25 Orinda Way, Suite 250
Orinda, CA 94563
www.schultzcollins.com
Direct 415.291.3000
Toll-free 877.291.2205
Facsimile 415.291.3015

<u>Schultz Collins 2nd Quarter 2022 Market Review and Commentary</u>

The second quarter ended with many markets declining. Investors continue to worry about the highest inflation rates seen in the United States since 1981, the ongoing conflict in Ukraine, and the supply-chain pressures from COVID lockdowns in China. To combat inflation, the Federal Reserve raised interest rates by 0.75% on June 15th, the largest rate hike since 1994, and the third increase this year.

The MSCI All Country World Index of global stocks fell 15.53% in the second quarter and ended the trailing 12-month period down 15.38%. In US markets, the S&P 500 Index of large company stocks declined 16.10% for the quarter and is down 10.62% over the past 12 months. Small companies in the United States fared worse. The Russell 2000 Index of small US companies dropped 17.20% in the quarter and is down 25.21% over the trailing 12-month period. The Dow Jones US Select Real Estate Investment Trust Index, a benchmark for US real estate performance, was down 18.10% for the quarter and down 6.41% over the previous 12 months.

Stocks in companies abroad also struggled in the second quarter. Overseas stocks, as measured by the MSCI Europe, Australasia and Far East Index, fell 14.29% over the past 3 months, and fell 17.34% over the past 12 months. The MSCI Emerging Markets Stock Index fell 11.34% in the quarter, and about 25% over the trailing 12-months.

Bond holders were hurt by rapidly rising interest rates in the second quarter. The combined market for government and corporate bonds in the United States, as measured by the US Aggregate Bond Index, was down 4.69% for the quarter and down 10.30% for the trailing 12-month period. Intermediate-term corporate bonds in the US declined 3.92% in the quarter and fell 9.42% in the last 12 months. The global bond market fell even more than the aggregate US bond market. The FTSE World Government Bond Index fell 8.91% in the past 3 months and dropped 16.78% in the past 12 months.

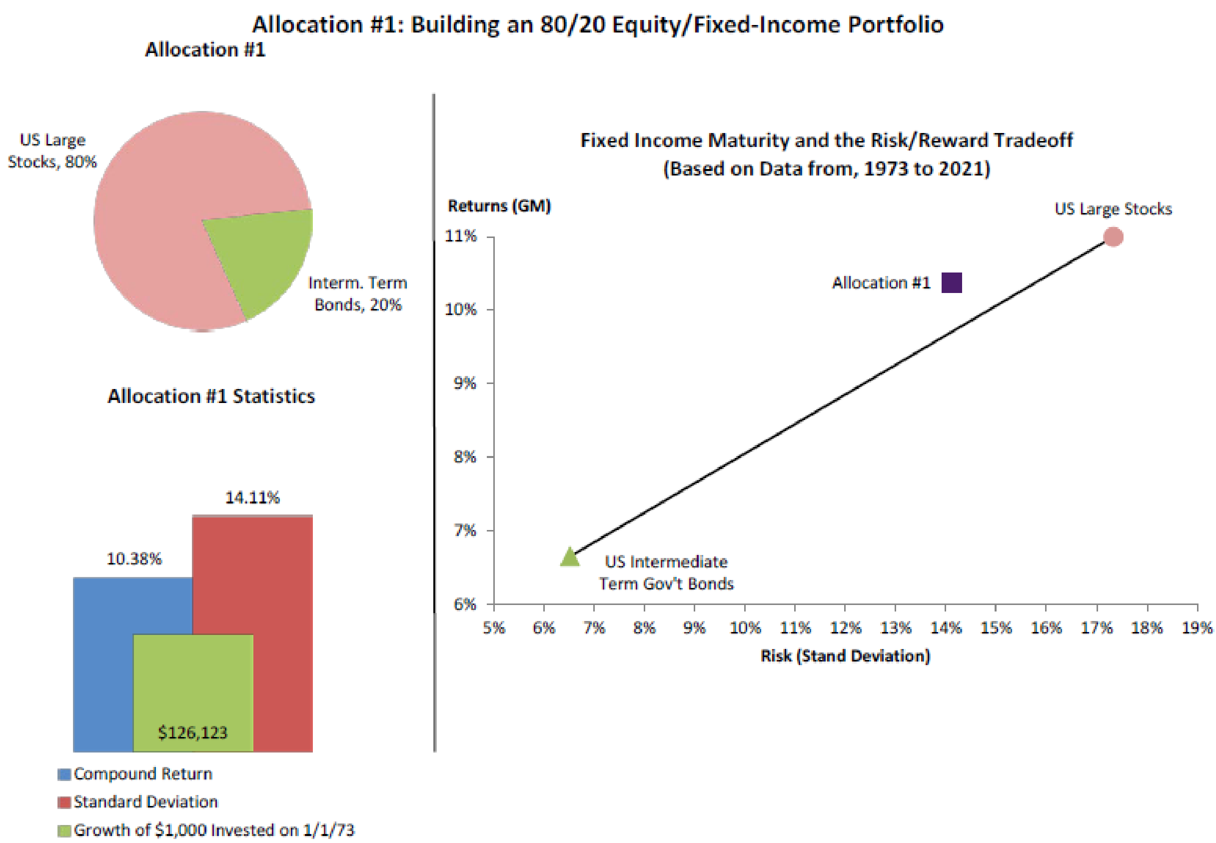
Interest rates continued to rise in the second quarter. The yield on the 10-year Treasury sat at 2.98% on June 30th, up 1.46% since the beginning of the year. The Federal Reserve is expected to raise interest rates further to fight persistent inflation. Raising interest rates should help cool inflation, but doing so puts recessionary pressures on the economy because borrowing to spend and invest is more difficult.

