PERSONAL WEALTH ADVISORY BY
Laird Norton Wetherby

Q2 2024 Commentary

Risk Management in the 2020s: Beyond the Market as Monolith

> "Monolith: a large single upright block of stone, especially one shaped into or serving as a pillar or monument."
>
> – Oxford English Dictionary

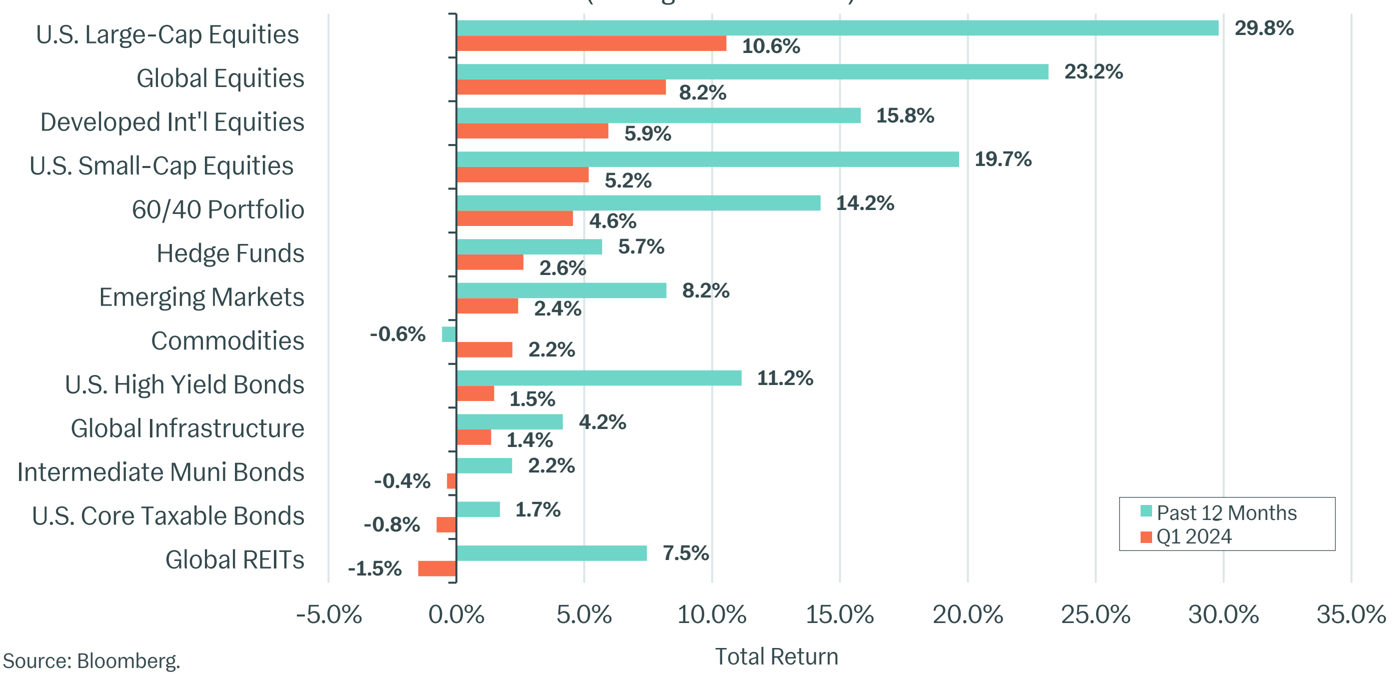
I've always been fascinated by monoliths, man-made or natural, many of which I've visited around the world – the Washington Monument, the Obelisques of Paris, Trajan's Column in Rome. A longtime pet peeve of mine, however, is that investment markets and asset classes are also often treated as monoliths, as one uniform unit.

The "market as monolith" allows the media and pundits to ask: Is The Market Overvalued? This can make for great click-bait or a way to promote investment services. But the real work of investing high-net-worth portfolios over the long term requires a much more nuanced approach: A focus on relative, risk-adjusted valuations across all markets, not just a myopic obsession with the S&P 500 that is typical of the media.

