ROBERTS WEALTH ADVISORS

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The Bear Market Continues to Roar

There are many narratives in today's headlines that suggest both U.S. and the global economies are headed for broad-based decline. The leadership of the Federal Open Market Committee (FOMC) has been the catalyst to much of that concern, articulating their focus on inflationary pressures and a desire to combat them with sharp increases in interest rates. Economists and market prognosticators have debated whether the U.S. economy is already in a recession and, if so, how far corporate earnings will drop when consumers react and dramatically slow their spending. Additionally, the impact of geopolitical conflicts, unpredictable weather events, and an upcoming midterm election add to the uneasiness of market participants. It is clear as to why the market has continued its downward trajectory through the first three quarters of 2022.

All these factors have weighed heavily on the investment markets, resulting in a dramatic round trip of returns during the third quarter. The quarter began with a positive surge, appreciating 13.7% through mid-August, only to come crashing back down to finish the quarter in negative territory. Valuation contraction has been the most notable contributor to the negative return environment. The forward P/E (price to earnings ratio on anticipated earnings of the next twelve months) has compressed nearly 30% this year from 21.4x earnings at the end of 2021, to a measure of 15.1x by the third quarter's end. The valuation adjustment far exceeded the ability for positive earnings announcements from corporations to overcome. As a result, the market has declined 24.8% in 2022.

The fixed income markets have not been spared. As the FOMC aggressively increased short term rates, the entire yield curve has adjusted. The yield on 10-year Treasury Notes bumped from 1.5% at the end of 2021 to 3.8% by the end September. This change caused the Bloomberg Aggregate Bond Index to fall 14.8%. The housing market has been under pressure as well. Mortgage rates have skyrocketed in 2022 to 6.7% on a 30-year mortgage. Increased borrowing costs have been the primary factor negatively impacting the potential buyer's ability to afford the purchase of a home.

While the concern is real and the scorecard of returns from nearly all asset classes is dismal, the question remains, "How far do markets have to fall and how long will it be until we reach the bottom?" While it is difficult, if not impossible to predict when a market will turn, here are some key market indicators we continue to watch.

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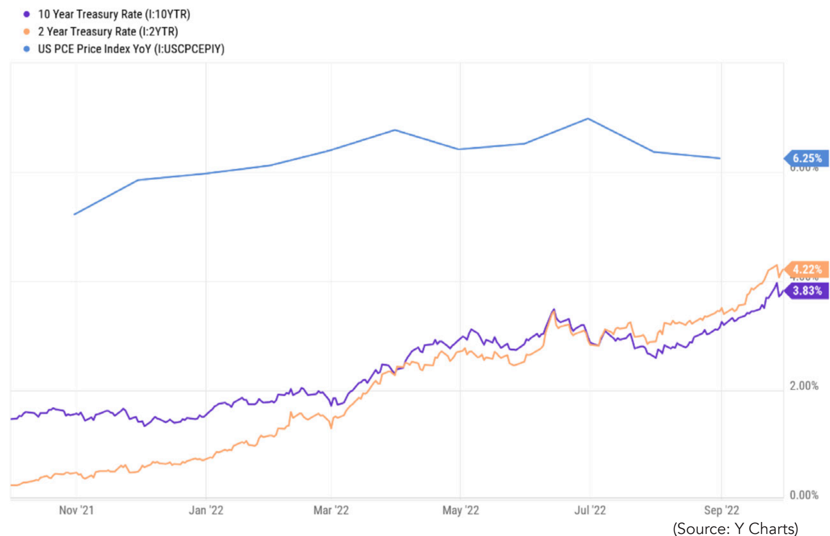
Inflation: The FOMC's response to the direction of inflation will continue to impact the direction of both equity and fixed income markets. The FOMC has placed inflation squarely in its crosshairs and has committed to raise rates until inflation has been brought under control. After the most recent increase of three-quarters of a percent to the Fed Funds rate, the target rate is now 3.25%. The FOMC's favored measure of inflation, the Personal Consumption Expenditures Index (PCE) is now at 6.25%. FOMC Chairman, Jerome Powell, has set a hawkish tone by indicating the committee's intent to aggressively increase rates until there is a 'real' rate of return in the bond market. In other words, the FOMC is intent on raising interest rates until the short-term rates exceed the level of inflation. The stock market would respond favorably if inflation levels dropped toward current rates, alleviating the need for the FOMC to raise rates much further.



