

From: Aequitas Investment Advisors

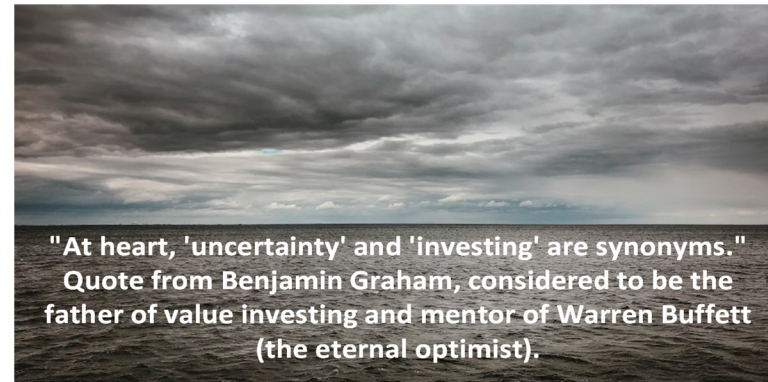
Re: Clouds on the Investment Horizon

*Warren  
is Your Team!*

As we were writing this quarterly letter, the horrific news of the attack on Israel and the subsequent declaration of war against Hamas has dominated the headlines. While tensions have been simmering for many years, the humanitarian toll on civilians is particularly tragic and disturbing. Our hearts go out to the victims of the attack and their families, as well as those innocent civilians who will suffer the repercussions of this senseless violence. We hope that diplomatic efforts will help turn the tide toward a de-escalation of the conflict as well as finding ways to create a longer-term solution so that Israelis and Palestinians can live in peace.

Beyond the immeasurable humanitarian cost, one of the fears of the Israel-Hamas war is its potential to become a broader regional conflict which might negatively impact the global economy. While it is still too early to determine how the conflict might turn out, this is yet another geopolitical concern to be added to the list which already includes the Russia-Ukraine war, and tensions between the U.S. and China. Regarding Ukraine, it appears likely the war will drag on and reach a stalemate at which point the two sides might negotiate some sort of peace agreement. Putin appears to be playing the waiting game with the hope that support from the west will wane. In order to arrive at an acceptable agreement for the Ukrainian people, the U.S. and our allies must remain steadfast in our support. With respect to U.S. and China relations, there is some relatively good news on this front given that both sides have been actively engaged in dialogue over the past six months and tensions have eased. China's president, Xi Jinping, appears to be pursuing a more pragmatic approach to relations with the U.S. at least for the time being. Obviously, with China being the world's second most powerful country, our challenge is to determine how to peacefully coexist over the long term. As a reminder, from an investing standpoint, geopolitical risks are ever present which is why our clients' portfolios are balanced between the safe haven of bonds and a highly diversified portfolio of stocks structured to deliver favorable long-term capital appreciation.

Adding to the aforementioned list of geopolitical uncertainties, investors also need to consider the political dysfunction in Washington, recently highlighted by the disarray in the House of Representatives as Republicans scramble to elect a



new Speaker to replace Kevin McCarthy. The major question is how the current political dysfunction will impact the need to address important issues such as a potential government shutdown and the longer-term debt ceiling crisis which will return to the forefront in 2024 after the general election. The cost of dysfunction is measurable given that the Fitch Ratings service downgraded our government's credit rating this past August from the highest level of AAA to the second highest level of AA+. Their explanation was that the lower rating reflected "the expected fiscal deterioration over the next three years, a high and growing government debt burden, and the erosion of governance relative to AA and AAA rated peers over the last two decades that has manifested in repeated debt-limit standoffs and last-minute resolutions." Fitch's downgrade may have contributed to the subsequent rise in interest rates, but more importantly, their statement about an "erosion of governance" clearly highlights the political dysfunction in Washington. Fitch mentioned that our government has implemented various tax cuts and new spending initiatives over the past twenty years, but has avoided addressing the necessary fiscal reforms to pay for these initiatives (not to mention the fiscal sustainability of Social Security and Medicare). It's very clear that the solution is a combination of raising additional revenue and reducing expenditures which will necessarily require compromises by both political parties. (In a previous Quarterly Letter, we provided the following link to a list of sensible options which have the potential to put our nation's finances on a sustainable course: [cbo.gov/publication/58164](https://cbo.gov/publication/58164)).

