QUARTERLY INVESTMENT NEWSLETTER

MIKE HORWATH,
CHIEF INVESTMENT OFFICER

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...

I'm a control freak. I'm the guy who's always trying to plan everything far in advance and put together the puzzle perfectly. Whether it be my job, planning vacations, housework, weekend events, or probably anything else, I'm always trying to control nearly every aspect. The good news is that my wife, who's much less of a planner than I am, can just show up to the airport and knows that "he's got it." The bad news is that I often find myself not living in the present and stressing about things I cannot possibly control. It's something I've really had to work on and candidly have a long way to go.

CONTROLLING THE CONTROLLABLES

I saw someone post the serenity prayer by Reinhold Niebuhr the other day and reference the relevance to our world (the financial services industry). For those of you who don't know it, below is what I'm referencing:

God grant me the serenity
to accept the things I cannot change;
courage to change the things I can;
and wisdom to know the difference.

While it's a great reminder for me to not always need everything perfectly buttoned up, I couldn't help but relate it back to many of the conversations I have today. The ability to know what you can control, adjusting those things to meet your needs/goals/objectives, and not paralyzing yourself with the things you can't control is one of the characteristics of what I would consider a great investor. Now, figuring out what you can and cannot control is a tough task but let's spend some time trying anyway...

WHAT ARE CONTROLLABLES?

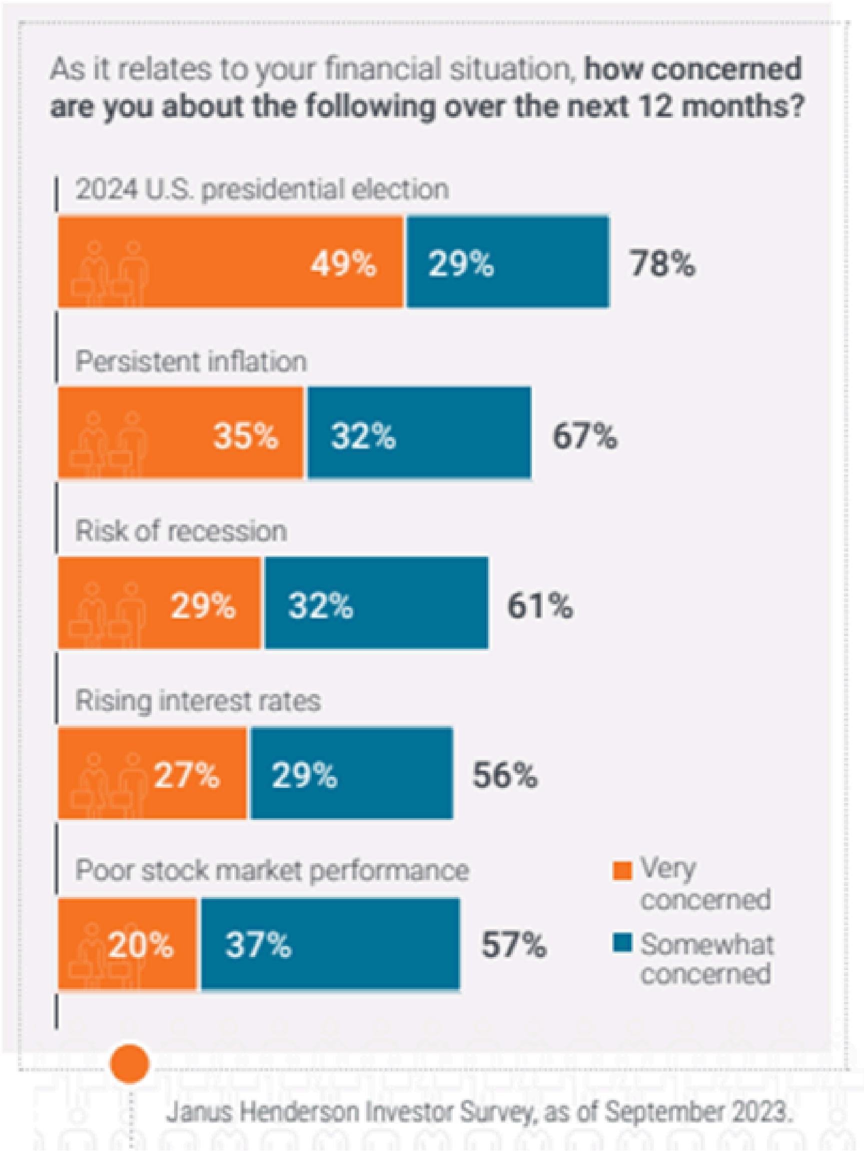
For those of you who haven't heard of it, the book Atomic Habits by James Clear is a great book for helping you create better processes to achieve whatever goals you set your sights on. Even though I'm naturally someone who loves routine and consistency, it was helpful when I revisited my failed attempts at various goals and why they may have happened that way. In many ways, it was a clear reminder of how the little things eventually lead to the big things.