(Source: Y Charts)

Employment: Now at 3.5%, the unemployment rate in the U.S. remains near historical lows. This has positive implications as it means the U.S. workforce is being utilized effectively and the American consumer has money for purchases. High employment levels also carry some negative implications, which has caught the attention of the FOMC. Employee compensation is often the single largest expense of U.S. corporations, estimated at over 53% of GDP according to J.P. Morgan. A tight labor market puts upward pressure on compensation expense, resulting in lower profit margins. While not often attributed as good news, increasing unemployment rates would relieve some of the expense pressures on corporations and would be well received by stock investors.

The U.S. Dollar: The exchange rate on the U.S. Dollar has skyrocketed to the highest level in over twenty years. This is a boon to purchasers of foreign goods, but also results in U.S. goods becoming more expensive to foreign buyers. More relevant for stock investors is that foreign revenues for U.S. corporations contribute less to reported profits once translated to U.S. Dollars. Companies in the S&P 500 derive over 40 percent of their revenues from foreign sources. We anticipate the dollar strength to negatively impact third quarter earnings. Stabilization, or even decline, in the U.S. Dollar will improve the competitive offering of U.S. companies abroad.

Cost of Debt: For over a decade, government, corporate and individual borrowers all benefited from historically low interest rates. With the recent moves, the benchmark treasury rates are at the highest levels since before the financial crisis fifteen years ago. This dramatically increases the cost of borrowing. Many borrowers have used debt opportunistically, but those that are reliant on financings will see a noticeable increase in their expense structure. We have scrutinized the balance sheets and debt structures of our portfolio companies and the U.S. Consumer debt service levels remain at forty-year lows, so neither generate near term concern. The higher borrowing costs will continue to impact the real estate market. The increase in housing inventory and soaring mortgage rates will put increased pressure on home prices.

Furthermore, the U.S. Government continues to run an annual deficit that exceeds a trillion dollars, which now must be financed at higher rates. The additional burden should add scrutiny to spending plans, which is likely to have a negative impact on public works projects.

Commodities: From June 2021 through early June 2022, the cost of commodities exploded, rising over forty percent as measured by the Bloomberg Commodity Index. The pressure from commodity pricing abated in the third quarter, falling nearly 20% off the highs, but remains at elevated levels. Like labor, commodities are an important input, and stabilization in this volatile measure would be well received by the investment markets.

Company Earnings: Our second quarter commentary discussed how difficult 2022 had been for growth stocks, both in absolute terms and relative to their value stock counterparts. The third quarter proved to be equally challenging for both growth and value stocks, each falling in negative territory. While stocks fell in price, companies, for the most part, met or beat the guidance they had provided investors for both company revenue and earnings. Over 75% of the companies in the S&P 500 exceeded analysts' earnings expectations in the quarter. Market investors are acting as though companies' revenues are in decline, but the quarterly reports tell a different story. Certainly, the environment has become more challenging for companies, but if they continue to announce solid revenue and earnings numbers, valuations will stabilize, and investor sentiment is likely to improve.

Though not enjoyable, market corrections of greater than 20% are certainly not unprecedented. The current pullback is the third 20% correction in the last three years. The concern over the direction of inflation and corresponding FOMC action necessitated the contraction in stock valuations, but as is often the case, we believe the correction has been overly pessimistic. We anticipate the FOMC will continue aggressive actions to combat inflationary concerns, keeping the pressure on stock and bond valuations. The volatility will create opportunity to pursue positive returns in the bond market and attractive entry points for longer-term stock horizons.

Tax Loss Harvesting: How RWA Adds Value Amidst Volatility

A declining market, like the one we are experiencing in 2022, creates opportunity to add economic value from harvesting tax losses as a strategy to offset investment gains and reduce a portfolio's tax liability.