At any one time, markets are comprised of a broad range of individual ingredients that may or not be a good value. Seldom, if ever, are components of the broader capital markets considered all cheap or all expensive. That is a very good thing because dislocations from intrinsic value can present opportunities.

In this Commentary, we look at the drivers behind U.S. equity returns and clouds that are forming on the horizon. Then we delve into each market/asset class in context of the current economic environment to point out pricing anomalies that may present opportunities.

Asset Class Total Returns: Q1 2024 & Past 12 Months
(through March 2024)



Source: Bloomberg.

Clouds on the Horizon

The S&P 500 rose pretty much straight up through the first quarter with barely a hint of risk. As a result, the Sharpe ratio for the S&P 500, which gauges return relative to risk, hit a record high in February dating all the way back to 1929. Supporting the optimism: healthy growth in the U.S. economy, new job creation, rising consumer spending and corporate profits. U.S. household wealth is at record levels buoyed by high real estate and stock prices. And recession seems less likely now. The Index of Leading Economic Indicators turned positive in February for the first time in nearly two years.

The current environment of higher U.S. interest rates and inflation relative to the recent past is not necessarily a problem IF paired with a growing economy, plenty of jobs and higher productivity. What can derail this are: (1) rising levels of geopolitical tension in the world; and (2) the potential for inflation to re-accelerate.

Inflation in the U.S. remains stubbornly above the Fed's 2% target, despite having dropped from the 9% highs hit in 2022. In March, the U.S. core Consumer Price Index (CPI), which excludes the volatile food and energy categories, rose slightly faster (+0.4%) to an annual rate of 3.8%. Until March, core CPI had been flat or lower on an annualized basis for 11 straight months. Not surprisingly, when asked "what is your single most important problem?" the most frequent response from small U.S. business owners was "inflation" (per the Feb. 2024 NFIB Small Business Survey).

Historically, inflationary spikes like the one we experienced in 2022 have been followed by a second wave. One catalyst this time could be an escalation of the Middle East conflict that disrupts oil markets and supply chains and creates a second inflationary wave. Iran's direct attack on Israel served to remind the world of the escalating geopolitical risk we have been writing about over the past year. This and other geopolitical hotspots, including Ukraine and the China Sea, have been the catalyst for a re-militarization of the world. Shifting geopolitical relationships are reshaping supply chains and support our thesis for an evolving macroeconomic landscape, including higher-for-longer levels of inflation and interest rates.

Concern about inflation is making the Fed's job trickier. The Fed is still generally expected to lower interest rates this year, but not the six times priced in just four months ago. Two or fewer rate cuts are now seen as more likely. And some pundits are now predicting no rate cuts – a real possibility.

The U.S. Presidential election is a potential catalyst for increased volatility. An uncertain or contested outcome in November is a real possibility, not to mention the prospects for substantial changes in U.S. economic and foreign policy. For example, former President Trump has floated the idea of a universal 10% tariff on all imports and 60% on imports from China, adding to inflation risk.

Another key consideration is potential changes to immigration policy. During the past three years, most of the growth in the labor market has come from immigrants, allowing the U.S. economy to both grow and to keep a lid on wage inflation (due to an expanding workforce and immigrants working for below-average hourly wages). There are an estimated three million immigrants in the U.S. with asylum cases pending, and many of these people continue to seek and find work as they await their cases to be heard.

As we get closer to November, we will be watching for signs that the broader capital markets are beginning to discount election-related risks.

S&P and the Fabulous 493

Through the first quarter of 2024, U.S. large-cap equities continued to lead with the strongest results in communications (+15.8%) and technology (+12.7%), as a handful of stocks in each sector continued to reap benefits from artificial intelligence enthusiasm. Additionally, the energy sector (+13.7%) was a notable outperformer on lower supply -- OPEC production cuts and tensions in the Middle East – and higher demand (rosier global growth forecast).

There continue to be sectors and stocks in the S&P 500 with relatively attractive valuations, even though the market was recently near record highs. If we sideline the 10 biggest stocks (including the tech heavy Magnificent 7), the median S&P valuation drops 23% to 16 times forward earnings, slightly below the historical average. Value stocks at trading for 14 times forward earnings.

