Investment Update

Fall 2023

Flower City CAPITAL

Inside

Executive Summary

- 2023 has been a pretty good year for financial markets with a 60/40 benchmark portfolio up almost 4%* in line with historical returns
- This may come as a surprise given the considerable negative sentiment surrounding inflation, politics, and general uncertainty
- Inflation is higher than normal because the economy is actually quite strong, even as central banks have raised interest rates
- Markets are functioning as they should and Covid distortions have largely run their course - the final normalization will depend on the path of inflation and interest rates
- Our portfolios have largely followed the economic phases since Covid - very overweight risk assets during the recovery, and very underweight risk for the comedown
- We recently removed much of that underweight, though our portfolios remain slightly more conservative through lower stock exposures and higher quality bonds
- We remain long-term investors focused on fundamentals and the things we can control like diversification, fees, and taxes

Relevance to Financial Plans

Market timing is difficult and the last few years have been exceptionally volatile. That said longer-term returns are intact and exceed the conservative 4-5% return assumptions we use to build financial plans. We now find ourselves in a much higher interest rate environment and stocks are less expensive - a preferred starting point for future returns.

**Benchmark references Vanguard LifeStrategy Moderate Growth Fund (VSMGX) from 1/1/23 - 10/24/23 as a proxy for a 60/40 portfolio*

Contextualizing the Last Few Years

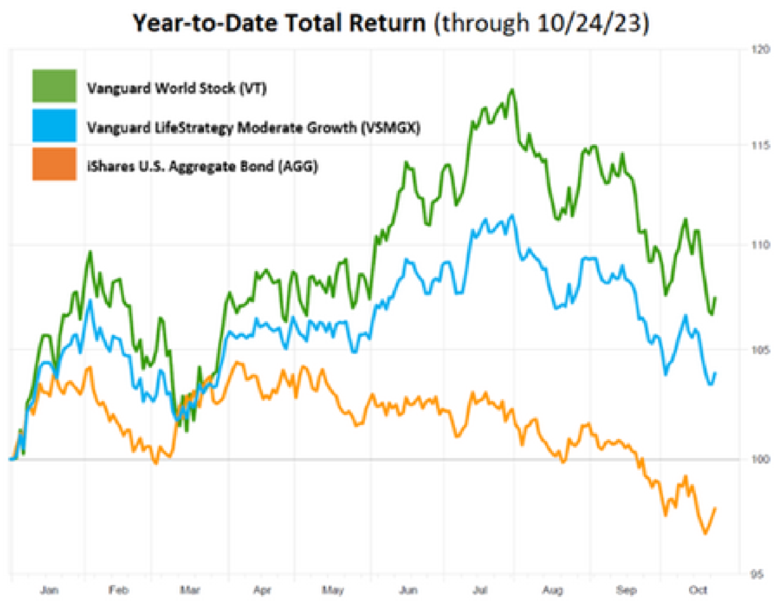
One cannot measure their portfolio or understand markets in short time periods. But first we'll need to understand how we got here. Everything tanked in the **Shutdown** of 2020, then surged in the **Stimulus/Recovery** of 2021. Last year the bill came due, and interest rates increased dramatically to fight inflation preceding the market **Comedown**. Now we're seeing **Normalization** with markets off their highs, though not by much, and interest rates likely to remain higher for longer until growth and inflation do slow.

	The Shutdown	The Stimulus / Recovery	The Comedown	Normalization
Time Period	First half of 2020	Second half 2020-'2021	2022	2023
Stock Market	Down ~30%	Up ~100%	Down ~20%	Up ~8-10%
Interest Rates	Record Low	Historical Low	Rapid Rise	4-5% (near historical avgs)
Inflation	Negative	Low/Rising	~9% highest in decades	3-4% slowing
Sentiment	Very Bearish	Extremely Bullish	Bearish	Oscillating Neutral
Govt. Spending	Normalish	Unprecedented	Unprecedented	Record non-war deficits
Our Positioning	Neutral	Extremely Risk On	Extremely Risk off	Slightly Risk Off

