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asset management

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Two Black Swans

We are humbled by the magnitude of change in the world. As if a war against a virus was not enough for the world to overcome, Russia's invasion of Ukraine begins a new geopolitical threat of economic and military war. The images from Ukraine display horrific atrocities that seemed a remote probability in a developed, sovereign country. As investors, we are tasked with anticipating future outcomes for the purpose of making better investment decisions for our clients. As Warren Buffett summarizes so succinctly, "If past history was all there was to the game, the richest people would be librarians." In anticipating what lies ahead, we often consider potential for a "black swan" event to emerge. A "black swan" is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Although rare, investors have recently faced two black swans, the global pandemic, and the Russia- Ukraine war, both of which will influence the global economy for years to come. Accordingly, we have made changes to the portfolio to address the ramifications of these events, specifically a higher inflation rate which has been the catalyst for higher interest rates.

During the first quarter, capital markets experienced significant price volatility as stocks, bonds and commodities adjusted valuations to account for a higher level of inflation and the concern of higher oil and gas prices as a further consequence of the war. During the quarter, the S&P 500 Index declined as much as 13% and rebounded to end the quarter with a decline of 4.9%. The Dow declined 10%, rebounding to down 4.6%. The Nasdaq Composite Index, an index with more than half of the companies are technology companies, the largest of which are also in the S&P 500, declined almost 20% and rebounded to end the quarter with a decline of 9.1%. Extreme volatility was also present in the bond market. The 10-year Treasury yield has increased by 0.82 basis points or 54% since year end rising from 1.51% to end the first quarter at 2.33%. This is a poignant moment to reiterate some mathematical fundamentals. To earn back the amount of a portfolio loss, the portfolio must achieve a higher percentage increase than the amount that it decreased. For example, if a $30 stock price declines to $20, or 33%, to return to its $30 value, it must increase by 50%. During volatile markets, it is important to recognize that minimizing downside risk and protecting principal should be a primary objective of investors, particularly for those who have a significant portion of their net worth exposed to equities or others that have the risk of losing principal, such as equities. A hallmark of AHB's forty-year investment management philosophy has been our attention to mitigating downside risk and this quarter has proven no different in achieving this objective for our clients.

Demonstrated by the indices declines, the changing economic landscape has created increased uncertainty. For the past two decades, the core rate of inflation remained comfortably below 2.5%, with many of those years below 2%. In its attempt to achieve its target rate of 2% inflation, during this period, the Federal Reserve maintained the Fed Funds rate, at or near zero percent, while also continuing its Quantitative Easing (QE) policy. Yet, all these actions were to no avail. It was the global pandemic that spurred a massive increase in U.S. government spending as well as a global supply chain shock to finally ignite inflation, albeit too much inflation. In our view, this inflation may not be particularly transitory. The recent core inflation statistics of 6.0% in January and 6.4% February were both higher than November and December of 4.9% and 5.5% respectively. A modest level of inflation is a positive consequence of vibrant GDP growth, however too much inflation will begin to create new problems. The war in Ukraine has now added another layer of supply shock in commodities, most acutely, oil, gas, nickel, and potash. From an

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investment perspective, the higher prices of necessities such as gas may increase the risk of a recession and would be a complication for the Federal Reserve that is fighting a rising inflation rate.

We recognize this is a period of extreme uncertainty. It is difficult, given the complex state of world affairs, to develop a long-term economic outlook. We have shortened our outlook to six to twelve months from eighteen to twenty-four months; in fact, we are beginning to wonder if three months is more realistic! The portfolios remain extremely nimble, invested in highly liquid, large multinational companies that have strong franchises with brands that will garner significant pricing power due to their superior products. Not only does each company in the portfolio have multiple revenue lines, often global, but also maintain low debt to equity ratios and significant cash on their balance sheets. The companies in the portfolio primarily have investment grade ratings, which will allow them to manage the higher interest rate environment with lower risk of default. The taxable and municipal bonds in the portfolios are what we consider "bullet-proof" as all are investment grade and undergo a rigorous credit screening process. Furthermore, each municipal bond fund balance has been carefully reviewed for any risk concerns including geographic risk.

During the past year, we meaningfully repositioned the client portfolios in all strategies, Equity, Fixed Income and Balanced, to prepare for the significant change that we anticipated in the economic environment. Our investment outlook had changed after an analysis of updated economic data as well as corporate earnings reports. The new economic outlook is a reversal of the past as the Fed unwinds it stance from easing to tightening. The near-term outlook includes higher inflation rates, rising interest rates, lower government spending (down from pandemic levels) and a quantitative tightening by way of the Fed's reducing the size of its balance sheet holdings. In equity portfolios, we have reduced exposure to high valuation stocks, such as technology, while at the same time added new investments in the financial services and energy sectors, which have lower price earnings ratios and higher dividends that can compete more effectively with the higher bond yields. In both the municipal and taxable bond portfolios, we lowered our target duration and reinvested in shorter-term bond maturities. As a result, client portfolios are offensively positioned to reinvest at the higher interest rates expected in the future.

Overall, we expect the economy to eventually return to a "normal" or classic environment that economic theory historically supports. This environment includes a modest inflation rate with reasonable economic growth that will provide both equity and bond investors an appropriate rate of return based on the risk associated with such investments. More classically, cash assets will garner a return in line with the inflation rate, equity and intermediate-term bond investors will achieve a return greater than inflation commensurate with their individual risk parameters. We have experienced very low interest rate rates during which investors were handsomely rewarded as valuations were able to expand. We may return to the days when investors must consider how their investments will beat inflation to maintain purchasing power. The move back to this normalized state will not be a straight line and will require an astute investment management team to delicately balance the portfolio to maneuver through the transition. Thank you for your support and confidence that you have placed in our firm.

Wishing you peace, good health, and a pleasant Spring season.
The AHB Investment Team

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