Portfolio Trick or Treat

QUARTERLY LETTER FROM THE DIRECTOR OF RESEARCH

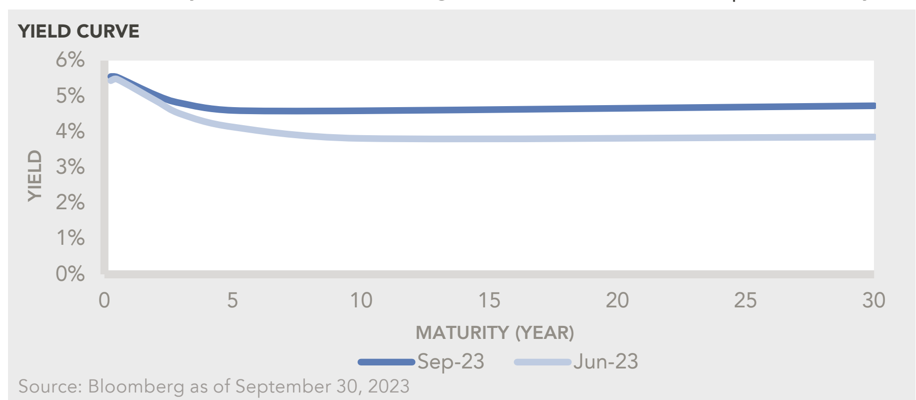
OCTOBER 2023

Coming into 2023, investors were cautiously optimistic about 2023 market returns; cautious considering the broad losses across asset classes during 2022 but optimistic about more attractive valuations and the inherent upside potential stemming from these price points. Nine months into the year, which of these opportunities have been "treats" for investors, and which have been "tricks"?

THE BIGGEST TRICK OF THEM ALL

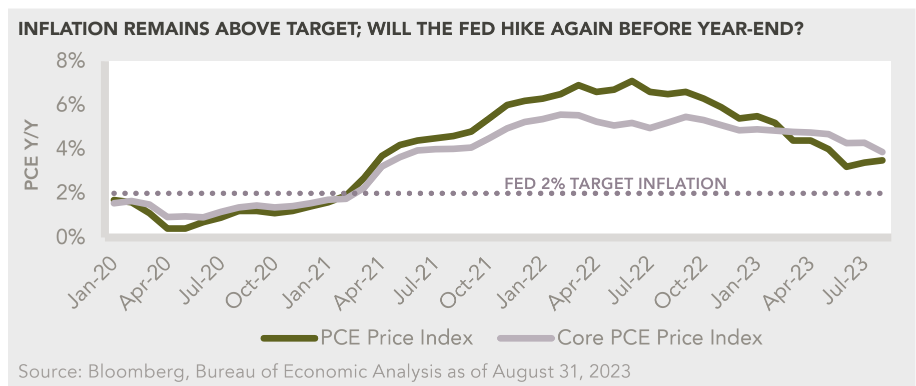
Going into the year, we felt most confident that investment grade fixed income sectors were best positioned to deliver positive returns: Starting yields were meaningfully higher across maturities, and therefore the income component would offset any price losses due to additional rate hikes. Furthermore, the Fed was close to being done with rate hikes, so how could fixed income lose?

Naturally, after the third quarter, the Bloomberg Aggregate index is down 1.2% for the year, with other investment grade sectors ranging from down 8.6% (long Treasuries) to slightly positive (1.7%; short Treasuries). By and large, this recent performance has been driven by the prospect of higher-for-longer interest rates and a steepening of the Treasury curve due to higher back-end rates, particularly in September.