The "Fabulous 493" (the S&P minus the Magnificent 7) could provide a boost to portfolios if and when capital starts to focus on more compelling valuations, perhaps due to an economic slowdown or less enthusiasm about AI.

In the near term, we are keeping a close watch on S&P 500 earnings to gauge the overall health of the U.S. global economy. Although S&P earnings are expected to have increased 3% overall in the first quarter, more companies are providing "negative guidance" or lowering their earnings forecasts. If Q1 2024 earnings surprise on the upside, momentum could continue to power equity markets higher.

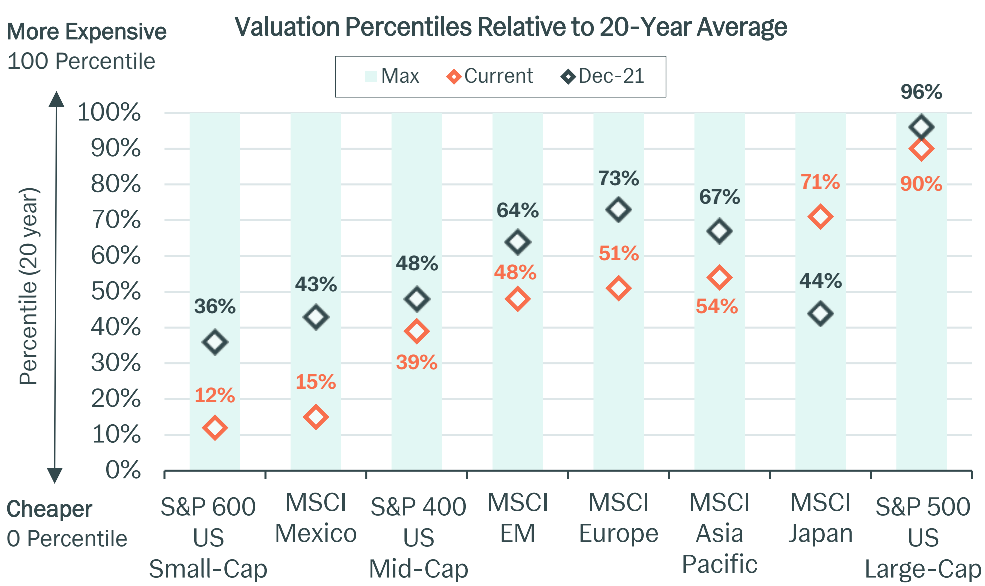
The World Beyond the S&P 500

For us, "The Market" thankfully represents far more investment opportunities than 500 of the largest U.S. companies. I say thankfully because it is access to the extended capital markets – the gamut of public and private markets encompassing equity and credit-based exposures across asset classes – that allows us to create portfolios geared to support client goals through bull and bear environments.

The asset managers we work with spend a great deal of time either assessing top-down drivers of valuation or bottom-up components (or both). We believe hiring and putting together managers who apply different lenses to valuation yields should be accretive to portfolios. Following is a closer look at valuations within the major markets and asset classes.

Global Equities: Counterbalance to U.S. Holdings

If you open the aperture a bit, there are plenty of opportunities to own parts of the global equity markets currently trading at lower valuations than we have seen in decades. The valuations on Mexican and Japanese equities, for instance, are on average in the bottom half of what they were over the past 20 years. While geopolitical risks and currency fluctuations are ongoing



Source: Bloomberg, Haver Analytics and KKR Global Macro & Asset Allocation analysis.
Valuations based on P/E (price-to-earnings ratio) on 12-month forward earnings. Data as of Nov. 30, 2023.

concerns, a strategic allocation to global equities can enhance portfolio diversification and long-term, risk-adjusted returns. For portfolios with little or no foreign exposure, rebalancing along the lines of the MSCI All-Country World Index, which is 64% allocated to the U.S., could make sense.

Core Fixed Income: Not Cheap but Still Valuable

Yields across fixed income are at compelling levels and support continued ownership, even though bond total returns have been minimal in the past year given the rise in interest rates. U.S. yields have climbed back up to around 4.6% on the 10-year Treasury vs. 3.9% at the end of 2023. The rise in rates has mostly hurt the pricing on high-quality bonds (the Bloomberg US Aggregate bond Index), while lower quality debt has managed to gain a bit as investors envision lower rates of default amid a growing economy.