Despite the weak economic outlook, it is important to remember that financial markets are forward-looking, so current prices are already reflecting these expectations.

Given the recent increase in stock market volatility, it is important to revisit *The Benefits of Diversification*. Put simply, diversification is the way investors reduce risk by owning many different assets instead of just a few. Although that may sound simple, diversification is more complicated than that. Yes, diversification can reduce risk, but when done right, it can also help investors efficiently trade risk for return. A well-constructed portfolio goes beyond buying 50 to 100 stocks or even a broad array of investment funds. Let's look at how Schultz Collins helps investors understand the pitfalls and benefits of diversification through a series of portfolios that become more and more diversified.

Let's imagine an investor who owns all the large company stocks in the US stock market. This portfolio is depicted as the circle on the righthand chart of Figure 1. He wishes to reduce his risk, therefore he allocates 20% to bonds. Bonds are depicted as the triangle in the chart. Doing so would reduce his exposure to risk, but also his expected returns. A naïve investor would think that buying a mixture of both stocks and bonds would result in expected risk and return levels somewhere along the black line connecting the two investments. However, this is not the case.

Figure 1



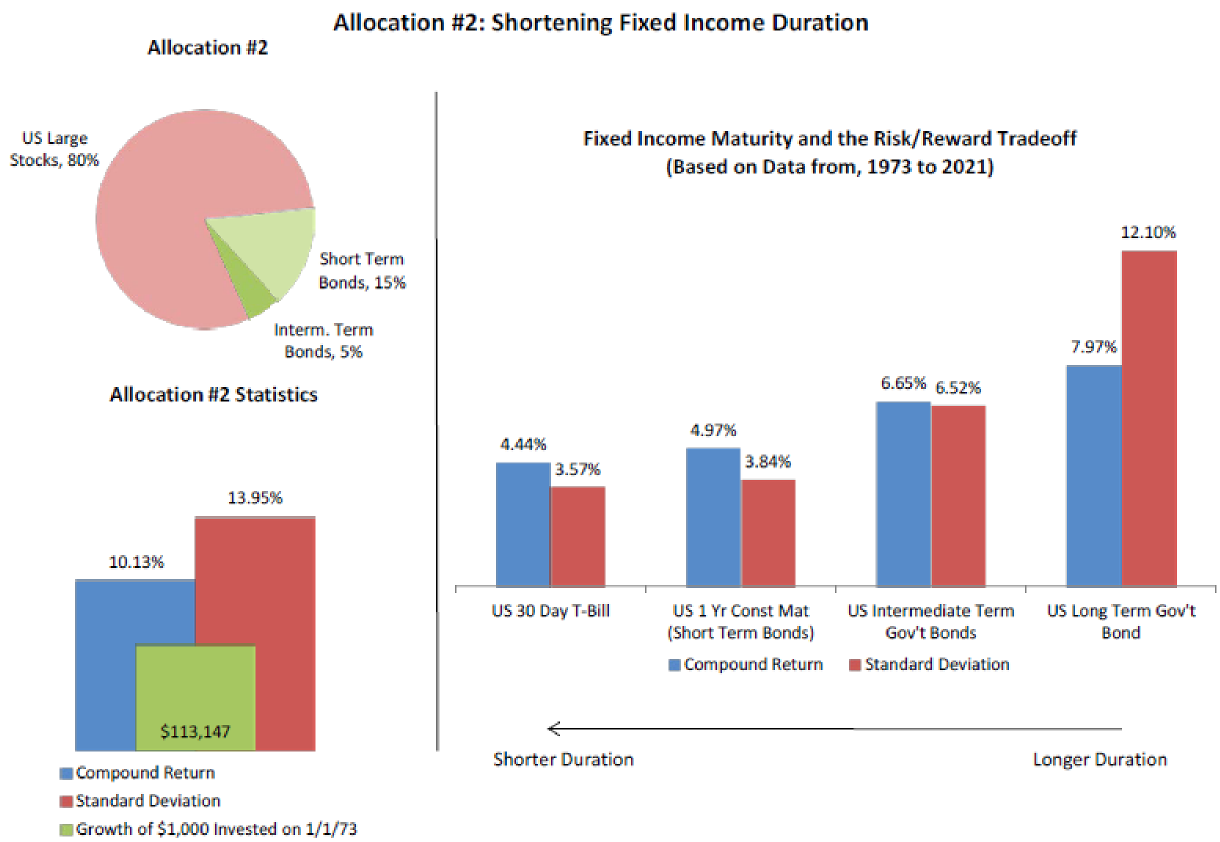
Data provided by Morningstar. For illustrative purposes only.

The 80/20 portfolio is depicted as the square on the chart. The square lies above the line, indicating a higher level of returns than our naïve investor would expect.

The top left pie chart shows the allocation of the portfolio to stocks and bonds. The bottom left column chart illustrates the historical risk and return characteristics of the allocation. We'll use these charts to illustrate how an investor can try to increase the diversification of their portfolio and how those attempts can affect the risk and return of the portfolio.

One way to diversify the portfolio further is to buy different types of bonds. The chart on the right of Figure 2 illustrates the historical risk and return for various bond maturities. The red bars represent standard deviation, a measure of risk. Shorter maturities offer the lowest risk, but also the lowest return. Let's assume our investor wants to reduce risk further, and so opts to split his 20% bond allocation into 15% short-term bonds and 5% intermediate-term bonds.