Source: Bloomberg as of September 30, 2023

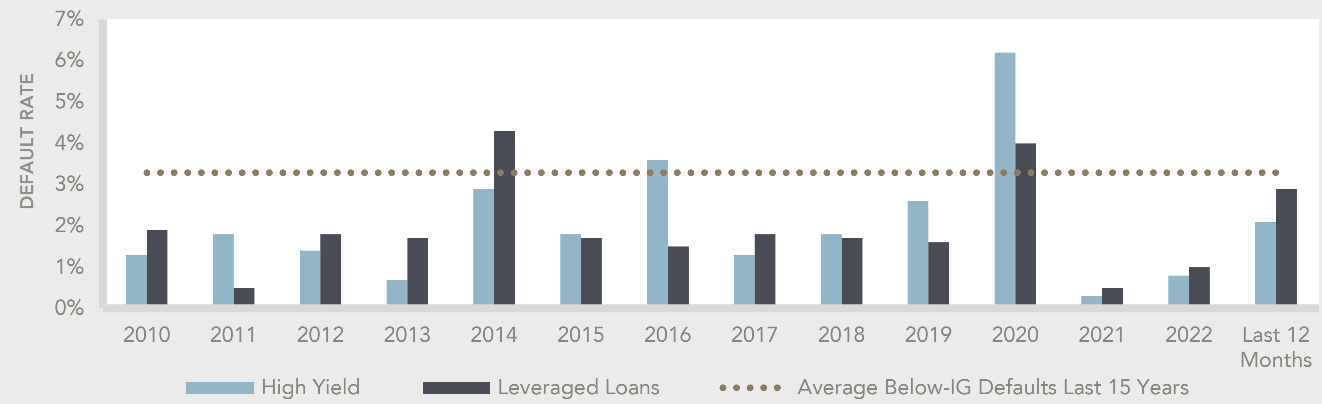
Given that inflation stubbornly remains above the Fed's long-term target, another rate hike before the end of the year is not out of the question, which would exert further downward price pressure on bond prices and all but guarantee negative returns for the majority of investment grade bond sectors. Considering expectations going into the year, this would indeed go down as the biggest trick of all for 2023.



Source: Bloomberg, Bureau of Economic Analysis as of August 31, 2023

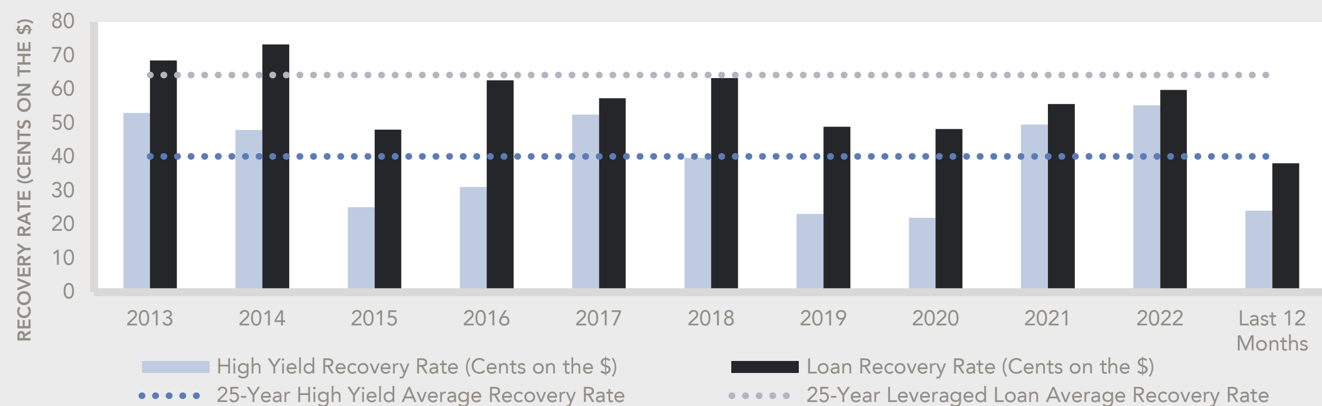
But not all of fixed income has been a trick…

High yield bonds and senior secured loans — the poster children for below investment grade bonds — have led the way for bonds to date, returning 5.9% and 9.9%, respectively, through the third quarter. Buoyed by above average yields to start the year and defaults remaining below long-term averages, these spread sectors have remained resilient.