Bonds remain a strong diversifier and income producer. Additionally, with central banks likely leaning toward easing monetary policy in the not-too-distant future, we could see a rebound in bond pricing.

Currently, mortgage-backed securities (MBS) are one of the most attractive segments in plain vanilla fixed income, offering relative value with limited risk: above average yield spreads, few concerns about mortgage prepayment/refinancing given the rise in rates and possibly additional purchases by the Fed at some point.

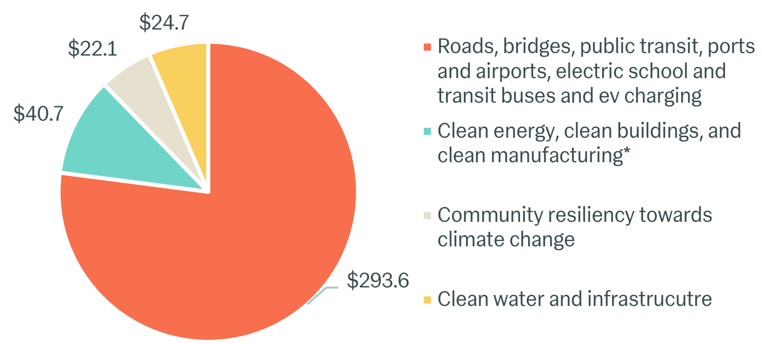
Real Assets: Triple Play

Our view is that real estate and infrastructure offer an important combination of long-term return, diversification and inflation protection. Near term, the steep rise in interest rates since mid-2022 has been a drag on real estate and infrastructure equities. But these two segments, along with commodities, may make valuable additions to portfolios because they are likely to benefit from inflation staying higher for longer and several new secular trends.

A near-to-intermediate term tailwind for infrastructure is U.S. government spending via the Inflation Reduction Act (2022) and the Bipartisan Infrastructure Law (2021). As of March 2024, these two government programs have provided more than $456 billion in funding for a wide variety of infrastructure across the U.S.

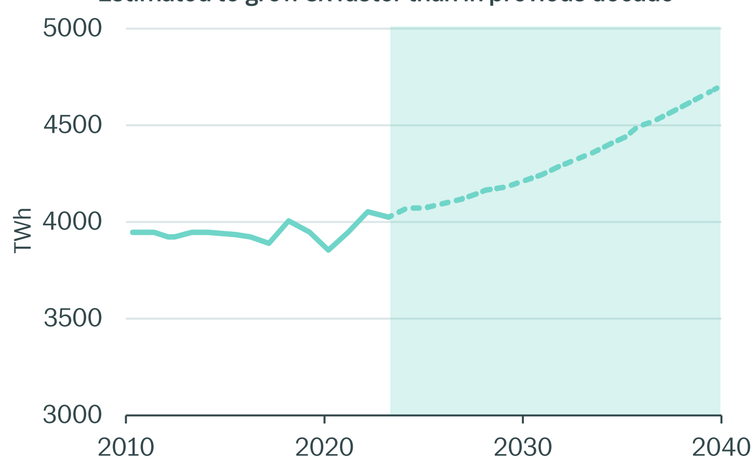
Another secular trend benefiting infrastructure, which includes utilities and renewable power generation, is the surge in demand for electricity to power the data centers that drive artificial intelligence applications.

U.S. Goverment Funding for Infrastructure*: $456+ Billion in Past Two Years



*Via the Bilateral Infrastructure Law (2021) and the Inflation Reduction Act (2022). Source: whitehouse.gov/invest.

U.S. Net On-Grid Power Demand: Estimated to grow 3x faster than in previous decade



In terrawatt hours (TWh). Source: Motley Fool.

Note that power isn't just needed for AI microchips. Cutting-edge computing generates heat, requiring cooling systems that consume yet more power (and sometimes massive amounts of water—another expensive and finite resource). Yet more power is needed to transport data between users and servers, which may be thousands of miles apart.