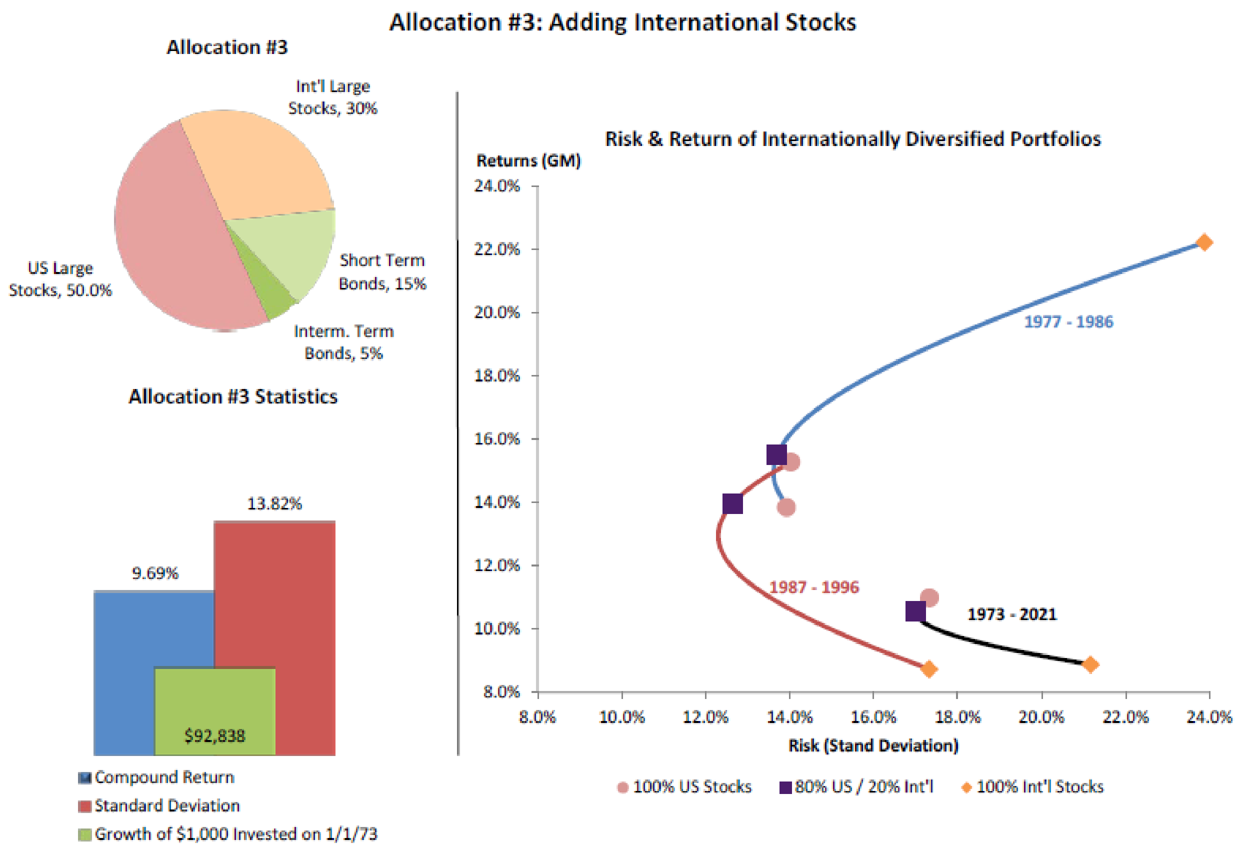
Figure 2



Data provided by Morningstar. For illustrative purposes only.

Another way to diversify is to own companies all over the world, rather than just in the United States. The chart in Figure 3 shows three curved lines. The curves represent different time periods and show historic risk and return data along continuums of allocations between U.S. stocks (as depicted by circles) and international stocks (as depicted by diamonds). The squares represent portfolios of 80% U.S. and 20% international stocks. These line charts show that sometimes US stocks outperform international stocks, but sometimes they don't. However, there appears to always be some reduction in risk to a portfolio that invests in both stock markets, as indicated by the black squares. We'll assume our investor allocates 50% of their portfolio to large company stocks in the US and 30% in international stocks. This change reduces the risk and return of the portfolio further.

