



# QUARTERLY INVESTMENT NEWSLETTER

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Welcome!

Every quarter the Investment Committee for Diversified puts together our thoughts on markets, the economy, and how it all pertains to our clients. We look to give our perspective on what it all means for investors and to share where our philosophy and processes are taking portfolios. Thanks for taking the time to give it a read...



## CHANNELING YOUR INNER TEDDY

In February, my wife and I welcomed baby #2 to the world. For those of you who read these letters religiously, you know how much fun my soon-to-be 3-year-old thinks it is to yell at me all day. All... day. So, I thought I'd share a live look at me surviving the current situation.



While it would also personally be timely, the title of this newsletter doesn't refer to teddy bears but rather Teddy Roosevelt. I'll dive into it deeper momentarily, but I think we're at point where his wisdom comes in handy. It may just be the lack of sleep, but I never would have thought that Teddy Roosevelt would make an appearance on these newsletters...yet here we are. What in the world could the 26th president of the United States have to do with markets, economy, and portfolios?

## THE DANGERS IN IRRESPONSIBLE COMPARISONS

Enough about me, this issue is actually mostly about my team...sort of. Many of you may not know the faces behind the scenes, but it takes a village to properly run the investment team at Diversified and we have fantastic individuals working on your behalf. Over the last few months, there were multiple times where something was said in passing that got me to perk up and really think about what they said. In one of his email responses, Adam (one of my team members) used this quote attributed to Teddy Roosevelt:

**“Comparison is the thief of joy...”**

So simple, so true. It may just be my position and what I do every day, but this has stuck with me ever since. In addition, I think it’s very timely given the market environment and what’s happened over the course of the last 15 years. The best place to start on this is with what Diversified does for our clients and it becomes clear why comparison is so dangerous.

At our core, Diversified believes in comprehensive financial planning and aligning portfolios to meet the objectives/outcomes of the ongoing planning process. I won’t speak for everyone here, but I believe that keeping our focus on that core tenet has been the primary reason for our ability to have such long-lasting client relationships. While I would love to pat myself on the back for managing portfolios in such an impressive way, the reality is that the strategies we implement for our clients have to align with their personal objectives or we’re doing it all wrong.

How does all of that relate to a quote from Teddy Roosevelt? What has become clear to me over the course of the last decade is that humans are bad investors. Our emotions cause us to have all kinds of biases where we chase returns, get overconfident, and ultimately lose sight of the “why” behind what we do. Our biggest bias is the belief that we don’t have any biases. One of the most common things that we see is when investors make irrational comparisons. Let me give you some examples of things we hear all too often:

1. The CNBC/Fox Business Example: “I saw on TV that weight-loss drugs are taking off. Can we buy some in my portfolio?”
2. The Neighbor Example: “I was talking to my neighbor this weekend and he said that he’s made a boat load of money in crypto this year. We should buy some in my portfolio.”
3. The Apocalyptic Example: “Check out this article. This guy says he expects the market to drop 85% this year so how can we hedge against that?”
4. The Return Chaser: “Stocks have outperformed bonds over the last decade. Let’s just sell all my fixed income and buy into big tech stocks since they’ve performed best.”