Tax loss harvesting refers to the process of selling investments that have dropped in value below their purchase price. Capital losses have economic benefit because they can be used to offset capital gains and up to $3,000 of ordinary income, ultimately, reducing one's tax bill. There are two main strategies we deploy when harvesting losses.

"Double Down" or "Sell and Buy Back"

When we identify a security that holds a loss we want to harvest, but we want to maintain a position in, we have two options:

1. Double our position in it at the lower cost and sell the original lot at a loss after 30 days, ***or***
2. Sell the position and buy back the shares after 30 days

Why do we have to wait 30 days? The IRS's wash sale rules strictly disallow any loss realized from the sale of an investment where the investor repurchased a "substantially identical" security within 30 days before or after the sale. This rule exists to discourage investors from manufacturing capital losses for the sole purpose of offsetting capital gains.

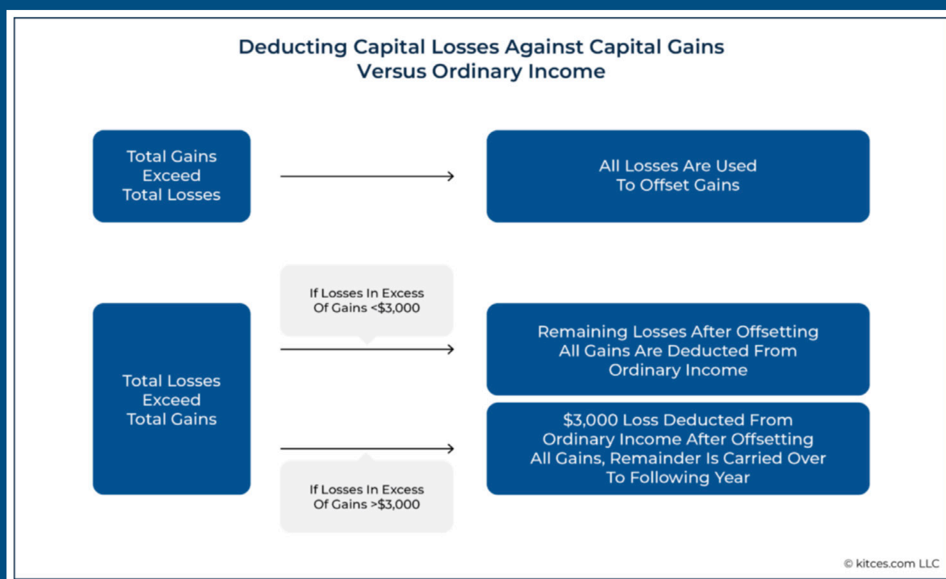
Many of you may have observed our "double down" strategy within your PayPal position. In taxable accounts (non-retirement accounts) that held a purchase lot of PayPal at a loss, we doubled the position of the lot we intended to sell and then sold the original purchase lot 30 days later. As a result, a capital loss was realized, with the net difference ultimately resulting in a reduction in the basis of the security.

"Swap"

A security swap is just as it sounds, selling one security at a loss and reinvesting the proceeds in a different but similar security. The benefit of a swap is that you avoid the 30-day waiting game. We can buy and sell on the same day without limitation of loss because they are completely different securities. This allows us to harvest the loss while maintaining investment exposure. This is an advantage of picking individual stocks for our portfolio rather than investing solely in pooled investment vehicles. With efficiency, we can swap an individual stock for a similar stock within the same sector, whereas the same strategy with mutual funds can be trickier. For example, if you realized a loss in the Schwab S&P 500 Index Fund, you couldn't swap it for the Vanguard S&P 500 Index Fund without waiting the 30 days because although they are different funds, they are "substantially identical".

There are situations where we intend to harvest a loss but there are not good options for a swap. In that case, we will sell the loss position and hold the cash. This is often the case if we intend to rebalance the sector or do not feel the security warrants long term investment.