Figure 3

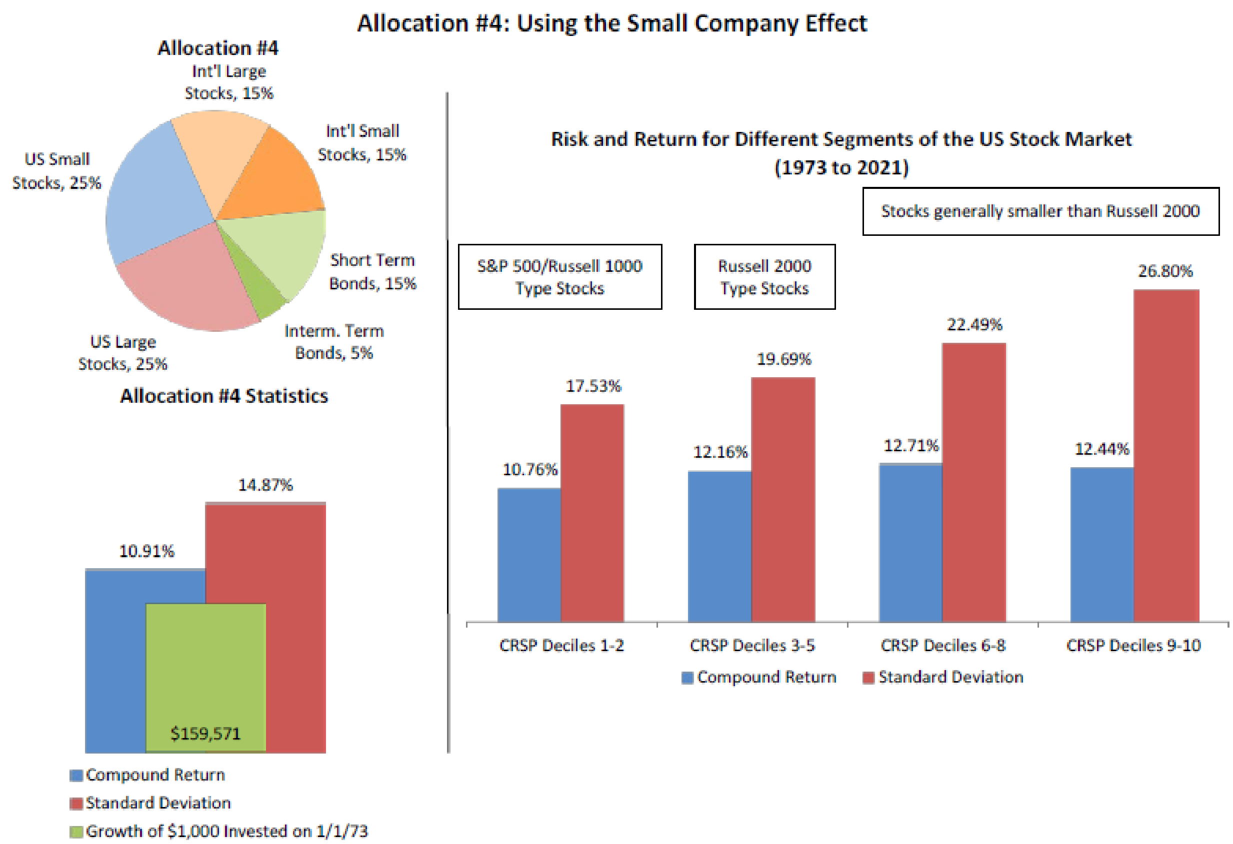


Data provided by Morningstar. For illustrative purposes only.

Our investor can further diversify by buying stocks in smaller companies. The chart on the right of Figure 4 shows various groupings of stocks with the largest stocks on left and progressively smaller stocks to the right. Historically, small company stocks have come with expectations of higher risk and returns.

Let's assume our investor allocates half of the stocks to small companies and half to large companies, both in the US and internationally. The inclusion of small stocks increases the portfolio's return, but also its risk.