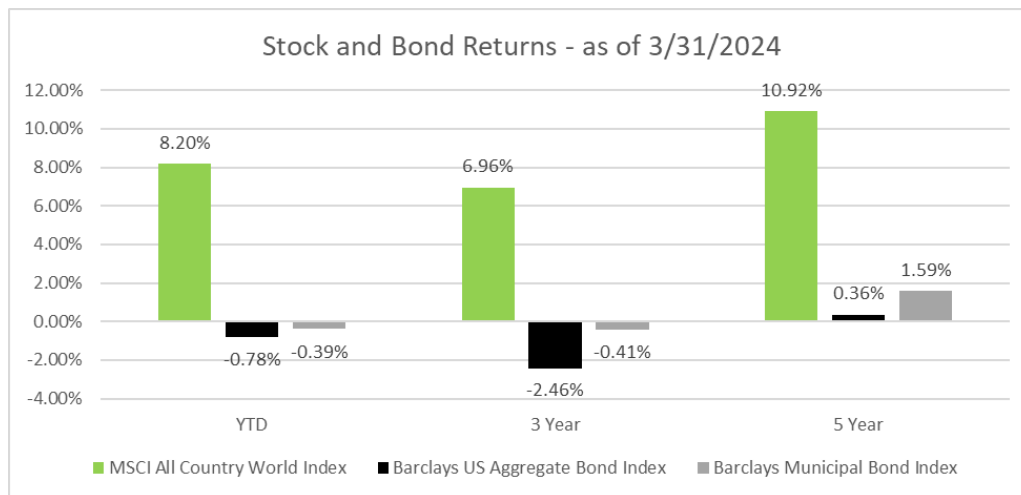
In every one of these examples, investors are ignoring basic investing principles and throwing out their long-term plans. So, my general feedback to these types of questions/comments is saying the quiet part out loud...It doesn't matter. Look, we should all try and get better at what we do and look for better ways of earning returns on our investments. Asking questions and facilitating conversations are both great things. Increasing the risk in our portfolios or irrationally preparing for something highly unlikely to happen isn't the way to do it. Here is the most important part, emotionally reacting to those questions deviates us from our long-term plan and goals. If we don't need to take on more risk, why would we do it? If our time horizon isn't very short, why are we building our portfolio to address it?

In a world where so many of us try to keep up with others regarding material items, most of it is just perception. As someone who loves a good pair of Allen Edmonds shoes, we have to be comfortable in our own financial skin knowing that we did the hard work up front, and we have a good plan moving forward. The next time someone talks about some biotech stock that is "poised to take off" or that cryptocurrency is taking over the US dollar, I want you to be comfortable saying "who cares." Not because they have no validity (although most are extreme scenarios) but rather because the stress of trying to keep up with Joneses will only make you unhappy when, in contrast, the planning you've done to meet your actual financial goals should make you feel happy and fulfilled. It's time to listen to Teddy and not let bad comparisons steal your joy. Thanks for the reminder, Adam.



# Q1 2024 – A WHOLE LOT OF THE SAME

In a lot of my conversations, my main takeaway has been that investors are starting to feel like it's Groundhog Day. We went from never discussing inflation to virtually only talking about inflation. The Fed Chair Jerome Powell is a known celebrity at this point. I'm not sure any conversation about markets escapes without a lengthy dialogue about artificial intelligence. These conversations have dominated markets and are unlikely to fade anytime soon. Before we do our best Bill Murray impression and talk about inflation/Fed/AI, let's start off with what actually happened from a broad stock and bond market return standpoint...



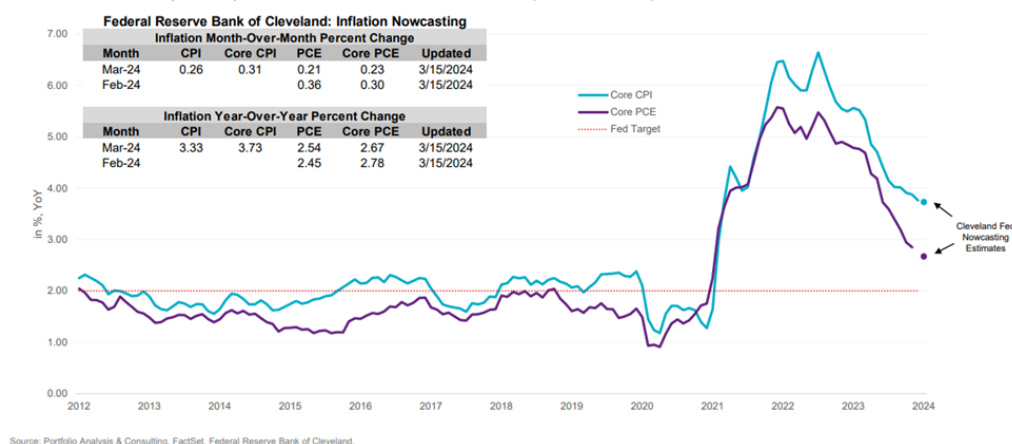
Source: YCharts; data as of 3/31/2024; periods over 1 year are annualized returns, Past performance does not guarantee future results.