Source: J.P. Morgan as of September 30, 2023

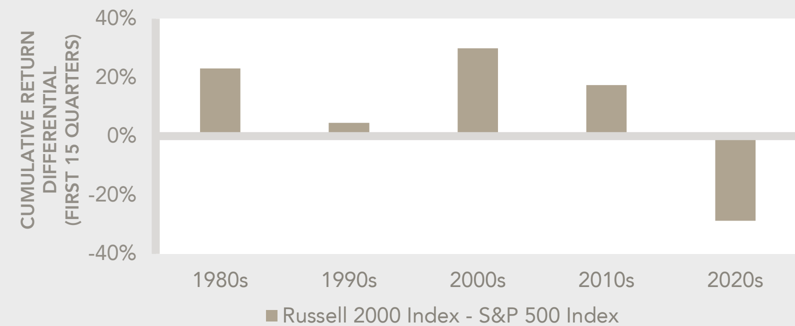
As the year finishes, we expect both sectors to remain soundly positive. However, as the chart above shows, defaults are trending higher and recovery rates are trending lower. Collectively, these trends could formulate a more significant headwind for 2024 and will be closely monitored over the next few quarters, particularly if the economy falls into a recession.



Source: J.P. Morgan as of September 30, 2023

TRICKS COME IN ALL SIZES

Similar to fixed income at the start of the year, the overall environment from a valuation and macroeconomic perspective suggested that U.S. small-cap equities would be profitable in 2023. Instead, they have underperformed their mid-cap and large-cap peers, with small-cap value the lone negative sector through the third quarter. In fact, small caps have posted their worst 15-month start to a decade over the last 50 years. The combination of COVID-19, the regional banking crisis, and an emphasis on mega-cap growth stocks has weighed heavily on the sector, in spite of glaringly attractive pricing versus the rest of the U.S. equity market.



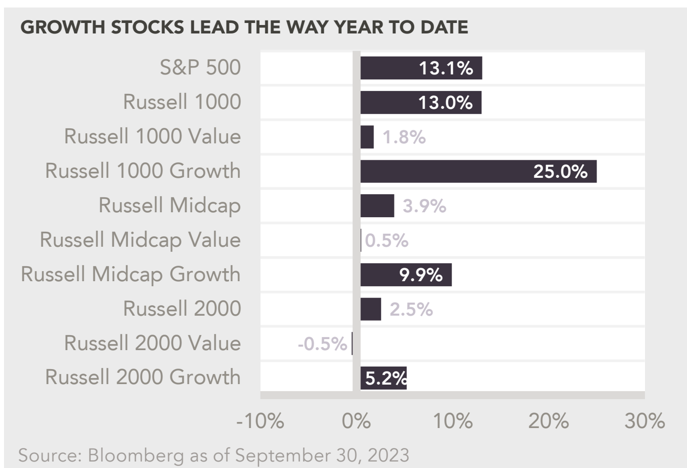
Source: Bloomberg as of September 30, 2023. Returns for the first 15 quarters or 3 years and 9 months of the stated decade (e.g., 12/31/19 – 9/30/23)

Despite the struggles of small caps year to date, diversification across the market cap and style spectrum remains important. Large-cap indices exhibit different sector biases relative to small-cap indices, with the Information Technology sector comprising over 28% of the S&P 500, while the Industrials sector makes up over 18% of the Russell 2000. As a result, allocations further down the market cap spectrum will help in diversifying an overall portfolio. Additionally, small-cap equities are now trading at an even larger discount relative to their large-cap counterparts and following periods of overconcentration in large-cap equities, small-cap equities may be in a strong position to outperform. While this may not materialize in time to reverse the relative underperformance this year, it figures to impact the outlook for 2024 and beyond.