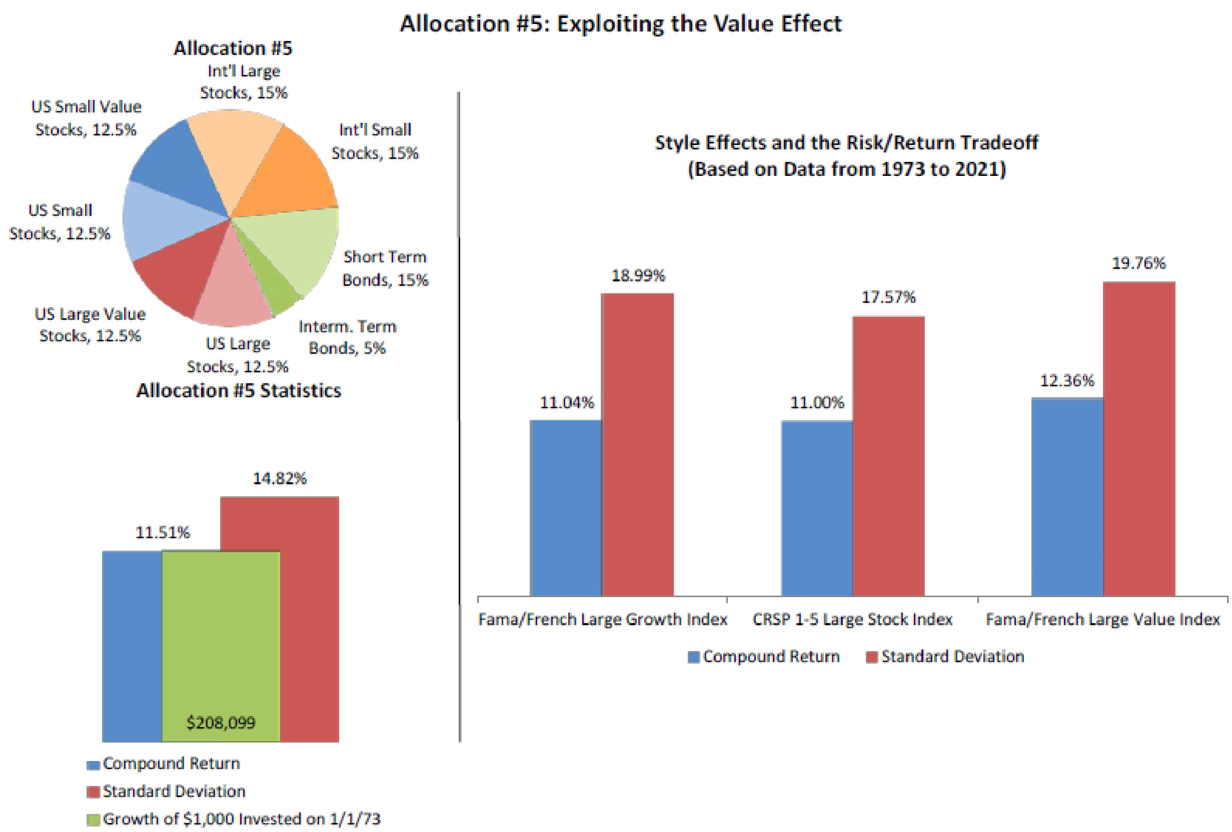
Figure 4



Data provided by Morningstar. For illustrative purposes only.

We will consider one more addition to our portfolio: "value" stocks. Simply stated, these stocks are considered relatively cheap compared to their expensive counterparts, called "growth" stocks. The chart on the right of Figure 5 shows returns for growth stocks and value stocks compared to a large company stock index. Historically, value stocks outperformed growth stocks and the large company stock index over the 1973-2021 period. Let's assume our investor allocates 50% of US stocks to value stocks, across both large and small companies. The result is a portfolio with higher returns but – surprisingly – slightly lower risk.