In short, equity markets have continued their 2023 rally into 2024 and bond markets remain choppy. The longer discussion is about how the market loves buying into a major theme and will stick to it beyond what appears like rationality. As repetitive as it feels, those major areas are primarily driving market sentiment, so they deserve some discussion.

## Inflation

The general consensus that I've received in my conversations is that investors are sick of talking about inflation, hearing about inflation, and worrying about inflation. Yet, we all know that it needs to be monitored for several reasons, one of which we'll discuss next in the Federal Reserve. There has been some recent concern that inflation may be reaccelerating, and the Fed could be forced to raise rates again. We don't see it that way right now, but rather we see some stubborn areas of the inflation measure that are keeping it above the Fed's target. The focus should absolutely be on those few areas such as shelter, which should be thought of as housing and rental prices. As you can see, core inflation has meaningfully come down from its peak but we're still sitting above the Fed's 2% target (shown as the red line in the chart on the next page). The longer we sit above that line and sort of plateau, we think the more risk there is that the Fed decides to hold off cutting rates. We believe the Fed is still done hiking rates and it's a matter of when they decide to start cutting.

US Personal Consumption Expenditures vs Consumer Price Inflation (3/31/12–2/29/24)

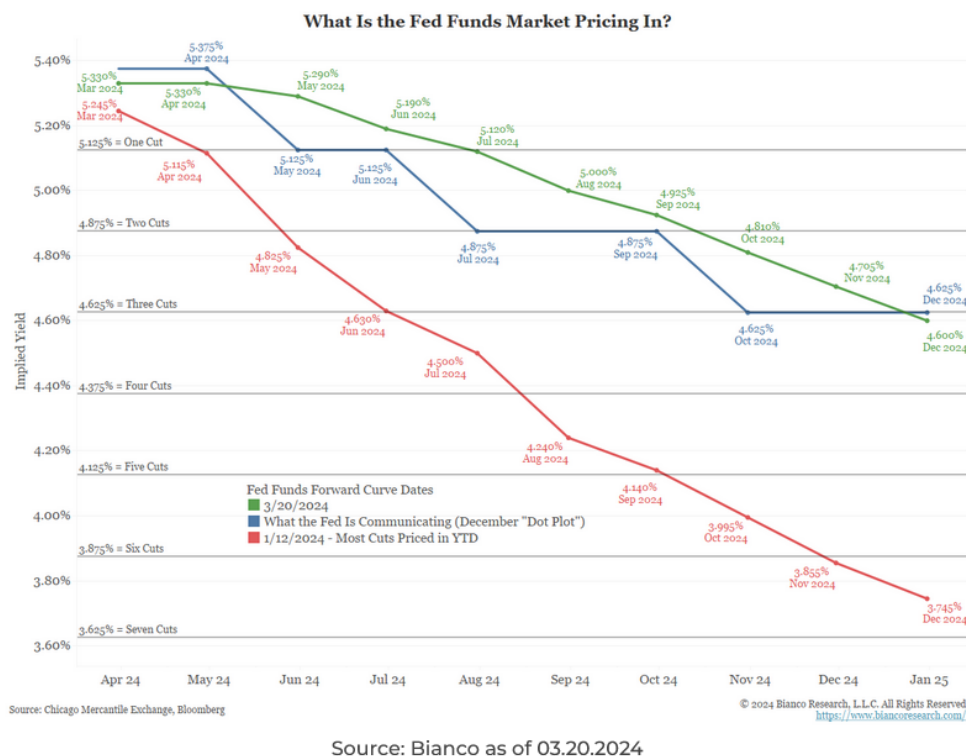


## The Federal Reserve & the Economy

You know that monetary policy is in full effect when the Federal Reserve chairman has become a celebrity. I don't think Fed chair Jerome Powell wants the kind of attention he's receiving from market participants, but market forces have collided to put him in that position. As we think about the Fed and their path forward, I do think it starts with inflation. They want to see inflation keep cooling so they can feel confident that it's under control and rate cuts won't reaccelerate the issue. As was just mentioned, they're close but not quite fully there.