### Looking at the Bright Side

Despite all of these uncertainties and clouds on the horizon, there are some good reasons for cautious optimism. First, with today's higher interest rates, investors are able to earn much higher yields on bonds compared to just a few years ago.

For example, the annual interest rate on a 3-Year Treasury Note is now close to 5% compared to two years ago when the rate was just 1% (a five-fold increase). Stocks are also priced more favorably today than they were a few years ago. For example, when stocks were trading at record-high prices in late 2021 (prior to the 2022 bear market), the expected annual return for global stocks over the subsequent 10 years was just 4.5% based upon numerous economic assumptions. Today, with much lower stock prices, the expected return for global stocks over the next 10 years is close to 7.5% based upon current valuations. Putting these potential bond and stock returns together, a 40% bond and 60% stock portfolio in late 2021 had an expected 10-year return of about 3.8% given low interest rates and high stock prices at that time. Today, a 40% bond and 60% stock portfolio has an expected 10-year return of 6.9% (to be conservative, we are using somewhat lower returns when creating or updating financial plans for our clients). So while the list of uncertainties has become longer, the good news is that the expected returns for bonds and stocks over the next 10 years appears favorable.

### The Outlook for Interest Rates

The minutes of the September meeting of the Federal Reserve's Open Market Committee indicated that there were various risks to the economic outlook, but that the economy was still expanding at a "solid pace" which has kept inflation elevated. As a result, the Fed stated it would keep interest rates higher for longer, with perhaps another rate hike in December. The markets reacted negatively to this somewhat hawkish messaging. The S&P 500 Index fell by more than 5% over

the ensuing two weeks. Interest rates at the longer end of the yield curve rose to their highest levels in more than 15 years. Pundits attribute the higher rates to the Fed's September statements, but perhaps more importantly to the growing supply of Treasury bonds necessary to finance the growing deficit. This upward shift in rates has prompted some Fed members,

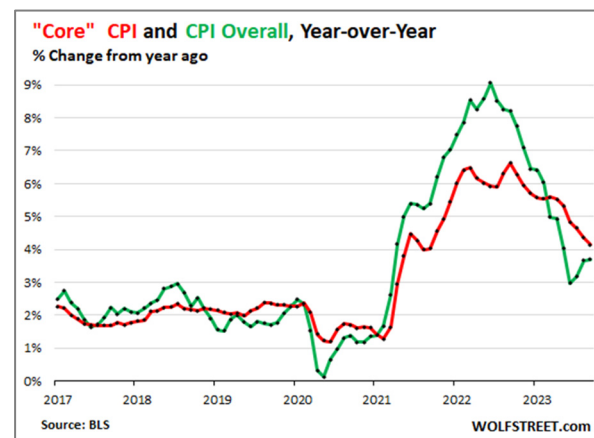
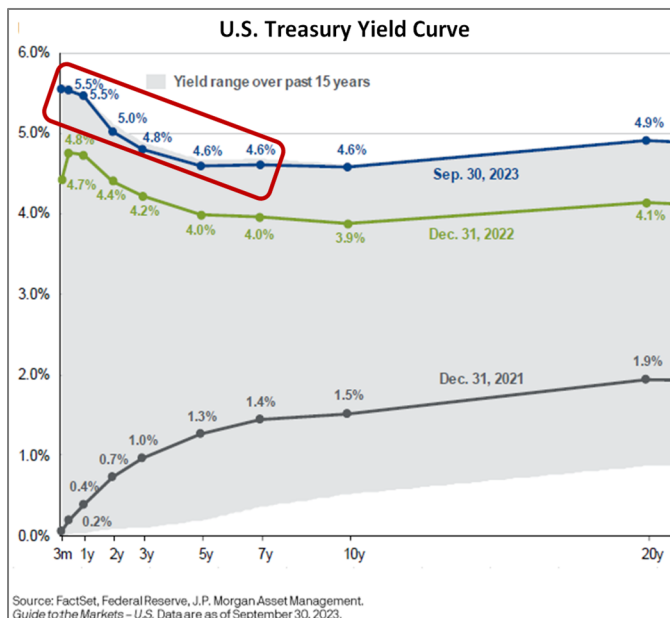
more

recently, to suggest that additional rate hikes might be unnecessary given that the higher rates across the yield curve might be sufficiently restrictive to bring the inflation rate down to the Fed's long-term target of 2% by the end of 2024. The Fed still has a "Soft Landing" as its primary objective for slowing the economy, and the current data supports this view. The economy is expanding, the jobs market remains strong, consumers are still spending, albeit at a slowing pace, and inflationary pressures are easing. Perhaps a Goldilocks scenario is what the Fed has in mind, i.e., an economy that has moderate economic growth, but not so much growth to cause a rebound in inflation, or too weak to cause a recession.