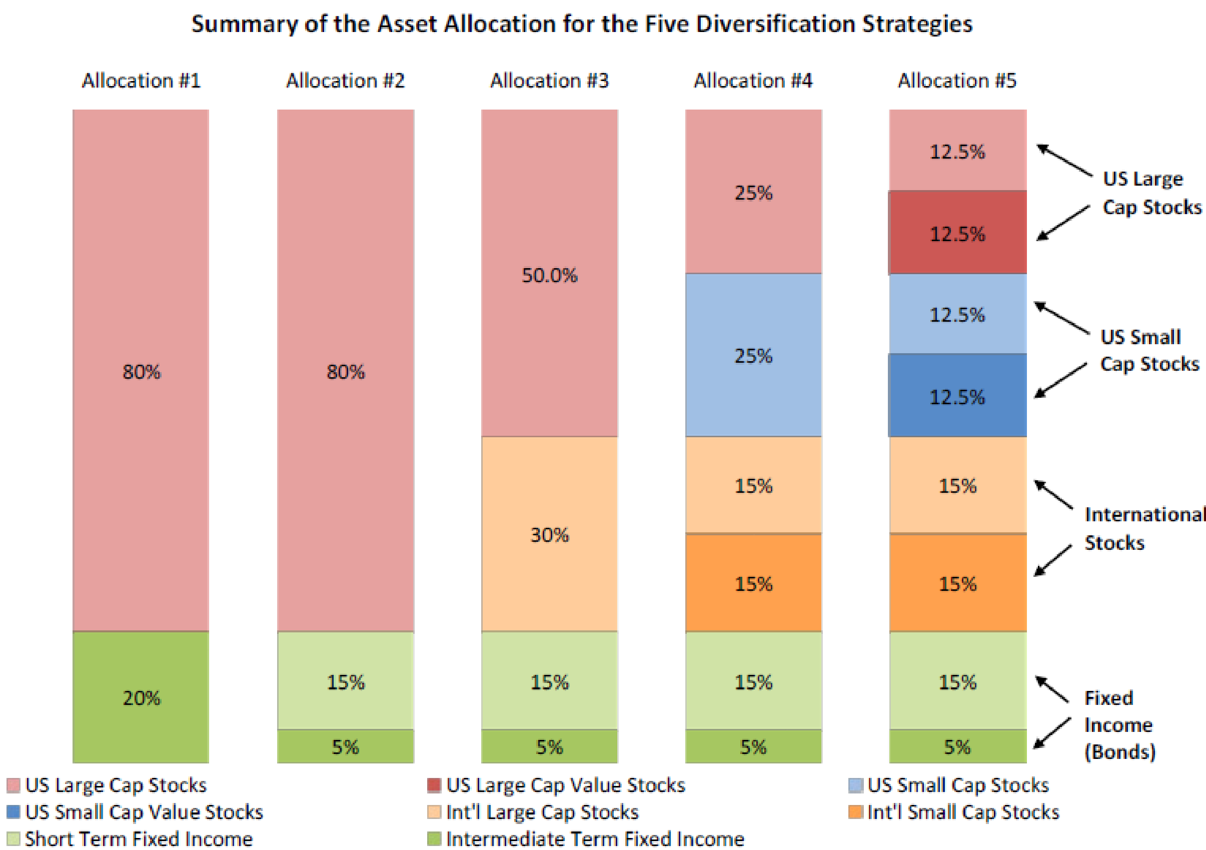
Figure 5



Data provided by Morningstar. For illustrative purposes only.

Let's compare these allocations by recapping the progression of the portfolio from the simple U.S. stock and bond portfolio to a well-crafted and well diversified portfolio. First, we started with our simple 80/20 portfolio seen in Allocation #1 of Figure 6. We then diversified our bond holdings to include a mixture of short-term and intermediate-term bonds, as shown in Allocation #2. In Allocation #3, we increased the portfolio's diversification by adding international stocks. Allocation #4 layered-in small companies to our US and international stock allocations. Finally, Allocation #5 incorporates value stocks in the U.S. stock portion of the portfolio.