In summary, no wealth manager can control market movement, but a diligent advisor can still create value during times of volatility. Tax loss harvesting is one tool we use to achieve this for our clients. Even so, our diligent research team works meticulously to determine the optimal positions for our client portfolios.



Portfolio Activity

Much of the pressure on equity markets throughout the third quarter of 2022 continued to stem from stubbornly high inflation, aggressive monetary tightening by the Federal Open Market Committee (FOMC), and fears of a significant slowdown in U.S. GDP. Our goal throughout this economic environment has remained steadfast: to own high-quality companies with reasonable valuations that make compelling investment cases for multiple years.

During the third quarter we took the opportunity to slim our portfolio and focus on names that we view as core holdings by opportunistically adding to the positions. On the exit side, we trimmed and outright sold some positions, whereas our portfolio additions were exclusively tailored to some of our existing, favorite ideas. Additionally, we identified tax loss harvesting opportunities in names where we have long-term conviction, but the market moved against us most notably in our DuPont (DD) and PayPal (PYPL) holdings.

We consolidated our portfolio by liquidating our position in Aspen Technology (AZPN) as the price increased beyond our valuation target, becoming a concern for future performance. We also exited positions in Envestnet (ENV), Wells Fargo (WFC), and Stericycle (SRCL) as the original investment theses for each name failed to materialize during this more challenging environment. We remain slightly heavier in cash at the start of this quarter, to combat macro uncertainty, but intend to allocate a portion of those funds to add to our existing positions in Generac (GNRC) and Take-Two Interactive (TTWO), the latter of which we discuss in more detail in this quarter's Featured Stock article.

Index Performance	Q3	YTD
Dow Jones Industrial	-7.14%	-19.72%
Standard & Poor's 500	-5.88%	-23.87%
MSCI EAFE (International)	-8.67%	-27.09%
Russell 2000 (Small Company)	-3.31%	-25.00%
MSCI ACWI (Global Stock)	-7.18%	-25.63%
Barclays Intermediate Term Bond	-5.33%	-14.61%
Barclays Municipal Bond	-3.80%	-12.13%
Barclays Short Term Bond	-2.53%	-6.62%

(Source: Y Charts)

Furthermore, we added to our core position in J.P. Morgan Chase & Co (JPM), which we view as a best-of-breed financial institution with the strongest management in the industry that trades at a significant discount to the S&P 500. The stock also offers a 3.5% dividend yield that has risen significantly since the beginning of the year and offers additional, safe income for shareholders. To fund an increase in our allocation to J.P. Morgan Chase & Co, we trimmed our successful investment in Charles Schwab (SCHW). We continue to maintain a smaller position in Schwab, but heightened valuation metrics and merger concerns warranted a more cautionary position.

We anticipate a challenging market to continue into the fourth quarter. We remain confident that stock valuations we are experiencing today provide excellent entry points for future appreciation.

