Pavlic Investment Advisors

Client Review & Outlook

1st Quarter, 2023

Dear Client,

Despite continued bouts of volatility, the market continued to show its resilience in the first quarter by posting its second quarterly gain in a row. The year began with investors feeling upbeat about subsiding inflation and the belief that the Federal Reserve would switch from interest rate increases to interest rate cuts. In February, several economic reports came in hotter than anticipated which negated the interest rate cut thesis and the market sold off. The biggest shock in the quarter, undoubtedly, was the collapse of both Silicon Valley Bank and Signature Bank within 48 hours. Credit Suisse was also on the brink of failure before being forced into the arms of UBS, a deal supported by significant Swiss National Bank support. Despite all of this, the S&P 500 managed to rise +7.0% in the first quarter. The Dow was up fractionally +0.4% and the Nasdaq Composite soared +16.8%, outpacing the Dow by the widest margin since 2001. **Our PIA core equity portfolios continued to perform well, up mid-single digits on average on a gross and net of fee basis, the second quarterly increase in a row.**

In the first quarter, the technology sector regained its positive share performance after a tough 2022. Two of our largest technology holdings remain Microsoft (MSFT) and Apple (AAPL) which continued to be bellwethers through the storm, up +20.5% and +27.1%, respectively year-to-date. Our recently added semi-conductor stock, Applied Materials (AMAT), was also up +26.5% in the first quarter. One drag during the quarter was Devon Energy (DVN). After rightly not owning energy for much of the last decade, we have started building a position in the sector as we expect demand to outpace supply over the next decade, especially as China (with a population that is 4x that of the United States) begins its reopening process after a 3-year COVID lock down. DVN trades at 7.0x forward earnings with a 10.0% dividend yield, which we believe sets a good floor under the share price. Another drag on portfolio performance was Dollar General (DG) which gave back some of its strong outperformance from 2022 as management set a very low bar with its initial 2023 guidance. We continue to like and own both stocks and added a relatively small allocation to Devon Energy on its weakness.

The largest portfolio weight change we made in quarter was not stock specific, but still highly value-added to our clients. We normally keep 2-5% of liquid cash on hand in client accounts. When we are more cautious and believe we will be able to buy shares later at lower levels, we hold more cash and vice versa. Liquid cash in a Schwab brokerage account currently earns only 0.45%. While this is likely more than your bank checking account, it is lower than bank CD rates with maturity dates. Schwab's prime money market fund however is currently earning **4.69%**, with no maturity dates or liquidity restrictions. Money market funds have a one-day settlement and have no transaction costs to buy or sell. We are now keeping liquid cash lower depending on account size and monthly distributions (if any) and maintaining a 5% position on average in the money market fund to capture this additional yield for our clients.

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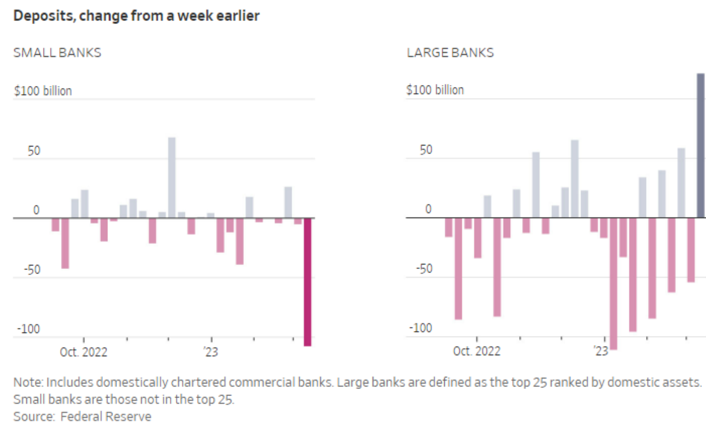
Stock Market Review

This quarter, we focus our stock market review on the recent banking turmoil, what to do with bank and cash deposits to earn additional yield. And, we put the recent tech layoffs in perspective.

Bank industry turmoil in 1Q23. It had been almost 2.5 years since we had a major bank failure in the United States until one weekend in mid-March when within 48 hours, we experienced the second and third largest bank failures in history as Silicon Valley Bank (SVB) and Signature Bank of New York (SBNY) fell under FDIC receivership. Many people are rightfully asking, "Are my deposits safe?", "How could this happen so fast?", and "What does it mean for my investment portfolios?"