The real assets category, especially renewable energy and infrastructure, has certainly been stymied by rising interest rates. Longer term, however, there is growing demand for energy, increasingly coming from renewables, and there is state and federal support to spur investment. If the AI evolution is to continue, it will do so on the shoulders of a reinforced and renewable energy infrastructure.

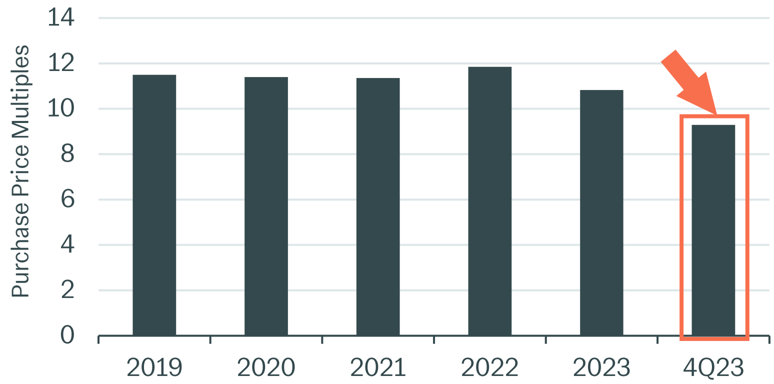
Private Equity: Singular Expertise

Over the last several years, a tremendous amount of capital has flowed into private equity causing valuations to rise. Investors became concerned that private equity managers would not be able to source enough new investments to match the high returns of the past decade.

However, higher interest rates since spring 2022 have helped reset the private equity market. Using leveraged buyouts as an example, valuations in that space peaked between 2019 and 2022 when low-cost debt was plentiful. Since the rise in interest rates, there aren't as many willing lenders, which means deals have to be funded with more equity. As a result, buyout valuations have come down to support transactions funded more with cash.

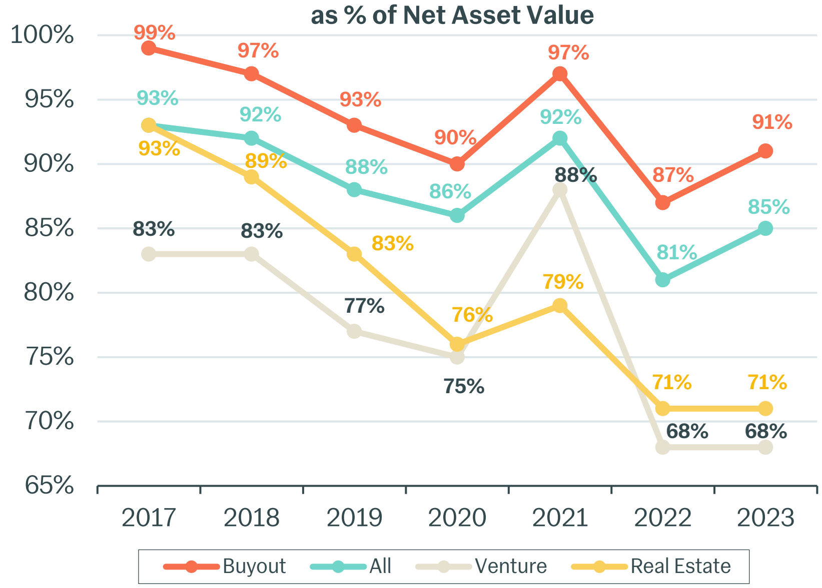
Even when private equity valuations get frothy, they don't tend to suffer severe corrections, and such has been the case in the recent downturn. Broadly speaking, the two major drivers of return here are (1) the prowess of private equity managers in identifying investments with high intrinsic value; and (2) portfolio holdings have historically had a stronger track record of improving operational efficiency relative to public equities.

Private Equity Shows Signs of Improved Entry Valuations
Purchase Price Multiples on All Leveraged Buyouts



Source: Pitchbook, Preqin as of December 2023.