When I think about our clients, financial planning, and managing their wealth, it's the controllable little habits that add up. It's when we try to control variables that we shouldn't try to control or when we're focused on the wrong picture that we get ourselves into trouble. In an article I read recently, it was articulated how so many of our goals are reached over long periods of time that incremental wins along the way are lost. Think about how hard it is to explain retirement to a 25-year-old. Try telling them the amount they'll need in 40 years to achieve whatever that goal may be…their eyes will gloss over. Instead, our advice and coaching will be to help them save, invest, and spend appropriately over a long period of time and use various tools/technology to evaluate our progress. Every time they make a 401k contribution it's a little win, yet it will feel like nothing has changed since the overall goal is much bigger. Our job is to change that narrative and give perspective.

Instead of focusing on little habits or the controllables, we find that many people are looking to solve:

- **Short-term stock market performance** -> As someone who does this every day of their life, I can't begin to tell you how difficult it is to predict daily, weekly, and monthly returns for stocks. If institutional managers have trouble, the average retail investor has no chance. Investors should focus on ensuring they have the appropriate amount of exposure so long-term returns meet their objectives.
- **Geopolitical events** -> We get asked quite a bit to describe what would happen if certain events were to happen. As an example, what happens if China invades Taiwan? It's better to find ways to mitigate any potential impact than worrying about when/if it would happen.
- **Macroeconomic Variables** -> Will the Fed start cutting in July or September? Is inflation going to be 3.25% or 3%. The Fed candidly doesn't know the answers to these questions.

One thing I like to do is review investor surveys periodically to see what is top of mind for people. I tend to find that the list is pretty obvious at any given time, mostly driven around the most newsworthy current events. Below is an example from the 2023 Janus Henderson survey… what's clear is that those items I just mentioned are weighing on investors' minds.



This is a long-winded way (rest assured that I've been told I can get "wordy") of getting to the things we believe investors and individuals should be focused on. This isn't an exhaustive list by any means, but rather some of the core tenants of how we can deliver successful financial planning and wealth management over time. Control the controllables…

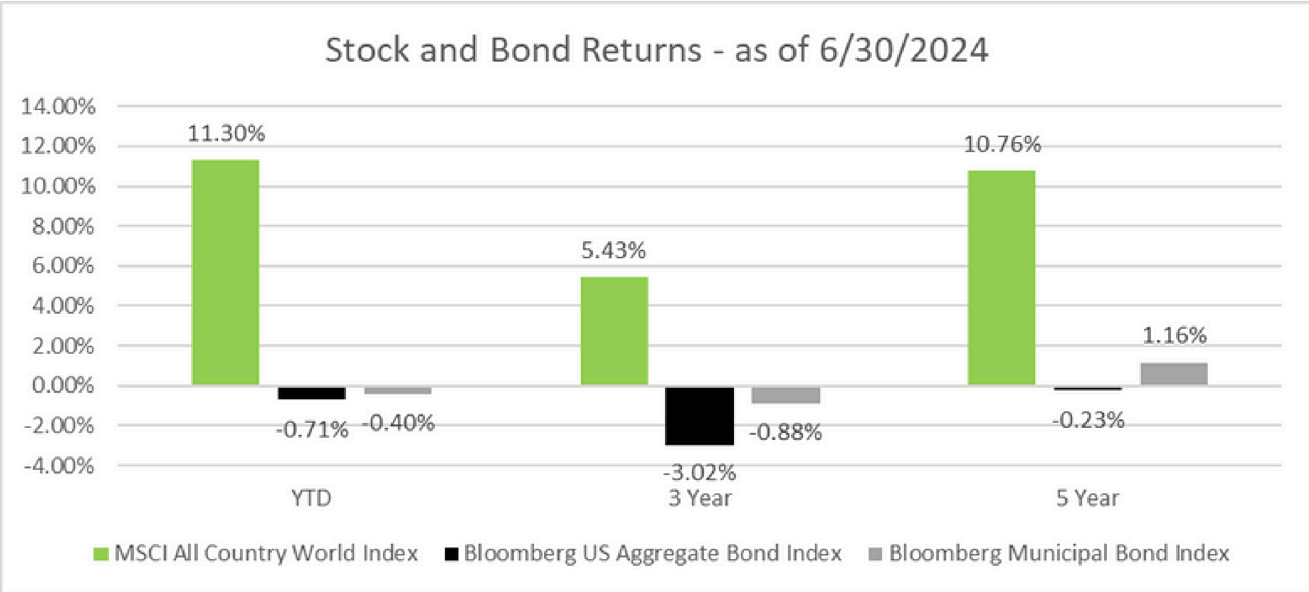
- **Spending vs. Saving** -> Saving is often a vital piece of a successful financial plan but here is a little secret…controlling your spending is just as important. If you enter retirement accustomed to spending a large amount relative to your savings, it's going to put a lot of strain on your retirement outcome. The story about the "millionaire next door" comes about because they both save appropriately over time AND live modestly to control their expenses.
- **Risk levels** -> Controlling short-term market movements is an impossible task. Instead, investors in both their accumulation and decumulation phases should understand the type of risk they need/want to take in order to achieve desired long-term returns. While you can't control the market, you can ensure that you have the right amount of exposure to different asset classes to drive the desired returns over long periods of time.
- **Behavior** -> Did I mention trying to control short-term market movements is useless? Some of the most successful investors that I've met behave incredibly well at the most difficult times. The reason they can be so successful is that other investors behave so poorly…selling when markets fall or jumping into trendy investments as examples. Keeping true to the plan and controlling your behavior is such a difficult, yet easy thing an investor can do.
- **Taxes** -> In my career, I have yet to meet anyone who actually enjoys paying taxes. We all understand they're a necessity, but they can put an extra burden on our financial plan if not handled well. While anyone can vote during an election, you have no control on current or future tax rates. What you can do, however, is work to ensure your portfolio is more tax efficient through either portfolio management techniques (tax loss harvesting) or owning more tax efficient investment vehicles (federal/state tax exempt municipal bonds).