1. "Are my bank deposits safe?" We recommend individuals not keep more than the $250k in their checking account, which is the FDIC insurance limit at any individual banking institution. One simple way to double this amount (if you are married) is to hold a joint account, as each co-owner of a joint account is insured up to $250k. Therefore, joint accounts are insured up to $500k. Although the situation was rather unusual with SVB/SBNY, it is important to note that the FDIC did step in and insure *all* deposits at both banks regardless of deposit size. Going forward, we believe the larger national banks (JPM, BAC, C, WFC) are in a better financial position to weather the current storm compared to regional banks, especially those with questionable lending standards and deposit outflows as shown in the fund flows from small banks to large banks (chart above).



2. "How did these bank failures happen so fast?" It was a classic run on the bank where panic ensued, and depositors were racing for the exits attempting to withdraw an astounding $42 billion from Silicon Vally Bank in a single day. It was later reported through Congressional hearings that over $100 billion was set to leave SVB the next day had the FDIC not stepped in, amounting to over 85% of the deposits at the bank. What precipitated the panic was the announcement by SVB of a $1.8 billion loss on the sale of a portion of its bond portfolio (Treasuries and Mortgage Backed Securities [MBS]) which had suffered declines in their value due to the sharp rise in interest rates. To replenish their capital, SVB then tried, but failed, to raise equity. The very next day, regulators stepped in to shut the bank down after the withdrawal requests exceeded SVB's available liquidity. It has never been more obvious that the foundation of the banking industry is trust, and within a 24-hour period, investors lost confidence in SVB which brought about its demise. The other key difference between banking of today versus years past is banking is incredibly digital. Just as social media has moved the so called "meme stocks" a year ago, so did social media play a roll in SVB's demise by spreading panic. Depositors all over the world were able to, with a few clicks on their iPhones, transfer money out of SVB—a new reality for the entire banking industry.

3. "How should investors react?" While there are no one size fits all answers, we encourage clients to keep cash levels below the FDIC insurance limits. We also encourage banking with the most reputable institution that is convenient for you. We have also lowered liquid cash balances in all our client accounts and invested that cash in prime money market mutual funds. Not only do we pick up additional yield (4.69% today) by doing this, but we also have reduced liquid cash below the SIPC insurance limitations for all our clients since the money market fund is classified as a mutual fund. From a bank stock holding perspective, we continue to own JPMorgan Chase (JPM) and Goldman Sachs (GS). We view these two names as the absolute best in class commercial bank and investment bank, respectively.

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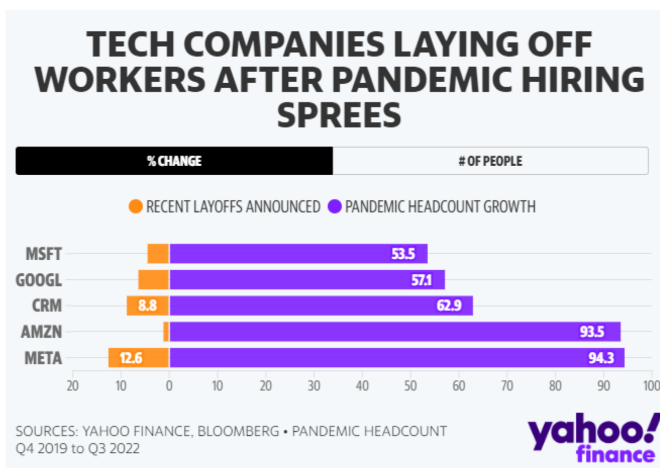
"Why is unemployment so low when I read about so many tech layoffs?" We believe the recession won't be a "everything craters all at once" event like the Great Financial Crisis, but instead a "rolling" recession where different parts of the economy struggle through the cycle caused by the Fed continuing to raise interest rates. Real weakness was first seen in housing starting last summer. US home prices have now fallen for seven consecutive months through January, dropping -0.2% from December and now down -3.0% from their June peak. While prices remain up year-over-year (+3.8%), the pace of annual growth has slowed as high mortgage rates and economic uncertainty discourages would-be homebuyers. Home price declines have been most acutely felt in the west (San Francisco, Seattle, and Phoenix), while the Midwest and Sun Belt cities have fared far better with lower cost of living and continued inbound migration demographic patterns.