The Market

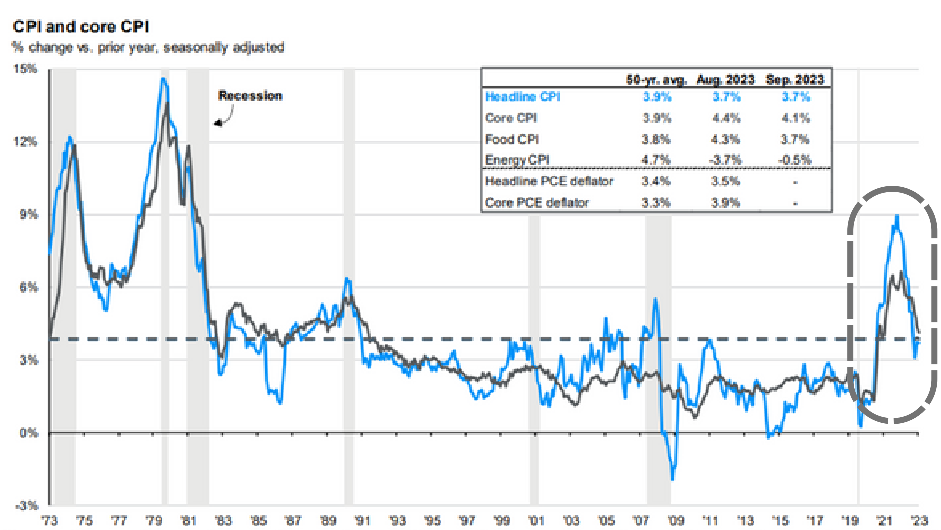
Financial markets are doing well in 2023. Global stocks (VT) have provided an effective hedge against inflation and are up about 7.5% year-to-date through 10/24 while US bonds (AGG) are slightly down due to the rise in interest rates. When blended together, a 60/40 benchmark portfolio (VSMGX) has returned almost 4% over the same time period which is in line with the five and ten year averages of 4-5% that we use to drive financial plans.

This is likely due to stronger than expected economic growth. Low unemployment, excess Covid savings, and lots of government spending is a perfect recipe for strong demand. In this environment both growth and inflation have remained resilient.



Why might investors not feel like the market is doing well? As human beings, we don't like paying more for the same things especially for big purchases such as cars and homes.

And after selling off last year, the market has been stuck in a sideways channel. This isn't all bad as the froth and excesses of 2021 have largely worked themselves out.



	50-yr. avg.	Aug. 2023	Sep. 2023
Headline CPI	3.9%	3.7%	3.7%
Core CPI	3.9%	4.4%	4.1%
Food CPI	3.8%	4.3%	3.7%
Energy CPI	4.7%	-3.7%	-0.5%
Headline PCE deflator	3.4%	3.5%	-
Core PCE deflator	3.3%	3.9%	-

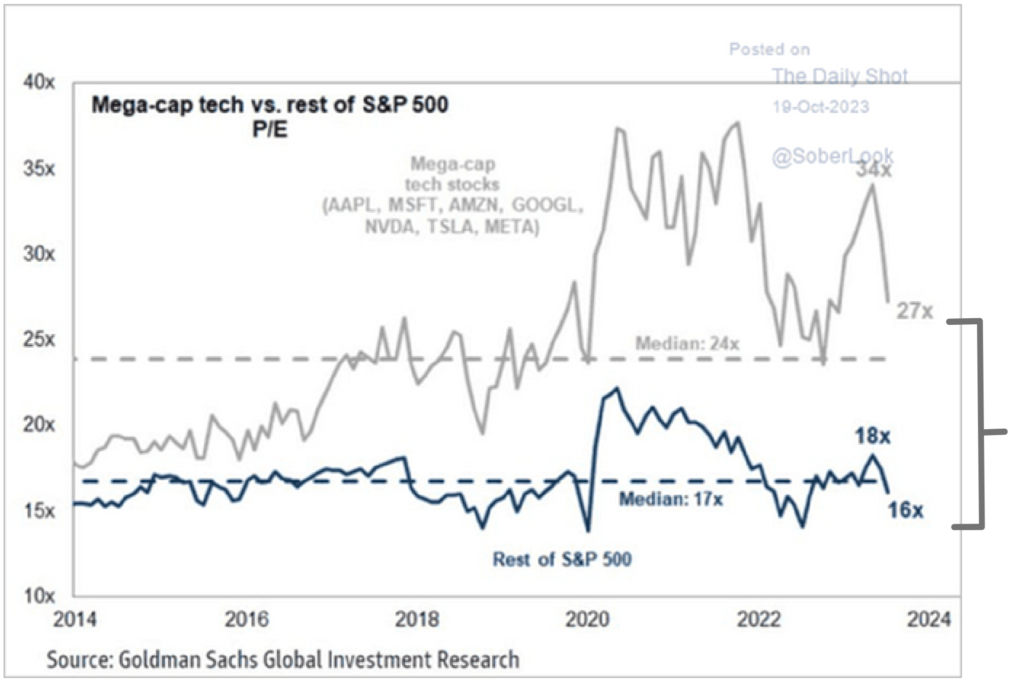
Source: BLS, FactSet, J.P. Morgan Asset Management.