We believe that by controlling the controllables, we can render many of those uncontrollable, exogenous factors less worrisome to your daily lives. We want our job to be focusing on daily market movements, changes in macroeconomic conditions, and integrating these changes into portfolios while our clients are focused on the variables they can control. Before jumping into markets and economic conditions, I wanted to leave you with one of the final great quotes (and there are many of them) from Berkshire's late Charlie Munger…

"It's so simple to spend less than you earn, and invest shrewdly, and avoid toxic people and toxic activities, and try and keep learning all your life, and do a lot of deferred gratification. If you do all those things, you are almost certain to succeed. If you don't, you're going to need a lot of luck."

Q2 2024 – THE UNCONTROLLABLES SHINE

To be perfectly honest, I have no idea if "uncontrollables" is a legitimate word, but this is my newsletter so I'm going to use it. For nearly two years, much of the focus in markets has stemmed around inflation, the Fed's reaction to it, and how well the economy is holding up. The story remains the same, the main factors continue to be those items along with underlying corporate fundamentals. First, where do broad equity and fixed income markets stand after the second quarter?



Source: YCharts; data as of 6/30/2024; periods over 1 year are annualized returns, Past performance does not guarantee future results.

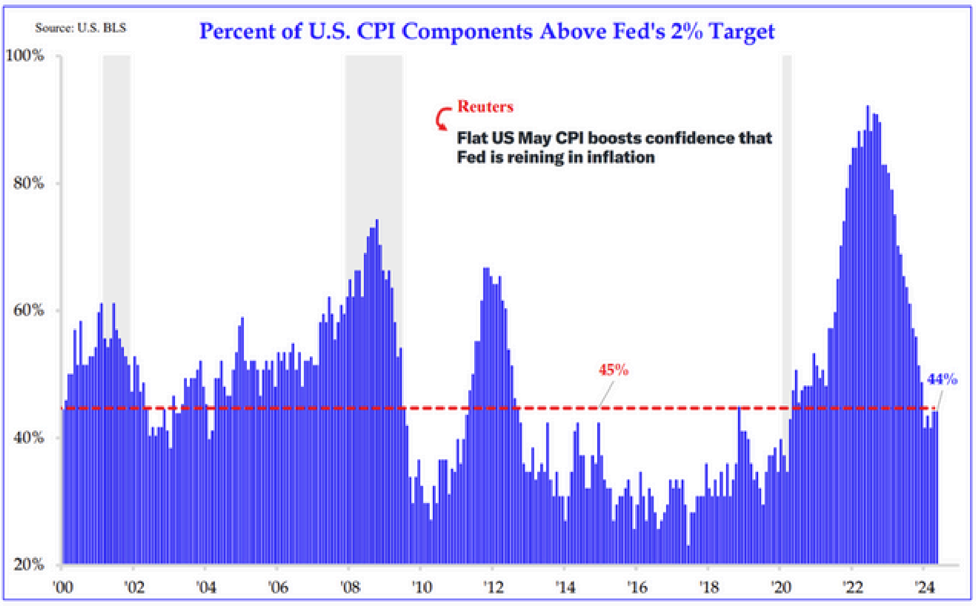
In a continuation from the first quarter, equity markets have maintained their 2023 rally for the first half of 2024 while bond markets remain choppy. One interesting development has been the lack of volatility in equity markets, while the long end of the bond market has actually been MORE volatile than its equity counterparts. A lot of this comes back to those macroeconomic conditions, where bond investors have largely had to grapple with the prospect of higher rates for longer and sticky inflation.