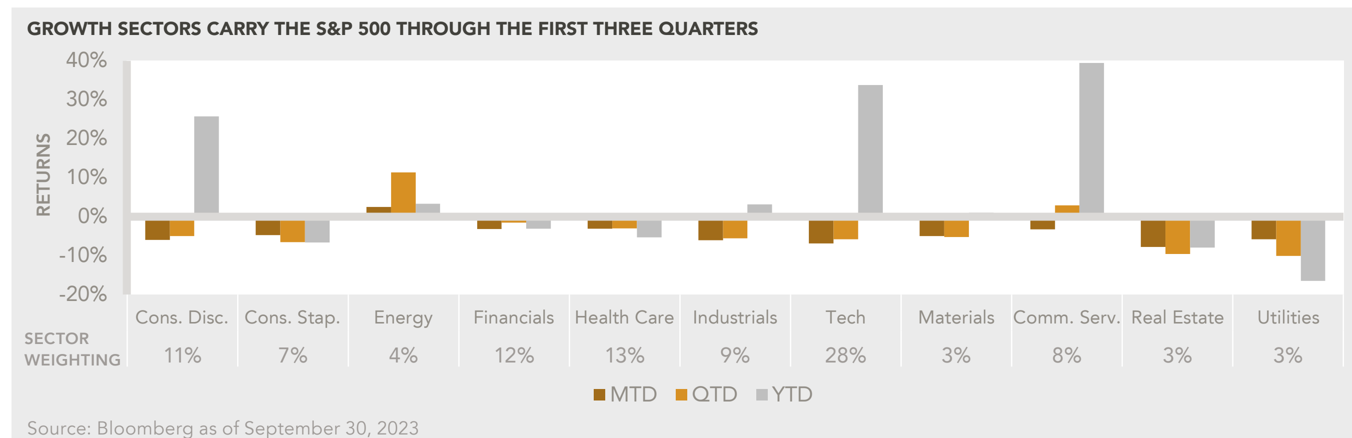
TRICK, TREAT, OR BOTH?

At a U.S. equity index level, growth stocks — especially large-cap growth stocks — have crushed the rest of the market. Largely driven by the Magnificent Seven, their overwhelmingly positive returns have also carried the core indices of each size segment.

The strength of the Magnificent Seven has powered large-cap indices in particular, with the Technology and Communication Services sectors leading the way for the S&P 500. Overall, the magnitude of this small group of stocks has to this point been a treat for investors solely based on index returns — most notably large caps.