Specifically related to technology, as the Fed has continued to raise interest rates, the ability for a non-profitable start-up company to operate is becoming increasingly more difficult. At the most basic level of finance, revenue less expenses = profits. If expenses exceed revenues, as is the case with most emerging start-ups, capital raising of either debt or equity must make up for the shortfall. Debt is no longer free, and equity investors are increasingly wary of negative cash flows in this rising rate environment. If an investor can earn 4.5%-5.0% virtually risk free by parking in money market funds or by buying treasury bills, the incentive to take risk (especially higher risk with non-profitable companies) becomes less and less attractive. The result is a drying up of credit, or at the very least much more expensive credit, and, as such, unprofitable companies must reduce their expenses—which often means headcount.



We are seeing headcount reductions across several technology companies—big and small, profitable and unprofitable. Each company's headcount reduction has a very different story to it. Some, as is the case with Amazon, is simply a reduction of what was likely over-hiring during the pandemic (see nearby chart). While Amazon's 18,000 layoff announcement catches headlines, they also hired 746,000 employees from 4Q19-3Q22. On a percentage basis, several companies hired, in some cases, 10x the amount of their recent layoff announcements.

Bond Market Review

Yields pull back from October 2022 highs, deep inversion lessens. This quarter is the first quarter in over a year in which we are reporting that the 10-year US treasury rate is lower than it was in the prior quarter, dropping from 3.88% at the end of last year to 3.49% at the end the first quarter, a decline of 0.39%. This is also ~0.80% lower than the peak reached in October of 2022. Lower yields mean two things: First, higher bond prices, as interest rates and bond prices are inversely correlated, a positive. Secondly, the rates of return at which we can redeploy capital into the bond market decreases, a negative. However, rates remain historically high in comparison to the prior decade. A rough rule of thumb we use is our investment grade bond portfolio yields about 2.0% above the standing 10-year US treasury rate, depending on the term structure of the bond ladder we design.

Because the BBB investment grade yield curve is elevated and relatively flat, investors are not paid as much to extend out duration. Said another way, if an investor can make 5.0% for a maturity date 1 year out into the future vs. the option to earn 6.0% for investing in a bond that matures in 10 years, there isn't a huge incentive to tie up your money for the longer term. However, at some point the Fed will pause on its interest rate increases and begin to reduce the Federal Funds Rate. This will lead to a continuing reversal of the yield curve inversion and incentivize us to *extend* our duration, i.e., purchase those longer maturities. "Why would I extend duration when short term rates are higher than long term rates?" we are often asked. The simple answer is reinvestment risk. If rates are falling, you want to lock in higher rates for a longer time period. If you stay short, you risk reinvesting at lower and

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lower rates. Although we are not in this environment yet, we will be and we are closely watching for this bond market transition to occur.

2022 Market Outlook and Commentary

In October of last year, we officially entered a bear market as the S&P 500 drawdown reached -25%. We have recovered just under half of the losses, and it seems like we are somewhat in no-man's-land for what comes next. There was a mini-banking crisis in the first quarter and stocks continued to march higher as interest rate increase expectations were pulled lower. Inflation remains elevated, but few are calling for continued increases—the debate is on how quickly (or not quickly) it comes down. As is always the case, the more time that passes, the more likely the bulls are to be right. That is why when we have our initial asset allocation meetings with clients, we talk about time horizon and risk tolerance. It has been 450 days since the S&P 500 hit an all-time high, which surpasses the average of the last 11 bear markets since 1950. Bear markets have lasted an average of 381 days. From a price decline perspective, the average bear market decline is 34%, which we haven't reach yet and might not have to reach either.

While we believe volatility will continue to be elevated, timing the overall market (which the textbooks refer to as beta risk) is a fool's errand. It isn't about *timing* the market; it is about time *in* the market. We spend our research hours not just focused on the macro environment, but we predominantly spend our time performing company specific research in search of great management teams, strong balance sheets, competitive advantages, and growth at a reasonable price. Although we must dig, we do see some opportunities in stocks. A great example, looking back, was our purchase of Stryker (SYK) last year. The stock is up ~20% since purchase despite a down overall market. As we expect continued heightened volatility in stocks, returns both in investment grade bonds and money market funds are now also very attractive. Gone are the days of "TINA" or "There Is No Alternative (to stocks)". With money market funds returning ~4.69% today and investment grade bonds returning 5.0% to 6.0% depending on duration, there is great opportunity to reduce overall portfolio volatility and earn very satisfactory interest income.

"Risk is what's left over after you think you've thought of everything." - Carl Richards

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