Inflation | The Fed

This seems to be the trifecta of economic data that I've spoken about for the last year, if not a year and a half. The easiest way to think about this trio is that inflation is driving the Fed's monetary policy around interest rates, and everyone is keeping a keen eye on corporate fundamentals as a product of those interest rate decisions.

Inflation:
It's amazing how short of a memory that individuals have had with regards to inflation. If we rewind back to 2021 and look backward, you'd see 20+ years of inflation under 2% even with rates at the floor for much of the time. In the wake of the pandemic, inflation had clearly become an issue, but we see it as much less of a concern at this point. There are still areas of frustration, such as the housing market, but we've methodically worked our way back down to around 3%. The narrative in the media will largely be focused on the absolute number of 3% being higher than the Fed's target of 2-2.5%, but rates aren't going to be pushed higher at current inflation levels (in our opinion). Time will tell how long it takes to get back down to the Fed's target level, but we do see evidence that it will continue to settle down around an acceptable level and that the next move in interest rates is more likely down than up.

U.S. CPI COMPONENTS > THE FED'S TARGET ... NOW IN LINE WITH HISTORY



The Fed:
I was only half joking last quarter when I said that Fed chair Jerome Powell is pretty much a celebrity at this point. We've spoken about the Fed ad nauseum over the last couple of years, so I'll keep it short and to the point. At the end of the day, the Fed board members don't know what they're going to do meeting to meeting. So much of their focus is in the data and reacting to inflation and unemployment conditions. Given that, investors shouldn't get too bogged down in the weeds on a meeting-to-meeting basis. Instead, focus on the general trend and risks associated with monetary policy. With where inflation and rates currently stand, it's highly likely that rates will be lower in two years than they are today. The pace at which it happens is less worrisome as bumps will happen along the way and will only paralyze you in terms of making decisions for longer periods of time. In summary, focus on the trend for rates over time rather than the frenzy that comes with each and every Fed meeting.

Equity Markets – A Familiar Picture

Let me know if this sounds familiar to you…equity markets broadly pushed higher, driven by returns in both the technology and communication services sectors. If you've been living under a rock, that's been the story for about the last year. For perspective, global equity markets are up just over 11% this year. Underneath the hood, the US has outperformed international by about 10%, growth has outperformed value by about 14%, and both the tech and comm services sectors are up about 18%. While we've seen some broadening in asset returns away from only the Magnificent 7, they've remained the primary driver of returns. It has affected "broad" market securities as well as this run of strong returns has pushed many popular funds into very concentrated territory. Just take a look at how concentrated many of these popular ETFs are today (the bottom shaded value is total percent of fund comprised of just the top ten stocks):

HOW MUCH GROWTH DO YOU OWN?

% Weight Across Various Core & Growth ETFs

Ticker	SPY	VTI	QQQ	IWF	VUG	SPYG	IVW	SCHG
MSFT	7.2%	6.0%	8.6%	11.7%	12.5%	12.6%	12.6%	12.2%
AAPL	6.8%	5.2%	8.6%	11.1%	10.8%	11.9%	11.9%	11.5%
NVDA	6.8%	4.2%	8.2%	10.6%	8.9%	11.9%	11.9%	11.5%
GOOGL	2.3%	2.0%	2.7%	3.8%	4.1%	4.0%	4.0%	3.9%
GOOG	1.9%	1.6%	2.7%	3.2%	3.4%	3.4%	3.4%	3.3%
AMZN	3.7%	3.4%	5.1%	6.0%	7.1%	6.6%	6.6%	6.4%
META	2.5%	2.0%	4.7%	4.0%	4.1%	4.3%	4.3%	4.2%
AVGO	1.4%	1.3%	4.7%	2.3%	-	2.5%	2.5%	2.5%
LLY	1.5%	1.4%	-	2.6%	2.9%	2.7%	2.7%	2.6%
TSLA	1.1%	1.0%	2.2%	1.7%	2.2%	1.9%	1.9%	1.8%
Sum	**35.2%**	**28.0%**	**47.5%**	**56.9%**	**56.1%**	**61.7%**	**61.7%**	**59.9%**