The current U.S. Treasury Yield Curve at the bottom left of the page indicates where rates were at the end of September (the blue line) compared to where they were at the end of 2022 and 2021. The Fed's monetary policies primarily impact interest rates at the short end of the curve, e.g., the 3 month yield which stood at 5.5% at the end of September and was closely aligned with the Federal Funds Rate. Interest rates at the longer end of the curve were in the 4.6% to 4.9% range. Many bond strategists believe that rates have either peaked or are very close to peaking, while the Fed has stated it will keep rates high for longer with one more hike possible in December. Combining these views, there's a chance rates might rise slightly, but it's likely we may see interest rates begin to decline over the next 6 to 12 months (if the economy slows more quickly than expected, the Fed might lower rates sooner). The red box on the Yield Curve chart is where we believe investors should allocate their bond portfolios, i.e., across the 3-month to 7-year timeframe, or in a combination of short and intermediate-term bond funds. There is also an opportunity to lock in these relatively high rates by creating a ladder of individual treasury securities aligned with scheduled portfolio withdrawals and/or Required Minimum Distributions from retirement accounts. As we review our clients' portfolios over the coming months, we will likely recommend

### Inflation is Heading in the Right Direction

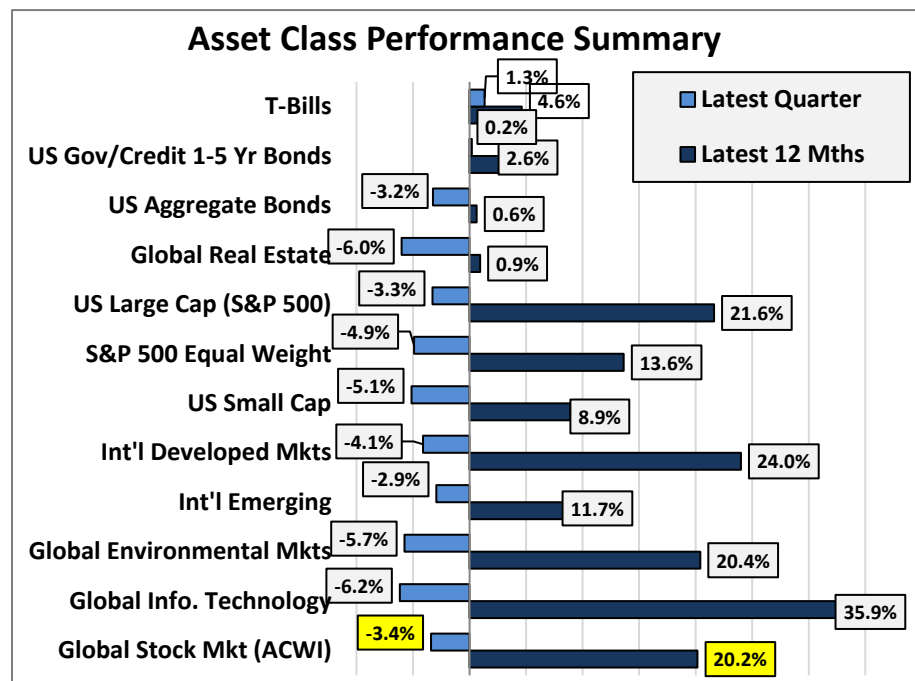
The Fed's monetary tightening policies have been effective at slowing the rate of inflation. The headline year-over-year CPI rate peaked at 9.1% in June of 2022 and has fallen to



3.7% as of the end of September. The International Monetary Fund projects that the inflation rate will fall to 2.3% by the end of 2024 which is in line with the Fed's most recent forecasts. (For planning purposes, we use a 2.5% long-term inflation rate for core living expenses with a higher rate for medical and educational expenses.) The Core Inflation Rate, the red line in the chart on the prior page, is the Fed's preferred inflation measure given that it excludes energy and food prices which are much more volatile. So far, at least, the Fed appears to be succeeding in its battle to bring inflation under control.

