LIVE OAK
PRIVATE WEALTH®

## Third Quarter Letter September 30, 2023

*"Patience and discipline can make you look foolishly out of touch until they make you look prudent and even prescient."*

*-Seth Klarman, The Baupost Group*

*"Nothing like price to change sentiment."*

*-Helene Meisler*

As we write this 3rd quarter letter, we are and have been experiencing several major headwinds for the US economy and the US equity and bond markets. While this is nothing unique to investors and markets, it seems as if an abnormal number of issues are at the forefront of markets.

We just averted a government shutdown over the past weekend. The US House of Representatives no longer has a Speaker of the House. We are currently embroiled in a UAW strike with the Big 3 auto companies and recently settled a writer's strike in Hollywood. And now this morning we have a 75,000-worker strike at Kaiser Permanente health facilities across the U.S...

Labor unions are more emboldened now as inflation has set in, as they demand higher wages and concessions. Wage inflation is a real threat to corporate earnings, and it seems Fed Chair Jerome Powell is acutely aware of this pressure.

The recent steep rise in the strength of the US Dollar versus other world currencies is having a major effect as well. However, for investors, the biggest issue we are struggling with is the rapid rise in bond yields and the effect they have on both the equity and bond markets.

Remember we had historically low (Zero Interest Rate Policy – ZIRP) interest rates for many years after the Financial Crisis. The normalization of rates was long overdue, and it will take longer to normalize than what investors want. Our economy here and abroad that was predicated on zero and negative interest rates is beginning to feel the effects of rates normalizing. That would only seem natural and logical. However, it is not a pleasant place or time for investors.

Bond yields have surged to multiyear highs not seen since 2007 and it is having a profoundly negative impact on most if not all companies and sectors. The 30-year mortgage rate is approaching 8% and sits at levels not seen since 2000, which is having a dampening effect on home sales, mortgage refinancings and new construction, all important sectors of our economy.

The 10-year treasury yield continues to rise to new multi-year highs (4.75%) and the bond market is headed for its 3rd consecutive losing year, something it has never done before.
In fact, according to Bloomberg.com, bonds maturing in 10 years or more have slumped 46% since peaking in March 2020, just shy of the 49% plunge in US stocks in the aftermath of the dotcom bust. The rout in 30-year bonds has been even worse, tumbling 53% according to *Bloomberg*.

The Federal Reserve remains committed to keeping rates higher for longer as it combats inflation but in the short term that is not necessarily good for the markets. We all know that money markets and bonds are now competition for funds and TINA (There Is No Alternative) is no longer the market mantra.

For instance, the utility sector is down over 5% today (10/5/2023) and almost 12% in the last week. We know higher rates are not good for utilities, but utility companies are somewhat of a staple and steady investment as we all need electricity and the other services they provide. Consumer staple companies like Coca Cola, Unilever and Proctor & Gamble have also suffered recently with the rise in yields.[1]

We remember what happened in March as several large banks failed and the entire sector suffered as deposits left seeking higher yields and investors questioned the banks' bond holdings. The damage to the banks' investment portfolios will be seen in the coming weeks as they disclose earnings and their current situation.

This is why, as investors, we have and are continuing to allocate fixed income funds to shorter-term high-quality issues where protection of capital remains most important. We also are holding more cash in higher yielding money market funds than we might normally. As Will Rogers said, "the return of principal is more important than the return on principal." We remain dedicated and committed to ensuring that our clients' fixed income investments reflect this attitude.

September lived up to its reputation as being the worst month of the year for investors as the markets did in fact suffer their biggest decline in 2023 and we continue to face headwinds in the near term. But hopefully seasonal factors will come into play and provide some relief in the 4th quarter. Historically, Q4 is the strongest period and gains 4.8% on average and is positive 81% of the time. Time will tell if this scenario plays out this year. The third quarter was also the first losing quarter of the year as the markets were down across the board. Earnings season will begin soon, and we will be monitoring the reports and forecasts and making portfolio adjustments if needed.

The markets in the third quarter of 2023 (see chart below) posted their first losing quarter since Q4 of 2022 and it was broad and across all equity indices. Other than money market funds, all classes were negative.
In fact, the 50 largest stocks in the S&P 500 are up 23% this year, while the equally weighted S&P 500 is down 1% and small caps are down 2%, according to market statistician Charlie Biello.