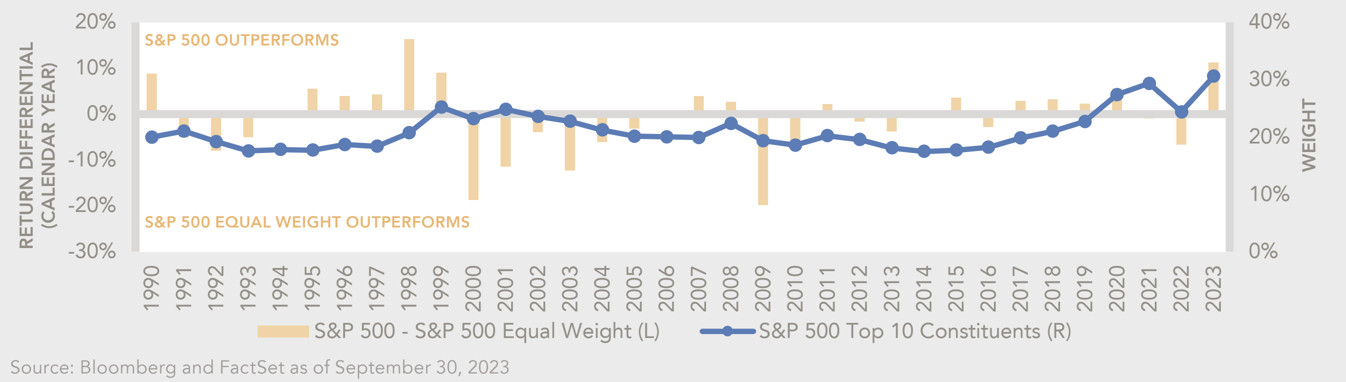


Source: Bloomberg as of September 30, 2023



Source: Bloomberg as of September 30, 2023

If we are blindly looking at index returns, the optics look far more “treat” than “trick.” However, the lurking trick here is that the disproportionate returns of the Magnificent Seven have driven them to occupy historically large weightings in their respective indices. Overall, the level of concentration across major large-cap domestic equity indices may be concerning (and, as alluded to above, is a compelling reason to diversify across size spectrums with U.S. equity allocations). With these companies trading at lofty valuations, any misstep or elevation of broader economic issues such as a government shutdown, labor strikes, or geopolitical tensions may culminate in a market sell-off. Market concentration has reached historic highs as Apple, the largest weight in the index, comprised 7.3% of assets in the S&P 500 at the end of the third quarter, with the top 10 constituents making up over 30% of assets. Following previous periods of overconcentration, the equal-weighted index has typically outperformed, including after the Dot Com Bubble and the Global Financial Crisis.

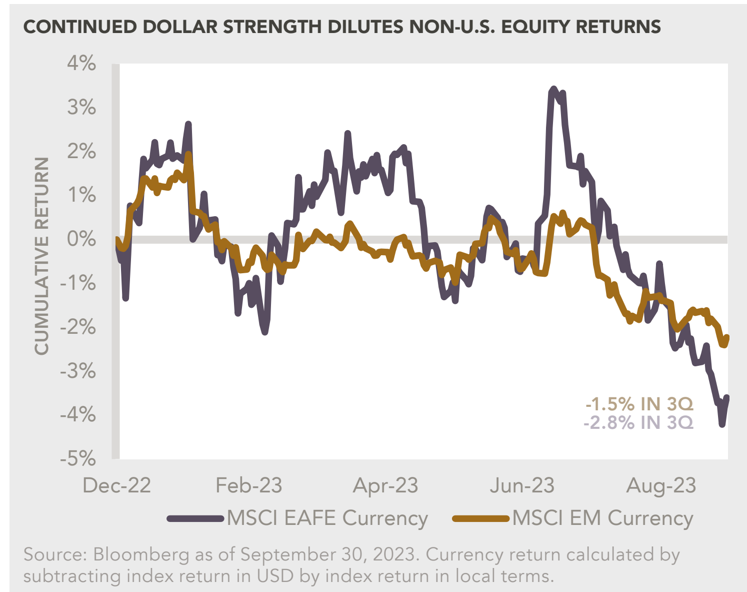


Source: Bloomberg and FactSet as of September 30, 2023

Amid the Magnificent Seven fervor, investors may try to draw parallels to the Dot Com Bubble, when similar fears abounded about excessive valuations and index concentration. A key difference between that market environment and today is the underlying cash flows and profitability of the companies driving the returns of the index, as the Magnificent Seven possess strong balance sheets — a claim that wasn't supported by the index leaders during the Dot Com Bubble. While every market environment is different, the weighting and overall market influence of the Magnificent Seven has proven more treat than trick to date, but we would argue this chapter isn't finished yet.

CURRENCY MOVEMENTS STILL TRICKY

Last year's aggressive rate hikes from the Federal Reserve dramatically impacted returns for non-U.S equities. The expectation going into 2023 was that the dollar would weaken versus foreign currencies and fuel tailwinds for international stocks this year. Markets have been tricked, however, by the dollar's further march upwards versus its foreign counterparts, at the expense of non-U.S. equity returns. Through the third quarter, returns for developed large-cap stocks — as measured by the MSCI EAFE index — have returned 10.7%, but only 7.1% in dollar terms. Emerging markets have followed a similar return differential, up 4% in local currency but only 1.8% in dollar terms.



Source: Bloomberg as of September 30, 2023. Currency return calculated by subtracting index return in USD by index return in local terms.

Currency movements tend to be rooted in interest rate changes, which are notoriously difficult to predict. As such, any prognostication about currency movements is another effort to time the market and offers limited opportunities for sustainable success. That said, the Federal Reserve has at most one more rate hike in sight while the ECB is committed to maintaining a restrictive monetary policy for the foreseeable future, so some weakening of the dollar may be in sight over the coming year, but not likely in time to reverse the impact for 2023 returns.