On the other side, they're keeping a close eye on economic conditions as worsening data could convince them that it's time to cut rates. The good news there is that economic growth has remained strong, unemployment just dropped down to 3.8% (a really strong figure), and corporate fundamentals appear healthy. It's hard to argue that the overall economy is in a bad place right now.

The combination of stubborn inflation with solid economic data will likely have the Fed holding off on moving rates right now. The strength of the economy buys them some time to decide on starting to cut rates and it took a bit of time for the market to come to grips with that. While this graphic looks really busy, I think it's a great representation of what happened this year in markets for pricing interest rate expectations. Coming into the year the market was pricing in the red line, which was clearly pricing in the Fed being much more aggressive than even they believed. The blue line is what the Fed was essentially saying is their expected path. Fast forward to March, the green line is what the market adjusted to which makes a lot more sense to us. This change is why bond markets are slightly negative to start the year. We saw markets get ahead of themselves late in 2023 and needed some repricing to match the more logical outcome. In short, the Fed will take their time, focus on the data, and likely start cutting later in 2024.



## Earnings & A.I.

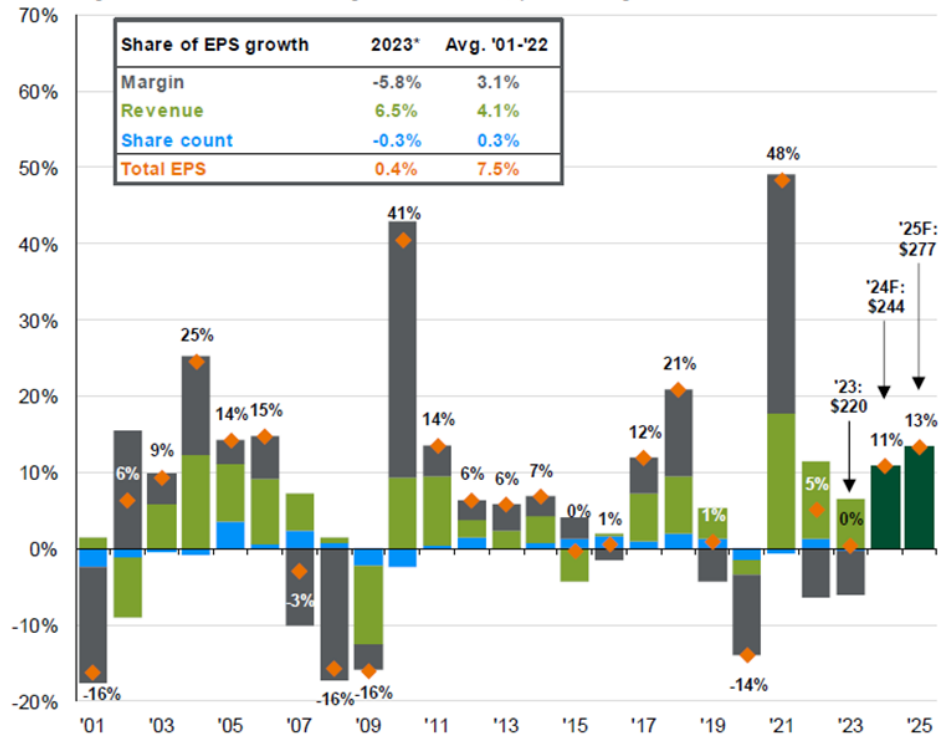
It was announced from Goldman Sachs that over a third of S&P 500 companies mentioned artificial intelligence on their Q4 2023 earnings calls. It's the new buzz word (or words I guess). There's no question that the development in technology in 2023 has formed an optimism around market sentiment and the potential for future growth. With that said, buzz words only work in the short term, and we need to continue seeing the data reflect the strength that markets are pricing in. The good news is that the data has been pretty good.

First, the consumer is still doing rather well. Compared to pre-pandemic values, household net worth is up more than 41%. As long as consumer sentiment, spending, and leverage remain healthy then we see it as a tailwind for markets.