Source: Strategas, Bloomberg, 6/17/24

On the surface, the natural question is how a few names can just get to this point both from a return and weighting standpoint. It really comes down to earnings growth and margins for these businesses, they've been the engine behind the U.S. equity market growth for more than just a few years. Both things can be true…the U.S. market has become a bit concentrated at the top and yet these businesses have fully deserved it based on their underlying fundamentals.

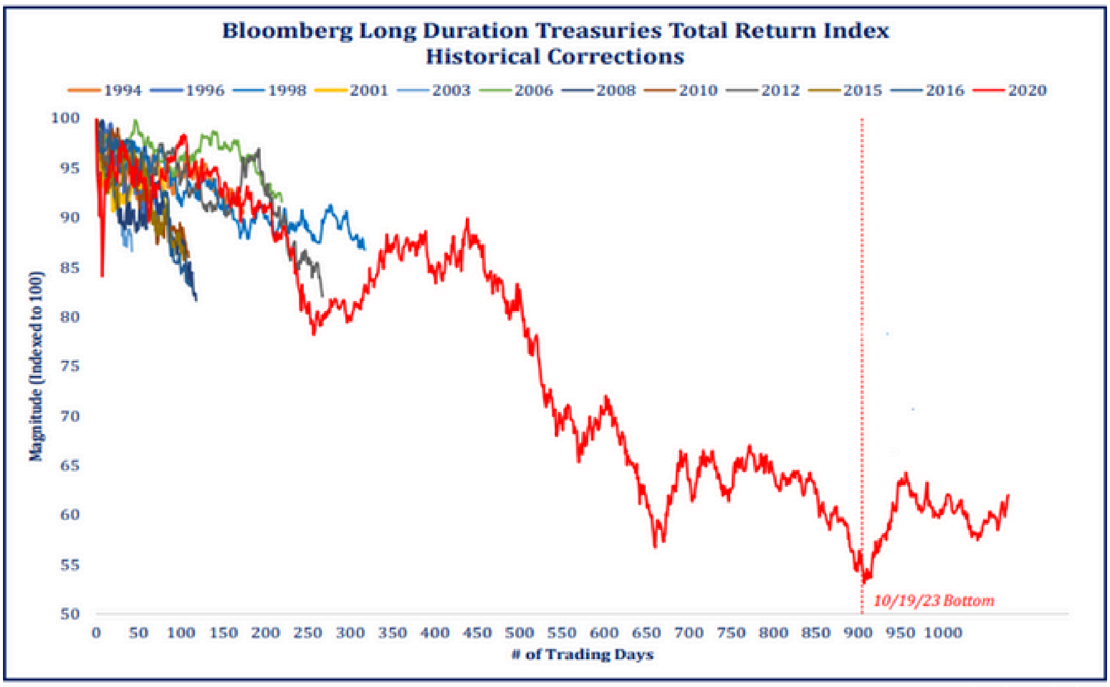
So, where do we go from here on the equity side? We find that market breadth (the number of stocks beating the overall market index) ebbs and flows over time. The biggest names in the current market have earned their place through strong cash flows, immense growth, and retaining high margins. As we look forward, we do look for market breadth to revert based on history and earnings projections. Its going to become harder and harder for these companies to grow at the same rates given their current size, and we're seeing earnings growth projections start to show that stocks outside of the top 10 in large cap and the small cap space are expected to start becoming bigger factors in overall growth towards the end of 2024, early 2025.

Overall, we're maintaining many of the same tilts in our equity portfolios that we have for over a year now. First, we have a preference and bias towards U.S. equities over international. The combination of a strong U.S. dollar, better relative GDP growth, and businesses with strong underlying cash flows push us to maintain that overweight. In addition, we'll have a lean into dividend-paying stocks, a small allocation to U.S. small companies, and still own our direct allocation to the semiconductor industry.