Figure 6



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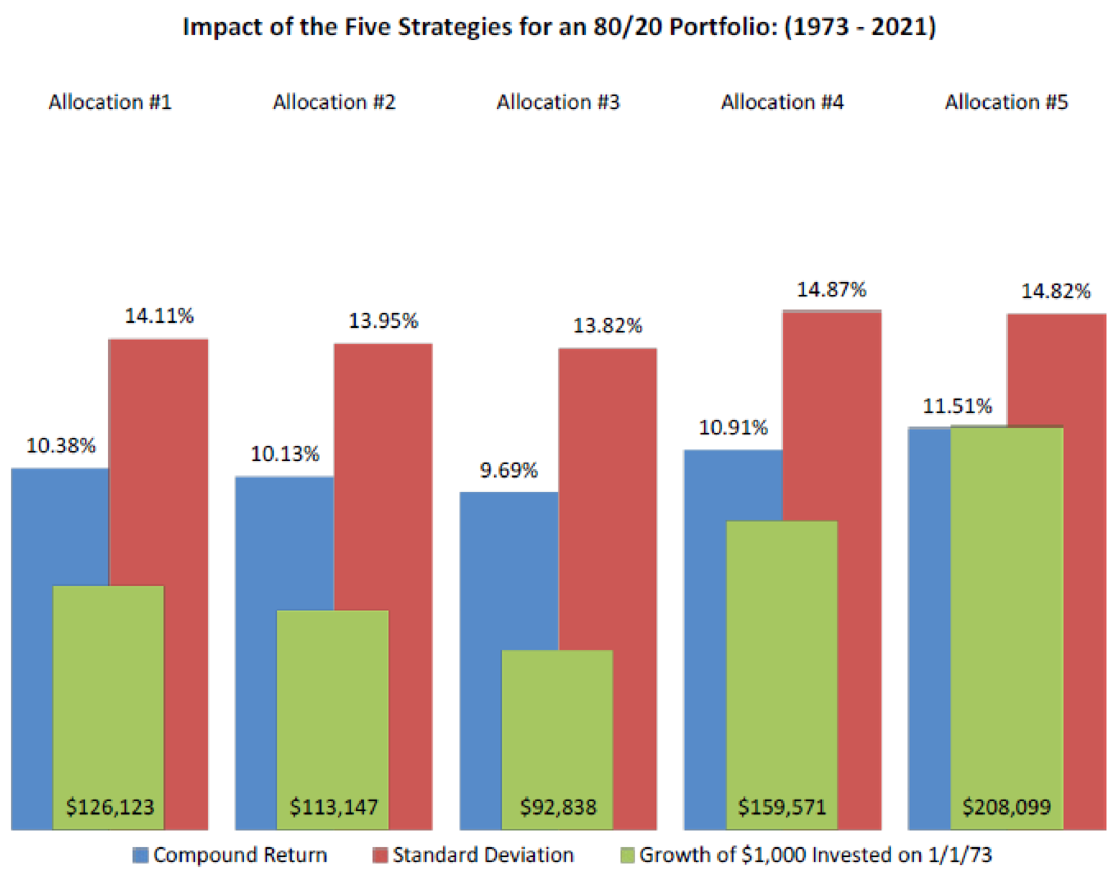
Finally, let's compare the performance statistics along each step of our diversification example by examining Figure 7. The data show diversification can reduce risk, as seen in the addition of short-term bonds and international stocks in Allocations #2 and #3. However, diversification may also increase expected returns with modest increases in risk, as seen with the addition of small companies in Allocation #4, or even reduce risk, as seen with the addition of value stocks in Allocation #5. In summary, diversification is not just buying more assets to lower risk. Diversification may also provide a warranted exchange of higher risk and potential return.

It is important to note that this article is just an example of how we help investors diversify. We haven't discussed other important assets investors should consider, like real estate and international bonds. Furthermore, these allocations are not recommendations, nor would we recommend any prefabricated allocation to our clients. Each person is unique, and we can help determine the allocation that best fits each investor's needs and risk preferences.

Figure 7



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