The other side of the coin is that major economic data has been primarily just as strong as the consumer. You'll see in the graphic that corporate earnings are expected to grow close to 10% in each of the next two years. Both corporate margins and leverage look very solid. Lastly, it's hard to imagine a recession when unemployment sits at 3.8%. All of this isn't to say that higher rates couldn't put pressure on both growth and underlying economic data, but right now the economic and corporate picture appear as a strength in the U.S.

## S&P 500 year-over-year pro-forma EPS growth

Annual growth broken into changes in revenue, profit margin and share count



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

### *In summary:*

If we're to boil down what we're seeing and expecting, below is how we'd look at it:

- Inflation is still above target and quite stubborn, but the last push for inflation usually takes the longest to achieve.
- The Fed is done raising rates unless an unexpected reacceleration in inflation happens. They will be patient when cutting rates and its likely a reflection of the strength in U.S. economic data.
- Corporate earnings, margins, and leverage still look healthy. The consumer remains a strength and we all know that the consumer is the most important part of the U.S. economy.



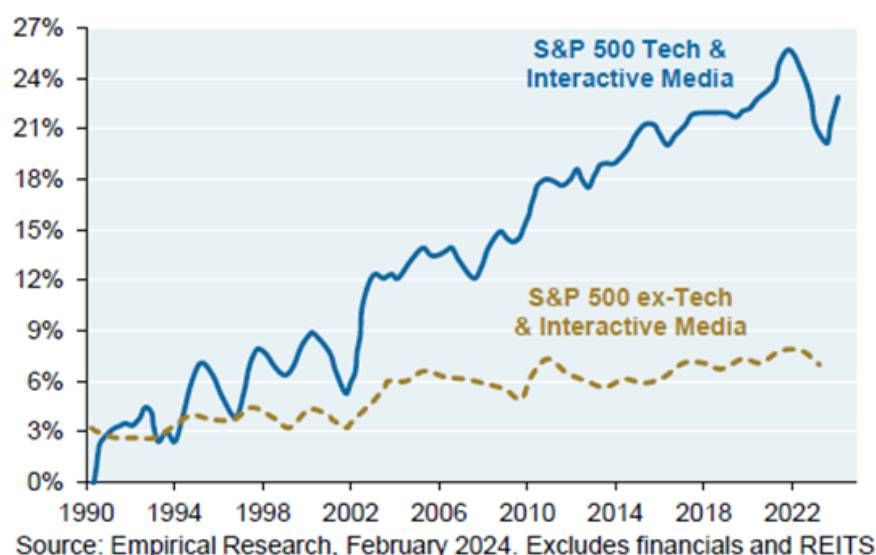
# Magnificent 7 – March Madness Edition

When I attended the University of Pittsburgh, the basketball team happened to be the #1 seed in the NCCA tournament in two of the four years. Even though none of the years ended the way you'd hoped, it was a blast and a reminder of how much fun the tournament can be. I was speaking with James, another member of my team, just before the most recent tournament started and he posed a question to me that I thought was pretty creative...

***If the Magnificent 7 stocks are a #1 seed in a market tournament (ignoring the fact that there would be seven stocks for four #1 seeds), which asset classes would we consider a potential Cinderella?***

It's probably best to start with the foundation of why the Magnificent 7 stocks (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia, and Tesla) would be the number one seeds. I think the easy answer is to just say they've performed well over the last several years. While both true and a major reason for irresponsible comparisons (remember our friend Teddy?), they've also been some of the most profitable, fast-growing businesses in the world. The combination of technology consuming more of our lives and the recent developments in artificial intelligence have really put these businesses, and their success, at the top of the market. Even just looking at technology in general (a lot of it is thanks to the Mag 7), you can see how much their free cash flow margins have exceeded the rest of the market.