Bond Markets – A Historical Period

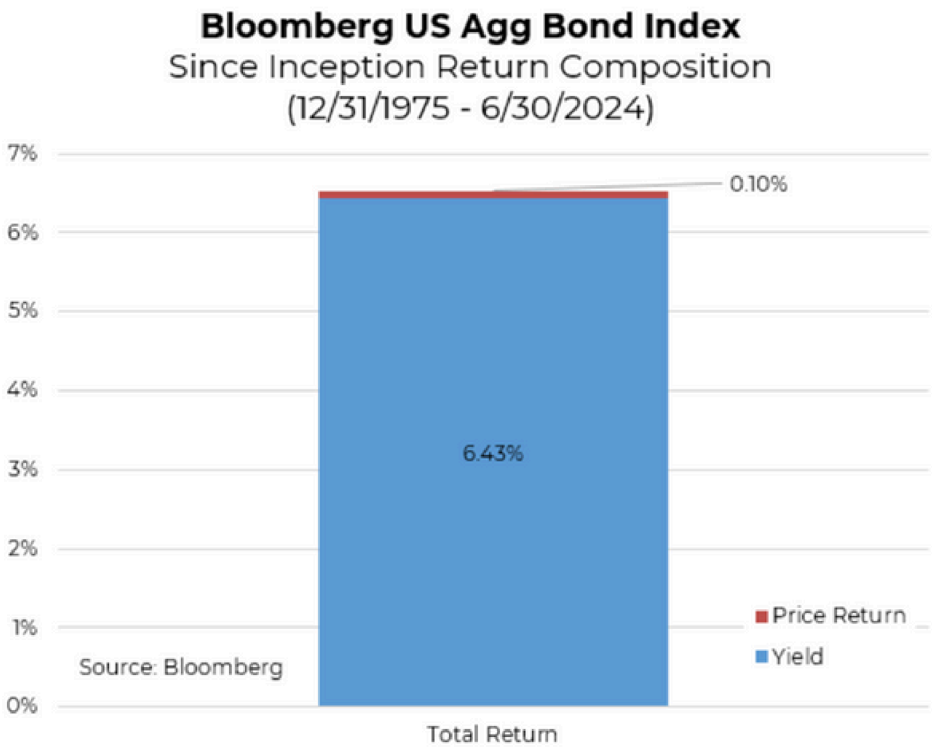
Most investors know the deal that stocks are equity in a company while bonds are the debt of a company or entity. While stocks have historically offered investors higher returns, bonds have provided lower volatility, income (through interest payments), and diversification from stocks to manage risk in a portfolio. Since 2020, it's been a rough environment for bond investors.

For perspective, see this graphic of the longest corrections in long-term government bond history. The outlier is clear as day, we're living in it. In modern history of the stock and bond markets (let's use the last 40 years or so), 2022 was the only calendar year where both the S&P 500 Index and Barclays US Aggregate Bond Index were down simultaneously. Many investors have various forms of bonds built into their portfolio asset allocation so it's no surprise that the frustration has been pretty widespread.



Source: Strategas, Bloomberg, 6/17/24

With elevated inflation requiring the Fed to raise interest rates, the bond market has been swimming upstream since the beginning of 2022. The good news is that inflation has come back down to around 3% and the Fed has clearly indicated that their next move is cutting rates, so those headwinds have subsided for now. The important thing to us is that investors understand that they own bonds for diversification, stability (relative to stocks), and consistent income. While there are other ways to manage volatility in a portfolio that we'll utilize, allocating to the fixed income markets is going to remain one of the time-tested ways to diversify a portfolio. The other positive is this graphic showing where bond returns have come from over the last several decades.



