7% per year. However, massive economic stimulus and supply chain issues related to the pandemic propelled inflation to 7.0% by the end of 2021.

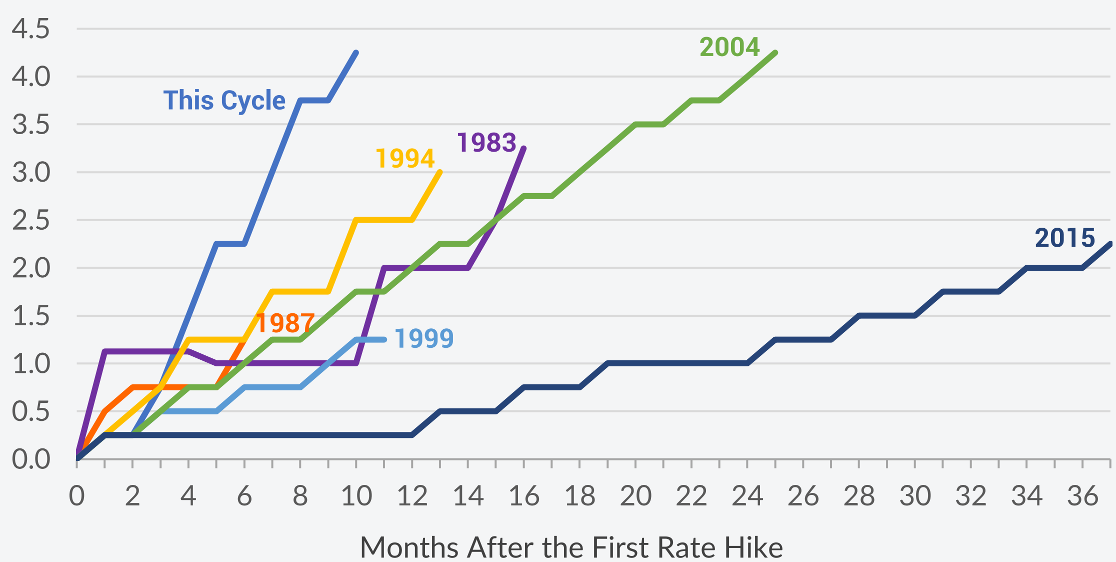
Throughout 2021, the Federal Reserve asserted that elevated inflation was transitory and would quickly decline. Instead, inflation continued to increase into 2022 and reached a 40-year high of 9.1%.

The most effective tool employed by the Fed to cool inflation is its ability to dictate short-term interest rates by changing the Fed Funds interest rate. The Fed Funds rate is the target rate that banks use to lend to each other overnight. Increasing the Fed Funds rate causes borrowing to become more expensive, which causes economic activity to decline and inflationary factors to ease. Rising rates also cause bond prices to decline because bond values and interest rates are inversely related.

In March, the Fed acknowledged that inflation was not transitory. They went on to state that inflation is alarmingly sticky and began raising rates at the fastest pace in recent history. In just nine months, the Fed Funds rate rose from 0% to 4.25%, the most severe rate tightening since the 1980s. The rapidity of rising rates took many investors by surprise and created a very difficult landscape for bond investors. In fact, bond values dropped more in 2022 than any year in recorded history.

The Fastest Rate Hiking Cycle Since the Early 1980s

Change in Fed Funds Rate (%)

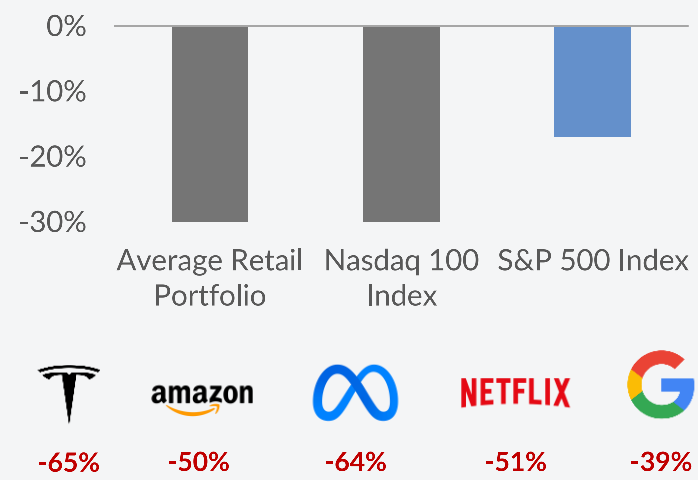


Source: Bloomberg. Federal Funds Target Rate - Upper Bound (FDTR Index), using monthly data.

Importance of Portfolio Diversification for Long-Term Investors

In a rising market environment, it is easy to give way to emotion and stray from what has proven successful. In 2021, many retail investors overallocated to individual securities and rising asset prices made almost every investment a winner. Reminiscent of the decline that followed the dot-com era of 2000, asset values normalized in 2022 and many investors who put money in high flying stocks experienced outsized losses. These short-term focused investors learned that concentrated exposure to a few volatile investments can quickly destroy wealth. According to Bloomberg, the average retail investor portfolio dropped 30% in 2022 versus an 18% decline for the S&P 500. While it may be exciting, the data is clear that chasing high flying investments is rarely a good investment strategy.

2022 Performance of Individual Investors and Indexes

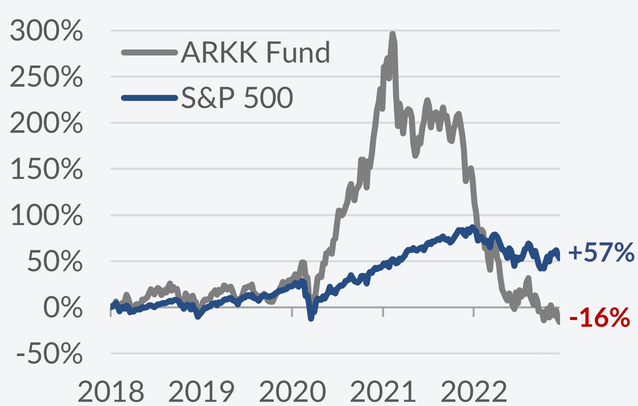


Source: Bloomberg, Morningstar. Note: Performance 12/31/2021 – 12/30/2022

Stock Pickers Trailed Indexes During this Year's Downturn

Many news outlets chase "eyeballs" with sensational stories in an effort to retain a diminishing pool of subscription and advertising dollars. One such story looking to garner attention was that "2022 will be the year for stock pickers". As the year progressed, a reason often cited was that this market downturn was "different". However, most stock pickers continued to be embarrassed by the fact that they performed significantly worse than the indexes. The data remains clear – over a 20-year, period actively managed mutual funds and separately managed accounts have underperformed the index 95% of the time.

Case Study in Underperformance



Source: Morningstar.

ARK Innovation fund is a perfect case study for underperformance. The fund invests in companies focused on tech innovation. ARK capitalized on the spirit of risk in 2020 leading many media outlets to laud the fund's manager. This increased exposure by media outlets led to a massive inflow of capital as investors chased recent performance. At its height, fund assets totaled nearly $28 billion. ARK posted a negative return of 75% after its assets peaked and left investors with significant losses.

BlackDiamond Financial

ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment adviser with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax-efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, returns optimized, and tax-efficient. Where appropriate, we incorporate institutional quality private investments to capture illiquidity premiums or yield opportunities. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is well-below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

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