Investment Update

Fall 2022

Flower City CAPITAL

Inside

Executive Summary

- The first three quarters of 2022 saw one of the worst periods of market performance in decades (S&P 500 down ~24% and the Bloomberg US Aggregate Bond index down ~14%)
- This follows one of the best periods of market performance (US stocks were up 18%+ each of the previous three years), but that doesn't make it any easier when looking at your account balance
- A short time horizon makes everything feel more extreme
- Returns have been healthy over longer time horizons
  - As of 9/30/22, the S&P 500 has returned 8.2%, 9.2%, and 11.7% annually over 3, 5, and 10 years respectively
  - When combined with bonds, returns have exceeded the 4-5% targets we use to build financial plans, which means many clients are ahead of their long-term goals
- Our portfolios remain defensively positioned
  - We own less stocks and higher quality bonds
  - That said, we are starting to see opportunities and are beginning to ease into those positions
- Our proactive approach is working, therefore we ask for your help in updating Investment Policy Statements allowing us more latitude to navigate current market conditions
- As we approach the mid-term elections, politics are of course important, but they tend not to have a material impact on long-term portfolio performance

Impact to Financial Plans

No one likes to see their portfolios decline, but there are positives. Higher bond yields and lower stock prices mean higher expected returns going forward. Our portfolios are defensive, and opportunities are starting to reveal themselves. We will continue to be patient.

Market Recap

The S&P 500 was down almost 24% year-to-date through Q3 while global stock markets were down even more. This is not particularly noteworthy as pullbacks happen every couple of years. Whereas bonds can normally be counted on to offer protection, the US Aggregate Bond index was off over 14% over the same period. Putting the two together, a 60% stock / 40% bond allocation has combined for the worst balanced portfolio start in 50 years.

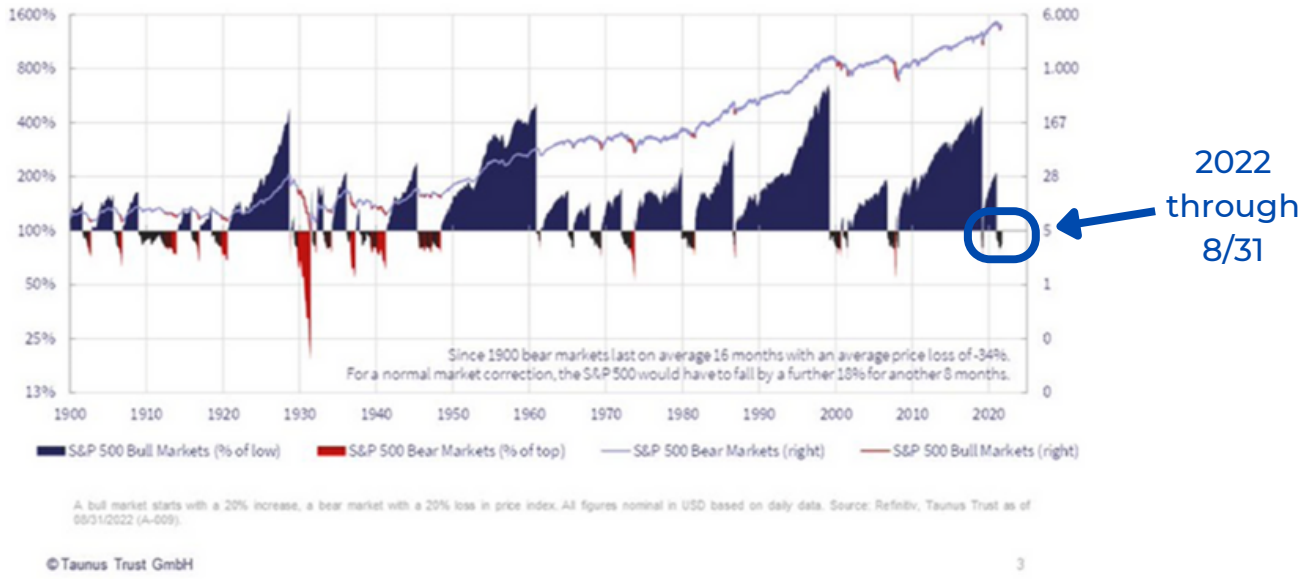
Taking a step back, market returns have been extremely healthy over longer periods of time. As of 9/30 the S&P 500 has returned 8.2%, 9.2%, and 11.7% annually over a 3, 5, and 10 year time horizon respectively. After factoring in bonds, portfolios are exceeding the roughly 4% return targets we use to build financial plans leaving many of our clients ahead of their initial goals.