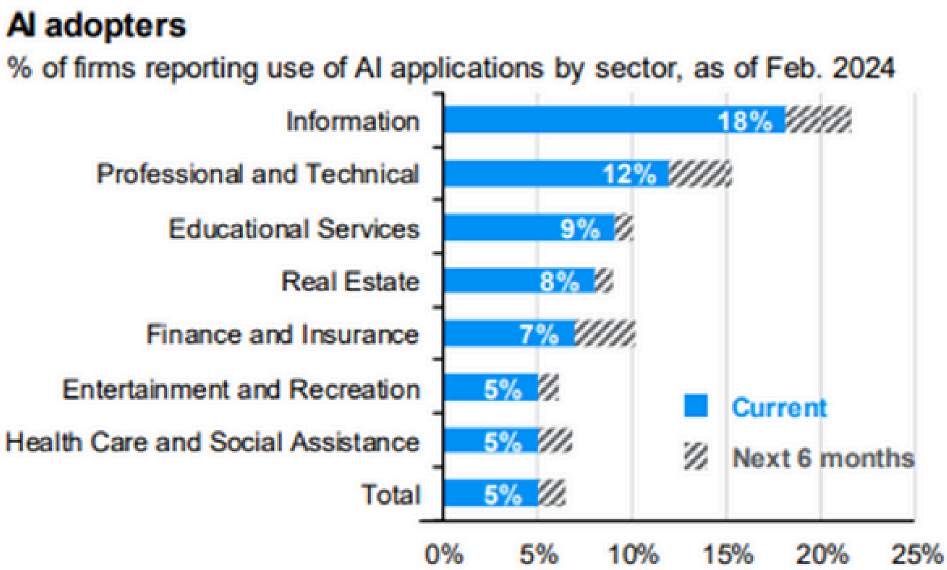
Source: Bloomberg, Aptus

From our experience, a lot of investors worry about where rates are going in the short-term and don't think about the bigger picture (*cough cough* trying to control a very uncontrollable variable). Over time, one of the best predictors of future returns is your starting yield in bonds. Meaning, if I buy a bond today that matures in 10 years and has a yield-to-maturity of 5%, the return over those 10 years will be very close to that 5% figure annually. If we relate this back to today, one of the byproducts of the last couple of years has been rising rates and yields, where many areas of the bond markets are now yielding over 5%. Compared to where we stood at the end of 2021 (when rates were very low), it's a much more attractive spot to be for investors. I guess the best summary of what I would say for bonds looking forward is that starting yields today do look decent and prime for bonds to provide some value to diversified portfolios. The stock market will always get more attention and drive outsized returns (and volatility) over the course of time compared to bonds, but investors shouldn't sleep on the value the asset class can bring to a portfolio.

Artificial Intelligence (A.I.)

Outside of the major macroeconomic topics (inflation, rates, recession, etc.) I'd say that A.I. has been the most common question we've received from clients. It's completely understandable as well since it's not only been a major headline in financial media, but we've seen some companies really benefit early on in the process. The market darling has of course been Nvidia over the last year to year and a half, who has benefited from their GPU chips having functionality to help run A.I. technology. For the 1-year period from 7/1/2023 through 6/30/2024, Nvidia stock was up 192.1%! For perspective, the broad semiconductor ETF (VanEck – ticker SMH as a proxy) was up 72.3% and the broad US large cap market was up 24.6%. I think many investors are asking themselves where to put capital to find the next Nvidia.

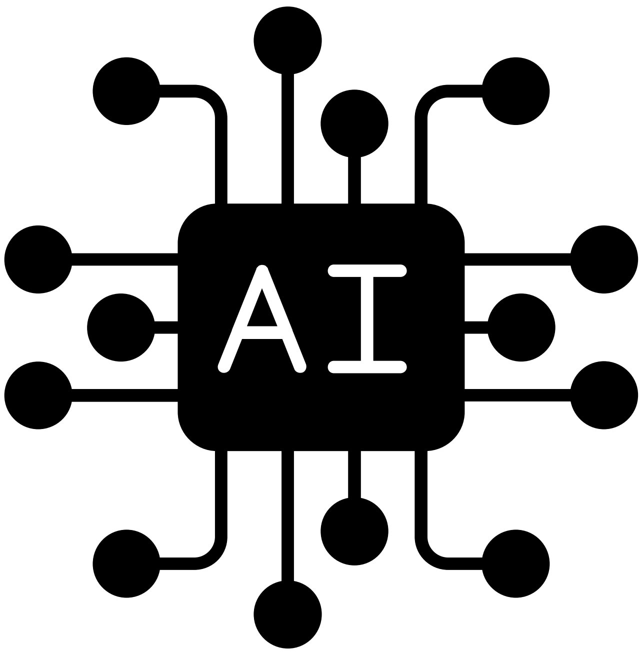
This is where I think it's vital that investors keep some perspective and not try to control something that no one truly knows yet. Here's why…while Nvidia has reaped the benefits early on due to their technology that helps run A.I. systems, we're in the infancy stages of where this entire industry goes. Technology has been and will continue to likely benefit from this evolution but in order to really expand we need to see other industries adopt and implement. This is a good graphic from a recent business trends survey:



Source: JPMorgan Asset Management; Census Business Trends and Outlook Survey (AI Supplement).

This is what we've heard all along from analysts and managers that we've spoken to about the A.I. transition. The short answer is that this needs to slowly work its way from building the infrastructure for A.I. to implementing it across various industries and businesses. There will be winners and losers just as there always are, and picking which health care or real estate business that benefits will be very difficult and risky until we have more information.