Limited Partnership Portfolio Pricing as % of Net Asset Value



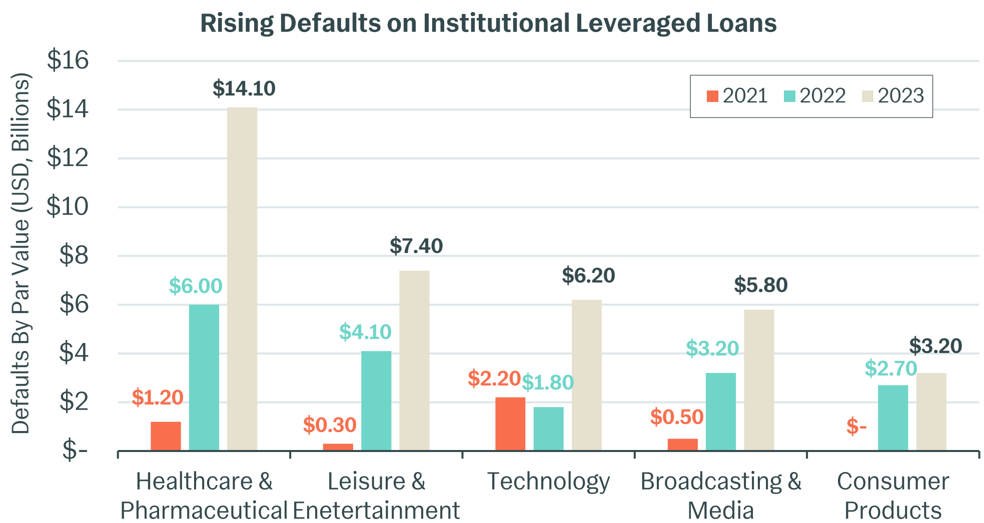
Source: Jefferies Global Secondary Market Review, January 2024.

Additionally, the secondary market (motivated private owners selling shares of equity or limited partnership interests) looks quite a bit more attractive than it has in several years. Since refinancing costs have become prohibitive for some venture capital and real estate deals, private equity managers are stepping in to buy into the more promising ones as current owners seek liquidity.

Diversifiers: Evolving Opportunities in Private Credit & Hedge Funds

Over the last several years, private credit has grown into one of the largest alternative asset classes as U.S. regulatory changes forced banks out of certain types of lending and investors stepped in to fill the void. Unlike in the public credit markets, there are relatively few lenders in private credit, the structures are often more complex and there is usually very limited liquidity – capital is locked in for years.

Private credit has typically offered 3% to 5% in additional return to compensate for the lack of liquidity. Today, private credit in Europe and the U.S. is becoming more attractive across a wide array of assets including CLOs (collateralized loan obligations), real estate debt and convertible bonds.



Source: Refinitiv, Institutional Leveraged Loans.

The distressed debt category is of particular interest, as many borrowers are seeking to refinance but finding few options for doing so, especially in the healthcare and pharmaceutical sectors where there been a rise in defaults. In this environment, investors can command advantageous terms, including higher yields.

Meanwhile, hedge funds have generally performed well since the last Fed rate hike in July 2023. Why? Rate hikes create stress and challenges for companies with high debt levels. Also, extreme valuations, either high or low, provide ample opportunities for hedge funds that specialize in stressed or distressed situations, including through short-selling and arbitrage.

In Closing

Strong U.S. equity markets that consistently generate new highs can lull investors into complacency. Conversely, new highs can frighten investors worried about investing at market peaks. One of the keys to long-term investment success is keeping two seemingly opposed ideas – in this case complacency and fear – in equal balance while making decisions.

As we have shown in this Commentary, market valuations are not homogenous; they differ across and within asset classes. Nor are they static; they are dynamic and influenced by a multitude of factors. We, and the managers we invest with, take advantage of discrepancies in valuations in two major ways: strategic diversification within and across asset classes; and portfolio rebalancing to target long-term allocations. While we cannot control the markets, these two things are under our control, and they do the heavy lifting in terms of compounding wealth over time. What's more, strategic diversification and rebalancing are more important than ever in an environment characterized by higher geopolitical and economic risk.

We want to know what you think

Please take a moment to provide feedback on our investment communications here. Thank You.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at LNW. As head of the investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with client advisory teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNW, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The LNW investment team is comprised of 11 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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