TOP 10
U.S. HOLDINGS

Microsoft

Apple

Google

Amazon

Disney

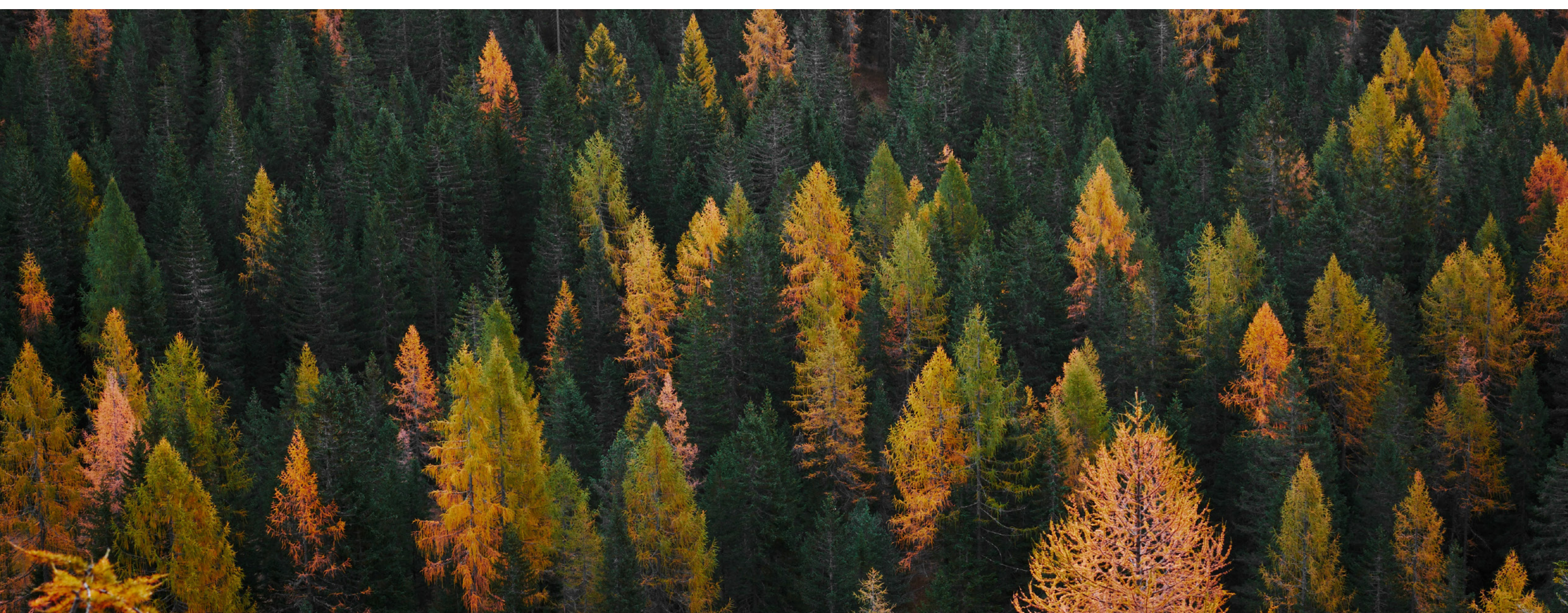
Illumina

First Republic Bank

Qualcomm

Salesforce

Medtronic



Featured Stock: Take-Two Interactive Software, Inc. (TTWO)

Take-Two (TTWO) is one of the world's largest independent video game publishers in the $200B global video game industry and is renowned for its wholly owned labels and hit franchises across consoles, PCs, smartphones, and tablets. Those key labels include Rockstar Games, which produces Grand Theft Auto (GTA) and Red Dead Redemption, and 2K, which focuses on sports-themed games and includes the most popular NBA series of all time, NBA 2K.

Take-Two's strength lies in the fact that it has some of the most valuable intellectual property (IP) in an industry where content is king. Over the last few years, Take-Two has initiated several strategic moves to leverage that advantage and broaden its scope. For example, Take-Two has engaged in a number of bolt-on acquisitions; most recently, it purchased Zynga, a leading social video game developer. The Zynga acquisition carried a large price tag ($12.7B) but will be monumental in bringing its existing franchises to the rapidly growing mobile gaming market, a pivot that will carry high margins as it transitions existing IP to the mobile space.

We believe there are three upcoming catalysts that have not been factored in by the market. First among them is Take-Two's R&D pipeline. Planning to release 20 titles a year for the next several years, Take-Two expects to more than double the 5 – 8 titles per year it has historically released, offering new games across the hardware spectrum with varying levels of immersion. Take-Two's headcount has grown twofold over the last five years to prepare for this advance, which we believe signals the commitment to a new chapter in its production machine.

The second key catalyst is industry momentum, capped off by a blockbuster announcement earlier this year that Microsoft would be acquiring Activision Blizzard, a top American video game company. Three other major acquisitions have taken place in the last two years including Take-Two's purchase of Zynga, Chinese gaming giant Tencent's acquisition of Supercell for $10B, and Microsoft's purchase of Bethesda for $7.5B. All four of these deals are significant, but Microsoft's purchase of Activision is potentially a game-changer as it gives Microsoft an enormous step up in content creation for its own platform and should generate other interest in the gaming space.