So, what do we do when we want to expose ourselves to A.I. growth in markets? At a more granular level, exposures such as that VanEck Semiconductor ETF position is something we've used historically as a way to get a more diversified implementation to various chip businesses across the supply chain. But I think this question and answer should really come back to the sentiment of this newsletter…control the controllables. Picking winners and losers accurately at this point is a very difficult task, but we can ensure we have the correct exposure to equities in general. We've seen it already; markets have broadly performed well over the last one-year period and this transition to A.I. has been a big part of it. While its not as sexy as only owning Nvidia on its own, in our opinion it's the better way to give yourself exposure to potential growth and not overconcentrate (which can add a lot of unnecessary risk) a portfolio. As the industry and technology advance, it's something we'll continue to monitor and determine if a different approach is prudent.

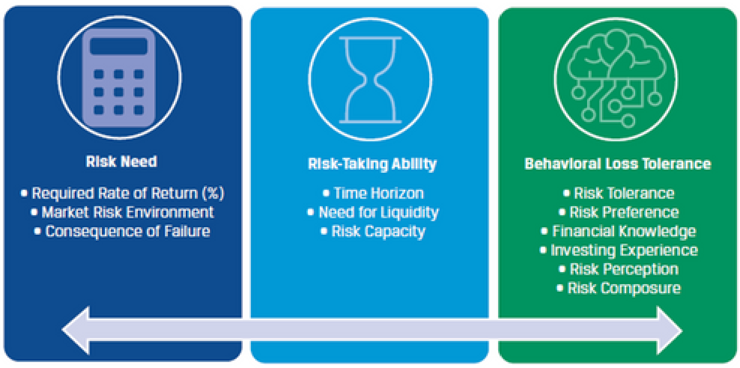


MIKE'S QUARTERLY TANGENT: WHAT IS RISK TOLERANCE?

I thought it would be foolish of me to spend all of this time talking about controlling the controllables but not discuss how to even come up with a risk tolerance. Risk tolerance in general is a buzzword that gets thrown around a lot in the investment industry and I think it loses a lot of its meaning because of it. Whether you're a high-flying gambler (insert Kenny Rogers joke here) or super conservative "cash under the mattress" kind of person, understanding one's risk tolerance is an important process. From our perspective, this overall risk tolerance is a big driver of the underlying asset allocation and portfolio experience that we seek to implement for our clients. So how do we think about it?

I personally think the individuals at the CFA Institute have done a good job breaking down the evaluation process for risk tolerance, or what they call Investment Risk Profile (IRP). The way we like to think about it is in the form of one's "ability to take risk" and their "willingness to take risk." Within the "ability" section, they break it down further into the risk need and risk ability. Below is a good graphic from the CFA Institute Investment Risk Profiling Guide.

FIGURE 1. IRP FACTORS AND RELATED ELEMENTS



Ability: The way we think about an individual's ability to take risk is through the lens of thorough financial planning. In that process, many of you have experienced various stress testing and monte carlo analyses that helped give us a thorough understanding of the needs for the financial plan. We can evaluate what rate of return is needed for success, and what happens when that rate of return isn't met. Additionally, we get a really good understanding of short-term liquidity needs and time horizons to meet personal goals. In summary, this is the quantitative piece to risk tolerance.

Willingness: This is the more interesting side of risk evaluation where we get to go inside the mind of our clients. As scary as that may be sometimes (just kidding, all of our clients are perfectly rational...) its just as important because investor behavior can make or break the success of a financial plan. By understanding how someone feels about risk/volatility, their experience with investing, and their financial knowledge we can get a more qualitative profile.
From there, we need to bring it all together and combine the "numbers" and the "feelings" to form our opinion for our clients' risk profiles. It happens frequently where the two sides of the equation are at odds with each other. Think about the 25-year-old sitting in money market in their Roth IRA...it happens more than you'd think.

When we say control the controllables, putting together this process and sticking to the plan is a big part of it. Irrational investor behavior often happens when they deviate from the original plan and do things such as selling at market bottom or wanting to buy meme stocks late in retirement. Informed and educated investors make better decisions (at least in my opinion) and, by understanding the risk profile for yourself, will only make you a better investor over time.

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 promise 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.

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 he 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.

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S&P 500: The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

Russell 2000: The Russell 2000® Index is a capitalization-weighted index designed to measure the performance of the 2,000 smallest publicly traded U.S. companies based on in market capitalization. The Index is a subset of the larger Russell 3000® Index.
MSCI All Country World Index: The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets

(EM) countries. With 2,937 constituents, the index covers approximately 85% of the global investable equity opportunity set.
GDP: Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

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