That said, no one likes to see their portfolio decline, even in the short-term. It's natural to extrapolate the present into the future and think markets will only ever go down, just like during bull markets investors may expect them to only go up.

Right now we might be considered halfway through a 1-2 year bear market. Fortunately, bull markets tend to last longer than bear markets.

Chart 1

A longer term view helps to keep difficult markets in perspective



How Did We Get Here

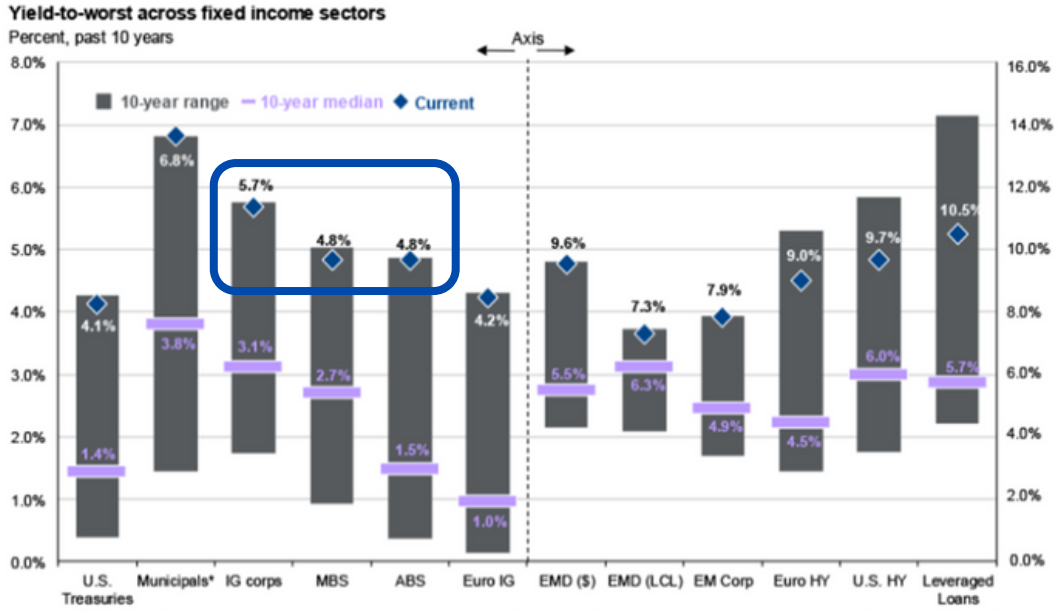
At the highest level, the current market cycle began in response to Covid. An oversimplified version goes as follows:

1. The pandemic hits, locking everything down
2. People and businesses are sent lots of money in response and spend it
3. The surge in demand exceeds supply and overwhelms already battered supply chains
4. Prices rise and keep rising (AKA inflation)
5. Central banks waited a long time, but are now raising interest rates
6. Higher interest rates increase the cost of borrowing and slow demand (think housing)
7. Slower demand cools the economy as well as inflation potentially causing recessions

Add war and energy shortages among other factors, it's no wonder markets have been volatile. But there are positives. With much higher starting yields (yields increase as prices fall), bonds are finally attractive again and stocks are no longer overvalued. Expected future returns are now higher as a result.

Chart 2

Bond yield are the highest they've been in 10 years



Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt and leveraged loans: EMD ($): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%.
Guide to the Markets – U.S. Data are as of September 30, 2022.

J.P.Morgan ASSET MANAGEMENT

What Have We Been Doing About It

We are not passive stock market cheerleaders saying not to worry. Quite the opposite. We have been actively engaged in shaping portfolios ahead of these market conditions. This year we have made the following significant changes adding value versus our benchmarks:

- Reduced risk across liquid portfolios in two main ways
  - Less exposure to stocks relative to bonds
  - Less exposure to rising interest rates through short-term, high quality bonds and exiting real estate holdings earlier in the year (very interest rate sensitive)

- Allocating to alternative investments for those who are eligible in order to enhance diversification and potential return (a separate update on these investments is provided six weeks after each quarter end)

We are also doing everything within our control in terms of day-to-day portfolio management including dollar cost average plans for new money, regular rebalancing, proactive tax loss harvesting, and monitoring for risk upgrade opportunities through the downturn.