Finally, the third major catalyst is Take-Two's partnership with Meta Platforms, announced in October of 2021. That agreement stipulates that Grand Theft Auto would be reformatted for the virtual reality (VR) platform and offered through Meta's VR Oculus headset. Meta has made a number of small gaming acquisitions over the last few years, but it continues to lack substantial content. We believe Meta could take Microsoft's cue as a chance to add to its owned content. The path to the metaverse is being led by gaming and Meta comes up woefully short to that end. Take-Two's platform on a standalone basis offers incredible value, but the potential for consolidation in the gaming industry is an opportunity that we find highly underappreciated.

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Topic Spotlight

T.I.N.A. Has Left the Building

A year ago, in September of 2021, the 10-year Treasury Note was trading at a yield of 1.5%. Its 2-year Treasury counterpart was offering a yield of 0.3%. Federal Open Market Committee (FOMC) governors were discussing increases to the Federal Funds rate that had been lowered to zero in March of 2020 amidst the early days of the pandemic. The FOMC moved forward with trepidation, sensitive to pumping the brakes too soon and disrupting an economy that was in recovery mode.

A popular investment mantra during a low interest rate environment (like March of 2020) was the T.I.N.A. trade, an acronym that stood for There Is No Alternative. This reflected the fact that the opportunity for investment return in the bond market was negligible, leaving the stock market as the best (or only) alternative. The returns in the stock market during the rally between the March 2020 FOMC rate reduction and September of 2021 were impressive, rising over 62%.

However, in the last twelve months, the unwinding of the emergency FOMC rate cuts, the introduction of the Quantitative Tightening (QT) program, and ongoing concerns of inflation has lifted yields and reestablished the bond market as a viable alternative to stocks. At the end of the third quarter in 2022, the yield on a 10-year Treasury Note was 3.8% and the 2-year Treasury Note was 4.2%. Investors have not experienced short term rates that high in over fifteen years.

Fixed income, or investing in bonds, has often been equated with a safe way to generate investment return. Sharp increases in interest rates, as experienced over the past year, can challenge that notion. Positive returns in fixed income investments are dependent on the bond issuers credit quality, the coupon (or bond rate) and the length or maturity of the contract. The Bloomberg Aggregate Bond Index is widely considered to be the best representative of the bond market, much like the S&P 500 is to the stock market. During the last year when the yield on the 10-year Treasury Bond increased by 2.3%, the value of the collection of bonds in the Bloomberg Aggregate Index declined by -14.7%. This negative performance was a function of the longer maturity bonds that comprise the index rather than a deterioration of the underlying credit quality of those bonds.

The bond portfolios we have constructed for clients reflect a much more conservative outlook on the direction of interest rates than the Bloomberg Aggregate Bond Index. The primary bond ETFs we utilize consist of short maturity, high quality Treasury Bonds and Corporate Bonds. Though interest rates on the short end shifted even more dramatically than the 10-year, the price adjustment was muted due to the shorter time to maturity on the bond holdings.

Fixed Income ETF	Ticker Symbol	Performance Last 12 Months
iShares Core Aggregate Bond	AGG	-14.70%
JP Morgan Ultra-Short Bond Fund	JPST	-0.20%
JP Morgan Ultra-Short Municipal Fund	JMST	-1.00%
Schwab Short Term Treasury	SCHO	-5.10%
Vanguard Short Term Corporate Bond ETF	VCSH	-8.30%

(Source: Y Charts)

We continue to believe there will be upward pressure on interest rates, but an opportunity now exists to make positive returns on the short end of the yield curve. We have begun to shift our portfolios from Exchange Traded Funds (ETFs), like the ones listed above, into individual Treasury and Corporate Bond issuances. The shift will enable us to better control the credit and maturity risk of the bond portfolio, which is our priority focus.

Past performance is not necessarily a guide to future performance. There are risks involved in investing, including possible loss of principal. This information is provided for informational purposes only and does not constitute a recommendation for any investment strategy, security or product described herein. Please contact us for a complete list of portfolio holdings.
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