MORE TREAT THAN TRICK

Given its weight in the emerging markets index, China exerts a substantial influence on emerging market returns. Through September 30, Chinese stocks are down 7.3% and are the primary reason why the emerging markets index is up only 1.8% over that same time period; the primary culprits for

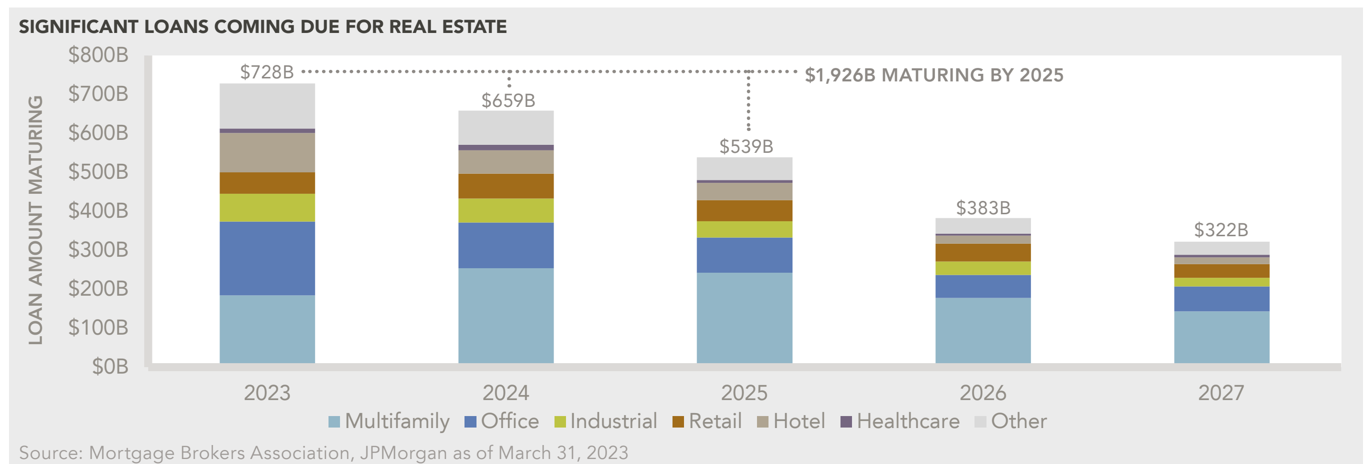
China's struggles are a slump in the property sector, ongoing geopolitical issues, a weak job market, and widespread debt stress across corporations.

Of course, there are other countries that are exerting far more positive influence on the index. Emerging market countries like Brazil and Mexico are well ahead of much of the developed world in the policy-tightening cycle, which has boosted their returns. Additionally, several countries including Mexico and India are benefitting from a reconfiguration of global supply chains. Finally, emerging market economies are poised to benefit from younger populations while many developed markets suffer from aging/shrinking workforces. Collectively, these trends outside of China have positioned the rest of the index to deliver impressive returns year to date and should bode well for the future.

Source: Bloomberg as of September 30, 2023

IF YOU'RE NOT SURPRISED, IT'S NOT A TRICK

We would be remiss not to include commercial real estate as part of the discussion, but given the expectations going into the year, the underwhelming returns have not tricked anyone: The year-to-date return[1] is down almost 4%, a stark contrast to the ten-year annualized figure of 7.8%. We could further argue that the upcoming loan maturities will only exacerbate the struggles of the asset class, especially considering the amount of loans coming due for the office sector, the most troubled area of the market.