*[1] Coca-Cola (KO) and Unilever (UL) are holdings in Live Oak Private Wealth portfolios and are subject to change without notice They were selected to help illustrate the investment process described herein. A complete list of holdings is available upon request. This information should not be construed as a recommendation to purchase or sell any particular security.*

| Index | 2023 3rd Quarter | 2023 YTD (9 mos.) |
|---|---|---|
| DJIA | -2.10% | 2.73% |
| S&P 500 | -3.27% | 13.07% |
| S&P 500 (equal weight) | -4.90% | 1.79% |
| S&P Mid Cap | -4.20% | 4.27% |
| Russell 1000/Growth | -3.13% | 24.98% |
| Russell 1000/Value | -3.16% | 1.79% |
| Russell 2000 | -5.13% | 2.54% |
| NASDAQ Comp. | -3.94% | 27.11% |
| Long Term Treasury Bonds | -11.56% | -8.39% |
| Inv Grade Corp Bonds | -2.70% | 0.45% |
| Gold | -3.87% | 1.90% |
| 3 Month T-Bill | 1.31% | 3.60% |

Within the market internals, only two sectors generated positive returns, Energy (+11.33%) and Communication Services (+2.84%). The other sectors were led to the downside by not surprisingly two groups tied closely to interest rates, Utilities (-10.10%) and Real Estate (-9.65%). The remaining sectors' performance was as follows: Materials (-5.25%), Industrials (-5.56%), and Information Technology (-5.84%).[2] So, as you can see, there were few places of shelter. Cash is no longer trash it seems or as acknowledged Bond King Jeffrey Gundlach said, it is best to "T-bill and Chill."

As we discussed in the most recent newsletters, the market continues to be fascinated with Artificial Intelligence (AI) and the benefits that it might bring to the economy and the companies that are heavily levered to it. The media talks nonstop about AI and most companies try to mention it on their calls with investors. To us, it is similar in many ways to the late 90's and how companies added .com to all their names and discussed how the internet would enhance their business models. In many cases it did, but in many cases it did not and when the music stopped playing, there were countless casualties that resulted in the .dot com bubble bursting and the tech heavy NASDAQ market losing almost 80% of its value over the 3-year bear market that ensued. We are not saying that will be the case here, but we all know that valuation matters tremendously and overpaying for companies will in most cases not work out well. The risk adjusted returns and the downside protection we hope to add by not overpaying for businesses is what we focus on.

As a simple exercise when writing this letter, we asked the two most prominent generative AI programs, Microsoft ChatGPT and Google Bard, an easy question. What was the stock market performance for the quarter ending September 30, 2023? Microsoft ChatGPT responded with "The stock market for the third quarter of 2023 witnessed a mix of ups and downs, driven by various economic and geopolitical factors. Overall, it was a period of moderate gains and increased volatility. It also said, "Major stock indices, such as the S&P 500, Dow Jones Industrial Average and NASDAQ, experienced moderate gains during the quarter.

[2] *Securities US Equity and Quantitative Strategy*; October 3, 2023; *Bank of America*

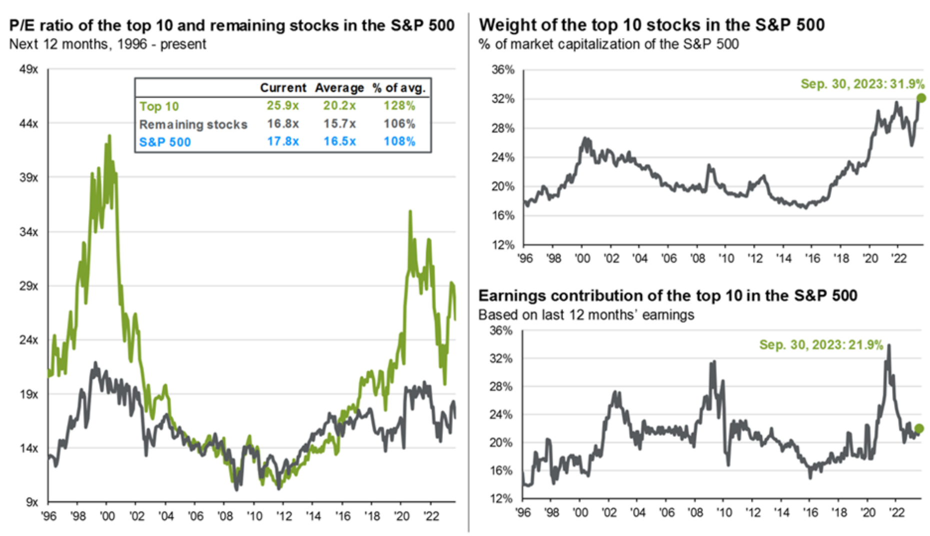
The S&P 500, which represents a broad range of U.S. stocks, posted a gain of approximately 2%, reflecting a relatively stable performance. The Dow Jones and NASDAQ also showed similar trends, indicating a balanced market sentiment.

Well, Google Bard had a completely different assessment of the third quarter. It responded, "The stock market had a mixed quarter in Q3 2023, with the S&P 500 ending the period down 3.2%". This was the first quarterly decline for the index since Q3 2022. However, the S&P 500 is still up 12.8% year-to-date.

A completely different outcome and one simple demonstration of AI not being perfect. It is a helpful tool that has been around for many years but the idea that it is foolproof and fixes everything is overrated and exaggerated to say the least in our opinion. We know that the danger of having the incorrect information in the wrong hands could have significant consequences.