Free cash flow margins

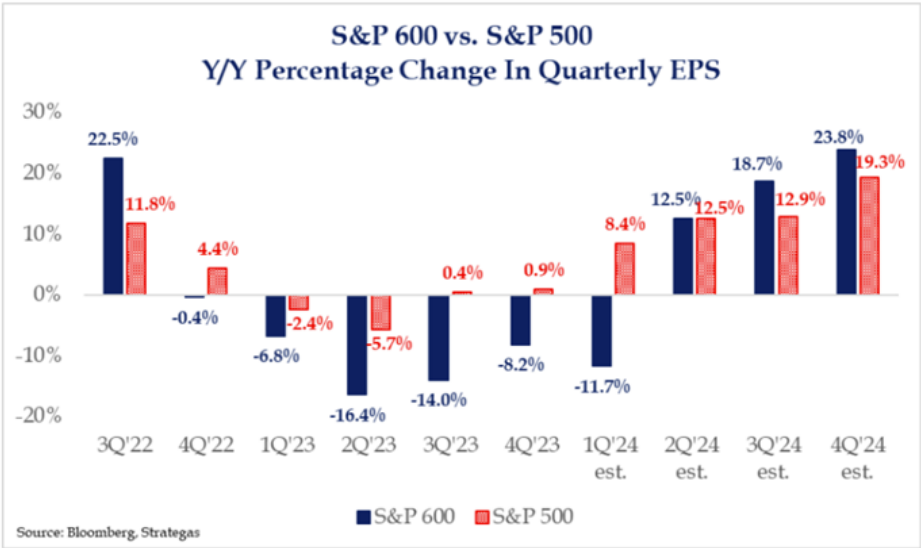


Back in 2011, my Pitt Panthers were knocked off in the round of 32 to the 8-seed Butler. That Butler team went on a run to the finals, where they eventually fell to UConn in the championship game. Similarly, if the major tech stocks are the tops seeds of the tourney, where can we find some value in a potential Cinderella story?

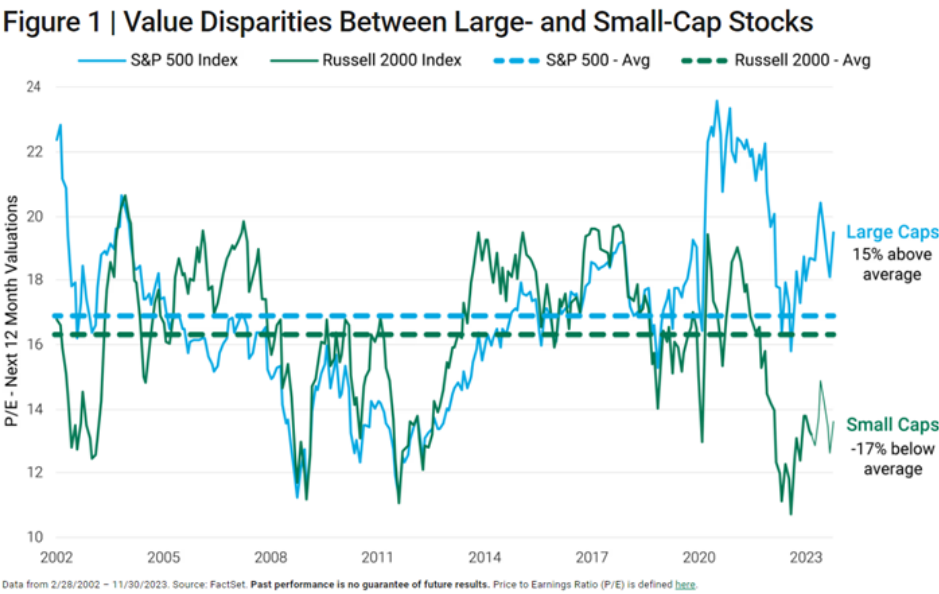


I don't necessarily think of US small cap as an ignored Cinderella story, but I've recently got the sense that it may be true. I've seen more and more investors completely leaving out the asset class in their portfolios and others only buying it for the unprofitable, high-growth businesses. I think there are a few reasons why investors shouldn't give up on small cap companies, even when the large cap counterparts have dominated headlines.

- 1. Academic research and market history has certainly shown the return ability of small cap as an asset class. While it does carry some additional volatility than larger, more mature businesses, over longer periods of time the asset class has often provided healthy rates of return. That would be the strategic case.
- 2. Looking more at today, we've seen small cap stocks really lag large cap stocks in terms of earnings growth. We're seeing that pivot quite a bit as you can see in the graphic, with the blue bars being small cap. Earnings growth in small cap is expected to accelerate after several quarters of struggle.
- 3. Valuation isn't a perfect science as markets are more complicated, but we do see some interesting deviations in prices of small cap stocks relative to large cap. It's not a predictor of short-term movements, but I do think investors should take notice of this gap and consider some allocation for growth-oriented portfolios.