### Asset Class Performance Review Latest 12 Months and Calendar Quarter

For the trailing 12 months through September 30<sup>th</sup>, most of the major asset classes performed remarkably well. The Global Stock Market (ACWI) gained 20.2% reflecting a sharp recovery in stocks during the fourth quarter of 2022 following the bear market, plus a modest gain so far in 2023. The leading sector, unsurprisingly, was Information Technology which gained 35.9% (many of the Top 10 stocks in the S&P 500 Index are represented in this index). The next best performers were International Developed Markets (+24%), US Large Caps (+21.6%) and Global Environmental Markets (+20.4%). The S&P 500 Equal-Weighted Index gained 13.6% followed by International Emerging Markets (+11.7%) and US Small Caps (+8.9%). Global Real Estate eked out a gain of 0.9%. Within the bond categories, U.S. T-Bills were the strongest performers



(+4.6%) reflecting the attractive rates at the short end of the yield curve. US 1-5 Year Gov/Credit bonds gained 2.6% while the longer term US Aggregate Bond Index gained just 0.6%.

For the most recent quarter, the results were mostly negative reflecting the impact of rising interest rates following the Fed's recent message of "higher for longer." The Global Stock Market (ACWI) fell by 3.4% for the quarter. All of the other stock asset classes in the summary had negative returns with the smallest decline being Emerging Markets (-2.9%) and the largest being Global Information Technology (-6.2%). With interest rates having risen during the quarter, US Aggregate Bonds fell by 3.2% while the shorter-term US 1-5 Year Gov/Credit Index gained 0.2%. US T-Bills advanced by 1.3%.

### An Extraordinary Year for the Top 10 Stocks in the S&P 500 Index (But Not So Great for the Other 490!)

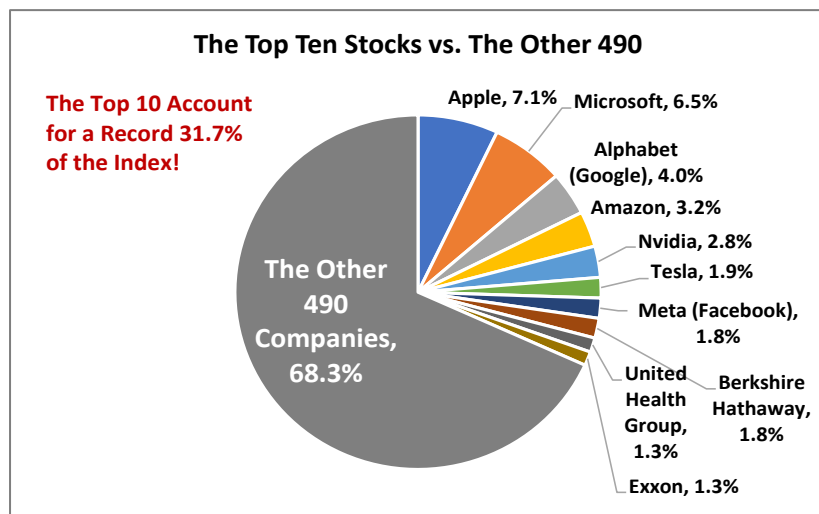
Through the first nine months of this year, the *average* stock in the S&P 500 Index gained just 1.8%, but wait, the S&P 500 Index gained 13.1%, so how can this be? The answer is that *close to 97% of that 13.1% gain was attributable to just the Top 10 stocks in the Index* (this is a record never seen before as evidenced in the table to the right). The S&P 500 Index was created in 1923 and has evolved from including about 200 stocks at its inception to 503 stocks today (we'll round it off to 500 for the purpose of this discussion). The weight of each of the 500 constituents is based upon its *market capitalization*, or the total dollar value of each company's outstanding shares of stock (this is why the S&P 500 Index is considered to be Capitalization-Weighted, or Cap-Weighted for short). Given that the

Annual Contribution of the Largest 10 Stocks During Positive Years			
Year	S&P 500's Performance (Excluding Dividends)	Percent of S&P 500's Return Attributable to the Top 10 Stocks	S&P 500's Return without the Top 10
2023 YTD	11.7%	96.5%	0.4%
2007	3.5%	78.7%	0.7%
2020	16.3%	58.9%	6.7%
1999	19.5%	54.5%	8.9%
2021	26.9%	45.0%	14.8%
1998	26.7%	36.0%	17.1%
1996	20.3%	33.9%	13.4%
2017	19.4%	33.3%	12.9%
2019	28.9%	32.8%	19.4%
1991	26.3%	28.6%	18.8%