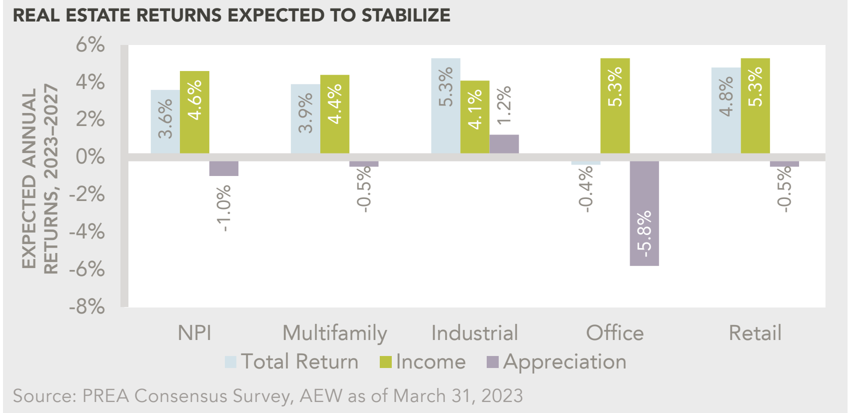


Source: Mortgage Brokers Association, JPMorgan as of March 31, 2023

Looking forward, the office sector will continue to weigh heavily on real estate returns, but as allocations shift away from office (driven by both declining property values and as strategies invest more in the

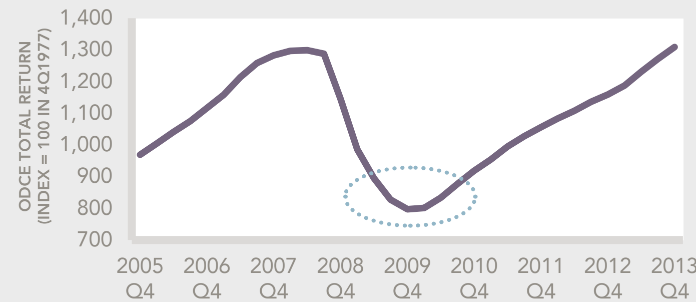
[1]NCREIF property index through June 30, 2023 (most recent available)

other sectors of the market) and towards more profitable sectors such as industrial and multi-family, real estate returns are expected to stabilize and reverse course, perhaps as soon as the second half of 2024.



Source: PREA Consensus Survey, AEW as of March 31, 2023

Redemption queues are comprising an increasing proportion of fund net asset values, compounding the "denominator effect" and failing to fund short-term liquidity needs. However, long-term fundamentals across industrial, multifamily, and select niche sectors (most notably life sciences, affordable housing, and hospitality) in markets with dynamic job and population trends remain strong. Investors generally remain favorable toward real estate, and many are still expected to increase capital commitments across opportunistic sector-focused strategies, debt, and secondary market deals. While the next year is likely to see more downward pressure on prices, private real estate has seen prior market dips and proven that patience pays off after a crisis. 2023 will end as a negative year but longer-term optimism can be justified based on previous market cycles.



Source: NCREIF, AEW as of June 30, 2023

EARLY 1990s		5 YR RETURN
	1995 Q2	11.92%
	1995 Q3	12.30%
Trough	1995 Q4	12.99%
	1996 Q1	12.97%
	1996 Q2	12.69%

TECH CRASH		5 YR RETURN
	2002 Q1	12.68%
	2002 Q2	13.51%
Trough	2002 Q3	14.01%
	2002 Q4	14.04%
	2003 Q1	12.50%

GFC		5 YR RETURN
	2009 Q3	11.34%
	2009 Q4	12.85%
Trough	2010 Q1	13.44%
	2010 Q2	13.33%
	2010 Q3	12.94%

MORE TREAT THAN TRICK?

Collectively, 2023 may very well end up more treat than trick when considering total portfolio returns. The strength of large-cap stocks — absent a massive value bias for U.S. equities — could more than compensate for the setbacks in the bond and real estate markets. The fourth quarter will ultimately determine how investors fare versus their return targets and the first three weeks have been more down than up. However, we know better than to be tricked by short-term market movements, and investors who adhere to a disciplined long-term asset allocation are treated the best when it comes to portfolio performance. That's not a trick or treat — it is a time-tested truth!

Until next time,

Greg Leonberger, FSA, EA, MAAA, FCA
Director of Research, Managing Partner
gleonberger@marquetteassociates.com

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601 PHONE 312-527-5500
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS WEB marquetteassociates.com

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