Data as of 03.18.2024



I’m not advocating for investors to jump into small cap across their portfolios because it does come with risk and volatility. My intention here is to make sure we don’t lose sight of small cap as an asset class, the potential for a strategic piece of the portfolio, and some interesting attractiveness right now. As much as it pains me to say it, small cap could be the 2011 Butler Bulldogs and provide us with a Cinderella run. As Teddy taught us, let’s not compare recent returns of small cap and its bigger brother and lose sight of where it could fit in a long-term growth portfolio.



# MIKE'S QUARTERLY TANGENT: AMAZON'S DAY 1 MENTALITY

As prominent as he is, I candidly didn't know much about Jeff Bezos prior to this year. I still don't think I've spent enough time reading and listening to his backstory and beliefs, but I committed myself this year to taking a look at a few of his core tenets. I wanted to share one that really sucked me in, which was the Amazon Day 1 Culture (<https://aws.amazon.com/executive-insights/content/how-amazon-defines-and-operationalizes-a-day-1-culture/>).

It should come as no surprise that the central vision of everything Amazon does is customer experience. Back in 1997, he wrote a letter to shareholders where he explained what he believed a Day 1 mentality comprised of. In short, his philosophy is that you should:

- Put customers at the forefront of everything.
- Be willing and able to make quick, quality decisions with small, nimble teams.
- Embrace failures.
- Prioritize long-term value and be innovative.

As a business, I'm proud to say that I believe Diversified shares a lot of these same values and I'm sure we could embrace them even further. What got me really thinking though was how this relates back to the conversations we've been having on financial planning and comparing ourselves to others. In many ways, Amazon doesn't care what Best Buy is doing. They're so focused on what they do and how they can make their customer experience better. They do this through their culture, philosophy, and teams of people rowing in the same direction. We can all do the same thing with our financial lives, with some slight variations:

- Start at the end: This should be the focus of a thorough financial planning process. Many of our clients have goals that last the rest of their lives, so our strategies should be centered around making decisions for that longevity.
- Put customers first: Instead of customers, put yourself first during the process. What would make you happy, not your neighbor? If your plan is centered around achieving what is most important to you, then it won't matter if your uncle has a really cool stock tip.
- Small nimble teams: Having a small team at your disposal to discuss cash flow planning, investments, and anything else that can possibly come up. That team can immediately shift focus if goals and priorities change.
- Be proactive: We call this "not accepting the status quo" internally. We hate the phrase "because we've always done it that way." We push ourselves and clients to be proactive and forward-thinking so that we're putting everyone into the best experience possible.

It's not lost on me that there are major differences between one of the largest companies in the world and comprehensive financial planning for individuals. Despite that, I do believe there are core principles here that can help our clients be comfortable with who they are, what they've accomplished, and the plan to get them through the rest of their lives. Being comfortable in our own financial skin can be a difficult endeavor but I hope some of these concepts can help us get closer. As someone once said, comfort and confidence should help us avoid our joy being stolen away.

## Keep Perspective

Just remember that your team here at Diversified is always working on your behalf to adjust portfolios in a quickly changing landscape. We strive to always remain unemotional, proactive, and transparent as to what we're seeing, thinking, and ultimately doing. We sincerely appreciate our partnership and just know that we're always here if you have any questions on your financial plan, portfolios, or just would like to talk. Thank you for the trust you put in the Diversified team.



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## Connect With Us



### Mike Horwath, CFA®

Mike is the chief investment officer at Diversified LLC, where he heads the Investment Committee and is responsible for the investment direction of the firm. He works closely with financial planners to support the investment side of the financial planning process. Mike oversees the ever-changing global investment landscape and evaluates the impact on each of our client's strategies. He's a proud father and husband and loves spending time with his dog.





# NEWSLETTER

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