Source: Todd Sohn Technical Strategist

Top 10 stocks have appreciated significantly over the past five years, their weight in the Index has increased substantially to the point where the Top 10 stocks now account for more than 31% of market value of the Index (another all-time record high). While such concentration has worked favorably in the recent past for S&P 500 Index, history has demonstrated that once a company reaches the Top 10 status, it is likely to underperform the overall market over the subsequent 3, 5 and





10 years. To avoid this dilemma, one option is to invest in an Equal-Weighted S&P 500 Index fund which, as its name suggests, equally weights the 500 stocks with the result being that instead of comprising more than 31% of the Index, the same 10 stocks would comprise just 2% of the Index (10 divided by 500 = 2%). Beyond the benefit of expanding diversification to reduce concentration risk, this approach might also improve portfolio performance. For example, over the past 20 full calendar years through 12/31/22, the Equal-Weighted Index has outperformed the Cap-Weighted Index 60% of the time and by an average of 1.5 percentage points annually. Translating this into dollars, \$10,000 invested in January of 2003 in the Equal-Weighted Index would have grown to \$85,152 by the end of 2022 compared to \$64,844 for the Cap-Weighted Index (that's 31% more dollars in the investor's portfolio!). The fundamental reason why the Equal-Weighted Index outperformed is that the smaller companies in the Index outperformed the larger companies. While history has demonstrated that the Equal-Weighted Index has cumulatively outperformed the Cap-Weighted Index over the past 20 calendar years through the end of 2022, there have been years when the more concentrated Cap-Weighted Index has outperformed, but never to such an extreme as we've seen so far in 2023.

#### Market Cap-Weighted vs Equal-Weighted Performance YTD and Prior 20 Years

	YTD	2003-2022	Value of \$10K Invested from 1/03 to 12/22
S&P 500 Cap-Weighted	13.1%	9.8%	\$64,844
S&P 500 Equal-Weighted	1.8%	11.3%	\$85,152

Source: Morningstar

We've limited our discussion so far to a comparison of the S&P 500 Index on a Cap-Weighted and Equal-Weighted basis. The conclusion is that a concentrated Cap-Weighted Index can perform very well for short

periods of time, but over the long term, a more broadly diversified approach has proven to be significantly more profitable for investors. Also, bear in mind that the S&P 500 Index tracks only the largest companies in the U.S. stock market, and history has demonstrated that Small Cap stocks have outperformed Large Cap stocks by an average margin of about 2 percentage points annually over the past 95 years. Another factor to consider is that the current composition of the S&P 500 Index is skewed heavily toward Growth stocks which have performed very well over the past few years, but have underperformed Value stocks by more than 3 percentage points annually since 1928. Given these two long-term factors, we believe it makes sense to "tilt" portfolios toward both Small Cap stocks and Value stocks in order to capture the potential for higher returns over the long run (even with those two tilts, our recommended strategy still includes the Top 10 stocks, but in a less concentrated allocation). Furthermore, including non-U.S. stocks in the portfolio mix allows for even greater diversification. With close to 4,000 stocks in the U.S., and more than 12,000 stocks overseas to consider, we believe there are many good reasons why it makes sense to diversify beyond just the 500 largest companies in the U.S., especially when the Cap-Weighted Index is so heavily concentrated in just 10 stocks.

### Closing Thoughts

Having opened this quarterly letter with thoughts about the Israel-Hamas war, we'll close with abbreviated excerpts from the October 13<sup>th</sup> NPR broadcast of *All Things Considered* during which the host, Ari Shapiro, spoke with Rabbi Sharon Brous and Imam Mohamed Herbert about how they are guiding their congregations in the U.S. during this crisis and what they wanted to say to each other:

Rabbi Brous: I will say to you, Imam Herbert, I'm holding you and your community, your beloveds in your mosque and their families in Gaza in my heart and in my prayers. And I know that there is a better way for humanity that we can walk together toward peace, dignity and justice for all people.

Imam Herbert: I share the same sentiment. ....one of the most profound things that I heard you say....was that you mentioned that the real enemies of this war are not the Jews or the Israelis or the Palestinians. It's those people who have decided that violence is the only answer. [This] shows that there actually is a way to have a conversation [and pathway forward].



Drawing by Mahmoud Al Tamimi, age 11  
"Art for Peace" project for children in Jerusalem