Which brings us to the valuation of the Top 10 holdings and the Magnificent 7 (Apple, Amazon, Meta, Microsoft, Nvidia, Tesla and Google) and the effect it has on the S&P 500 returns. As we discussed in detail in the last quarterly report, the S&P 500 is not the diversified index many investors believe it is. In fact, we told you last quarter the Barron's article by Laura Foster labeled the S&P 500 as a "Mega Cap Tech Fund."

According to *JP Morgan Asset Management*, The Top 10 stocks in the S&P 500 make up 31.9% of the market capitalization of the S&P 500. They contribute 21.9% of the earnings of the index and are currently trading at 25.9x current earnings vs. the remaining 490 stocks trading at 16x earnings. Both PE multiples are above average. According to Todd Sohn, 96.5% of the S&P 500 return in 2023 is from the 10 largest constituents…No other positive year is even close. See chart below.



As referenced in the Kobeissi Letter, an industry leading commentary on the global capital markets, “The S&P 7 (Magnificent 7) was up 52% for the last year while the combined S&P 500 as a whole is up 13% this year.” In other words, if you buy the S&P 500 today, you are buying a handful of companies that are driving the entire market. The 7 largest stocks in the index now account for a massive 34% of the entire index’s value.”

However, according to Bespoke Investment Group, despite their massive returns over the last one year, (Apple +32%, Amazon +51%, Meta +149%, Microsoft +33%, Nvidia +198%, Tesla+103%, Google +48% ) the results over the last 2 years are somewhat different, (Apple +20%, Amazon -23%, Meta -12%, Microsoft +9%, Nvidia +110%, Tesla -3% and Google -4%). This illustration is to emphasize that paying attention to the price one pays for a stock is essential to achieving positive results over time.

So, in closing the investment summary for Q3 2023 we want to take the time to thank you for the trust and confidence you place in us to manage your assets. We take this responsibility in the highest regard and will do all we can to help you achieve your goals and plan accordingly for your future. We just celebrated our 5th year at Live Oak Private Wealth and without you, none of this would have been possible. As always, feel free to contact us with any questions or concerns. Thank you again from our entire team.

**As the end of the year quickly approaches, it is a good time to review your financial plan. Below are some areas to keep in mind and discuss with your Advisors:**

## Income Tax Planning

- If there are changes in your family situation such as the birth of a child, a move to a different state, the loss of a spouse, or changes in your financial situation, have you informed your CPA to see if there will be an impact to your taxes?
- If you pay estimated federal and state taxes, do any adjustments need to be made?
- Are there tax savings strategies that you can take advantage of such as:
    - Contributing to a retirement plan (401(k), IRA, or other employer-sponsored retirement plan)
    - Contributing to a Flexible Spending Account or a Health Savings Account
    - Donating to qualified charities
- Additional areas to discuss with your CPA may include:
    - Is there anything that can be done to manage your income taxes given that the IRS increased the federal income tax brackets this year?
    - Have you taken advantage of and maximized all allowed tax credits and tax deductions? The IRS increased many savings incentives as well as the standard deduction for 2023.

## Retirement Savings and Accounts

- Are you able to maximize contributions to an IRA or employer-sponsored retirement plan such as a 401(k)?
- Do you need to take a Required Minimum Distribution (RMD) from a retirement account for 2023?
- Are your beneficiary designations on your retirement accounts still in line with your desires?

## Charitable and Family Gifting

- Have you accomplished your charitable gifting goals this year?
- Have you considered using a planned giving technique or vehicle to fund your charitable goals?
- Do you plan on making annual exclusion gifts before year end? The amount you can gift (per donor/donee) without having to file a gift tax return increased by $1,000 to $17,000 for 2023.
- Did you know that you can make a gift to charity using your retirement account's RMD, avoiding taxation on the distribution?

## Investment Review

- Have you had an annual portfolio review with your Investment Advisor?
- Would tax loss harvesting before year end be useful given your income tax situation?

## Estate Plan Review

- When was the last time you reviewed your estate documents to ensure they meet your legacy goals and objectives?
- Does your estate plan need to be updated based on changes in your family or financial situation?
- Could you take advantage of more complex estate planning techniques such as using irrevocable trusts, family limited partnerships, charitable trusts, etc.
- Review how your assets are titled and your beneficiary designations (retirement accounts, life insurance, etc.) to ensure they are in line with your current wishes.
- Certain estate planning provisions included in the 2017 Tax Cuts and Jobs Act are scheduled to sunset back to pre-2017 levels at the end of 2025 (which is approaching quickly!). Have you discussed the potential effect on your estate plan with your Advisors?

## Life insurance Review

- When was the last time you reviewed your life insurance needs?
- Are your beneficiary designations on any life insurance policies still in line with your desires?

## Personal Spending and Savings Review

- Take time to reflect on your personal savings and spending in 2023. What worked well? What changes would you like to make in 2024?

***DISCLOSURES:***

*This material is not financial advice or an offer to sell any product and is not a recommendation to buy or sell any particular security. Past performance is not indicative of future results. The opinions expressed are those of the Live Oak Private Wealth Management Investment Team. The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass.*

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