What Comes Next

As of today, **we have the most defensive portfolios we have ever had.** We believe the most important investment decision is overall risk tolerance in terms of stocks versus bonds. For most of this year our portfolios have remained positioned underweight their strategic stock allocation targets in favor of bonds.

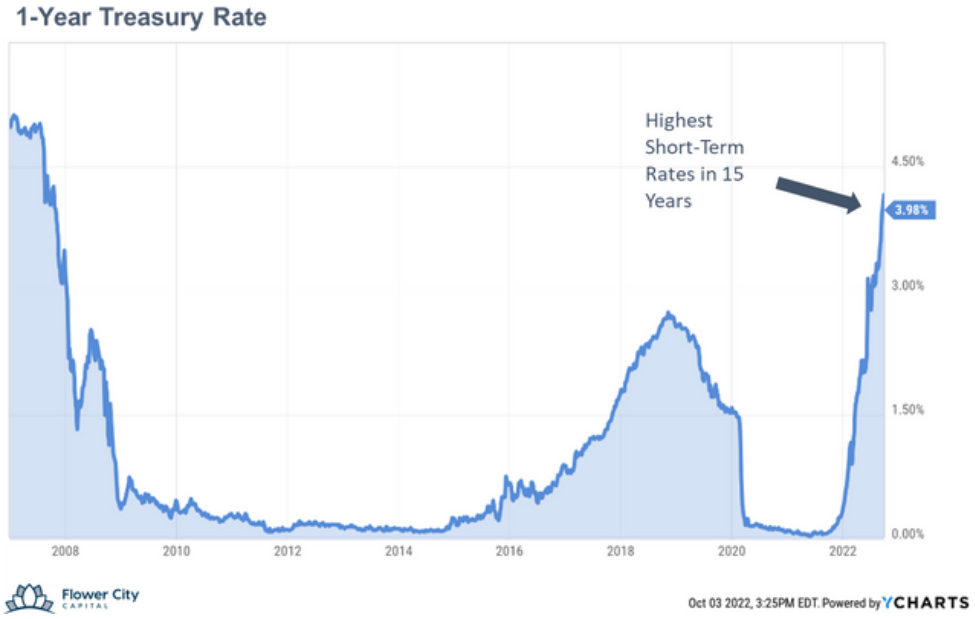
That said, this is also the most compelling investment environment we have seen in 2 years. Higher interest rates have created several opportunities.

The most obvious opportunity is cash where investors can earn as much as 4% in short-term government bonds. If you are holding cash in a 0% yielding checking account, we recommend moving it to a higher interest savings account or give us a call for other cash management options.

Higher interest rates have created several opportunities... Investors can earn as much as 4% in short-term government bonds

Chart 3

Cash is no longer trash



The second main opportunity lies within bonds themselves. High quality bonds now offer 5-6% yields while lower quality bonds are offering yields in the high single digits or even double digits. These are stock level returns, but carry less risk since bonds get paid before stocks.

We remain less bullish on stocks for the time being. Though valuation multiples have come down, earnings estimates have not. Stocks have additional room to fall should the economy continue to slow.

Currently the trend for interest rates is still higher and stock prices still lower. Each day that we remain patient could mean higher potential return on those investments when the time is right to start buying. We therefore remain patient. Until then, we will likely begin a measured program to add higher yielding opportunities within bonds. There will come a time when it makes sense to start buying aggressively.

One note as we approach the mid-term elections. There will be a lot of news coverage and speculation on the impact of one party versus another on the markets. Though politics are of course important for our society and culture, we have found no discernable market impact based on which party wins an election.

Investment Policy Statements

We believe the highest risk adjusted returns available are within bonds. We therefore ask for your help in updating our Investment Policy Statements. All of our clients sign these documents outlining how their portfolio is to be invested and managed. More information will follow shortly with next steps on making these updates.

Improved Policy Statements will include:

1. A clear space for alternative investments and their place in portfolios
2. Tracking retirement accounts and other investments we do not currently manage
3. Increasing allocation tolerance bands for stocks and bonds from 10% to 20%

We will remain judicious in utilizing the wider bands, but the greater flexibility will help to navigate volatile markets and follow our playbook of using safer bonds as a funding source to buy riskier assets during market sell offs.

Example 60/40 Portfolio Tolerance Bands

Asset Class	Current Policy Statements	Proposed Policy Statements
Stocks	50% - 70%	40% - 80%
Bonds	30% - 50%	20% - 60%
Cash	0% - 5%	0% - 10%

Important Disclosures

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