Though there is more work to do, inflation has actually fallen significantly from a peak of over 9% to around 3-4%

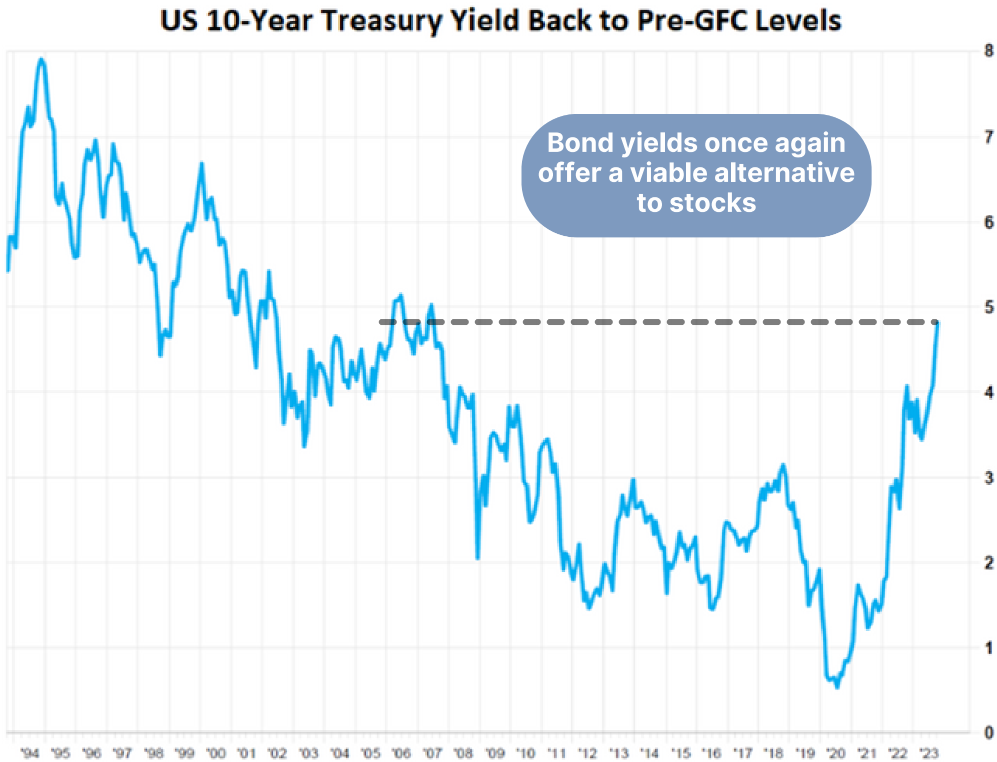
Stock valuations are returning to more normal levels after hitting all-time highs in 2021. The price-to-earnings ratio (how much investors are willing pay for a given level of earnings) for the S&P 500 is back in its average range for the last 25 years.

One metric doesn't tell the whole story though. These multiples are inflated by large tech companies whose prices have soared on artificial intelligence excitement. They also have lots of cash and locked in lower interest rates on their debt. As a result, higher interest rates actually benefit them in some ways causing their shares to trade at a premium.

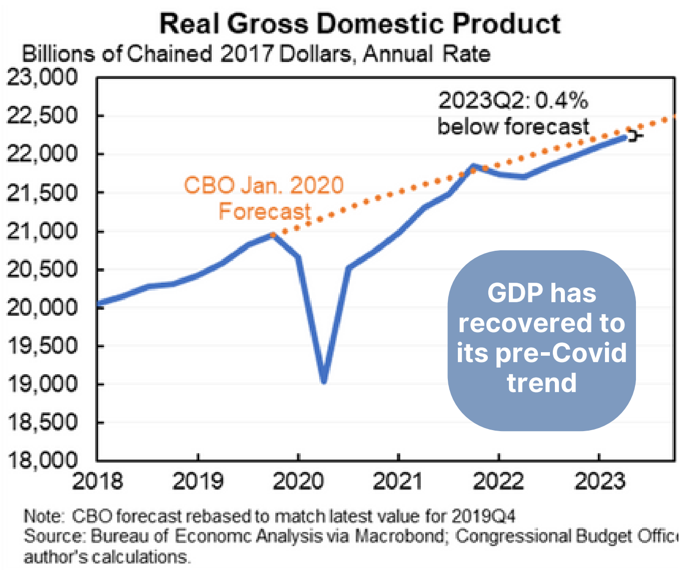
We have seen significant dispersion under the surface in terms of large companies vs. small as well as among sectors. Some microcaps are down over 40% and are even less expensive. These companies are a clear example of higher interest rates impacting their ability to borrow.



Likewise, bonds yields are back at their pre-Global Financial Crisis levels, removing a massive Covid era distortion. This means bonds offer a viable alternative to stocks for the first time in many years. They also would help to protect capital should stocks experience a pullback. In that case bonds could be sold to purchase equities when they're even cheaper (i.e. rebalancing.)



Looking past the last two exceptionally volatile years, the simple takeaway is that stock and bond markets are back in line with historical levels. The economy has also recovered as measured by GDP (Gross Domestic Product) or all the goods and services produced by an economy.



Our Portfolios

Broadly speaking, we've made the most of the post-Covid recovery. It made sense to take more risk coming out of 2020. It also made sense to be more conservative at the beginning of 2022 as it became clear the frenzy of the prior year wouldn't last forever.

Given the unprecedented rise in interest rates and historically high equity valuations, we decided it was prudent to give up some potential upside in favor of a lower risk profile. This tradeoff provided tremendous downside protection as well as comfort to our clients.

There was a cost to that hedge, however, as the market powered higher through 2023. It's very difficult to to be underweight risk overtime as things like artificial intelligence can come along and stoke markets. The key takeaway is that market timing is extremely difficult. There are too many moving pieces in the global economy and financial markets - the biggest one being people's feelings and emotions.

The stated policy goal of global central bankers is to fight inflation by slowing the economy. Higher interest rates take time to impact borrowers and slow demand. Therefore our portfolios are slightly underweight their target stock exposures and hold higher quality bonds. Though as markets continue to normalize we will continue to migrate towards neutral positioning.

Historically, any excess returns have come within each respective asset class (for example, selecting preferred fixed income exposures) as opposed to predicting market direction and timing trades accordingly. We continue to avoid interest rate sensitive sectors such as real estate and banks for the time being, and we are patiently reviewing bond and smaller stock opportunities for when it is time to start taking risk again.

For those who are eligible, our alternative investments provide some countercyclical exposure in the form of opportunistic and distressed lending activities. We continue to invest in our alternative investments platform as that has been a key source of diversification and return over these last couple of years.

We remain long-term investors focused on fundamentals and the things we can control. One of those things is taking advantage of the selloff in bonds to harvest tax losses, offsetting income and taxable gains elsewhere.

Outlook

The first thing to remember is that nothing is broken. Markets are functioning as they should and Covid era distortions have largely run their course. The final normalization will depend on the path of inflation and where interest rates are headed. There are three high-level scenarios.

- **Bullish Scenario or a "Soft Landing"**
  Inflation may continue to fall over the next couple of quarters without the need for interest rates to go much higher. With less pressure on the system, economic growth could hang in there with limited job losses. Then it's possible to move along into the next cycle without any major corrections.

- **Bearish Scenario or a "Hard Landing"**
  Interest rates may need to go higher in order to bring inflation back to target pushing the economy into a recession. This could result in a significant market pull back, though there is a lot of cash on the sidelines waiting for such an opportunity.

- **Muddle Along**
  It's possible that the next few years look like the last two in a sideways chop with continued volatility. Again, not all bad as markets grow into their current prices and start their next cycle a bit healthier.

Market timing is difficult and the last few years have been exceptionally volatile. That said longer-term returns are intact and exceed the conservative 4-5% return assumptions we use to build financial plans.

Important Disclosures

Flower City Capital (FCC) is a registered investment advisor. Information presented herein is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and unless otherwise stated, are not guaranteed. Readers of the information contained in this Newsletter should be aware that any action taken by the viewer/reader based on this information is taken at their own risk. This information does not address individual situations and should not be construed or viewed as any type of individual or group recommendation.