INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 1ST QUARTER 2022

The ACM Journal

Country Mouse

Country living has its benefits. Among them is our proximity to nature. It isn't unusual for us to see deer, fox, a variety of wild birds, and a wide assortment of other critters around our house. It is fun to watch them, and good for the kids to learn about wildlife firsthand.

However, on occasion nature can get too close. That was the situation late this winter when we started seeing evidence of a mouse around our kitchen. We get the odd mouse every now and again, but we usually just put out a trap and within a few days the problem is solved. Not so with this particular mouse.

This mouse eluded capture for a quite a number of days. Then, when I was out of town at a ski race, the mouse decided to make its presence known to my wife, who was already feeling less than enthusiastic about nature. Nipa was in the kitchen when the mouse ran out from behind the toaster and darted around first on the countertops and then on the floor. It

continued on page 6

IN THIS ISSUE

Country Mouse....................... 1
Portfolio Review................... 1
Chris's Corner........................ 4
Alternatives: An Idea
Whose Time has Come?........ 5

Portfolio Review

The first quarter of 2022 was a challenging start to the New Year for investors. After falling into correction territory, the S&P 500 cut some of its losses late in the quarter to end the period down 4.6%. This marked the first time the index experienced a negative quarter since Q1 of 2020.

Investors Wary on Inflation, War

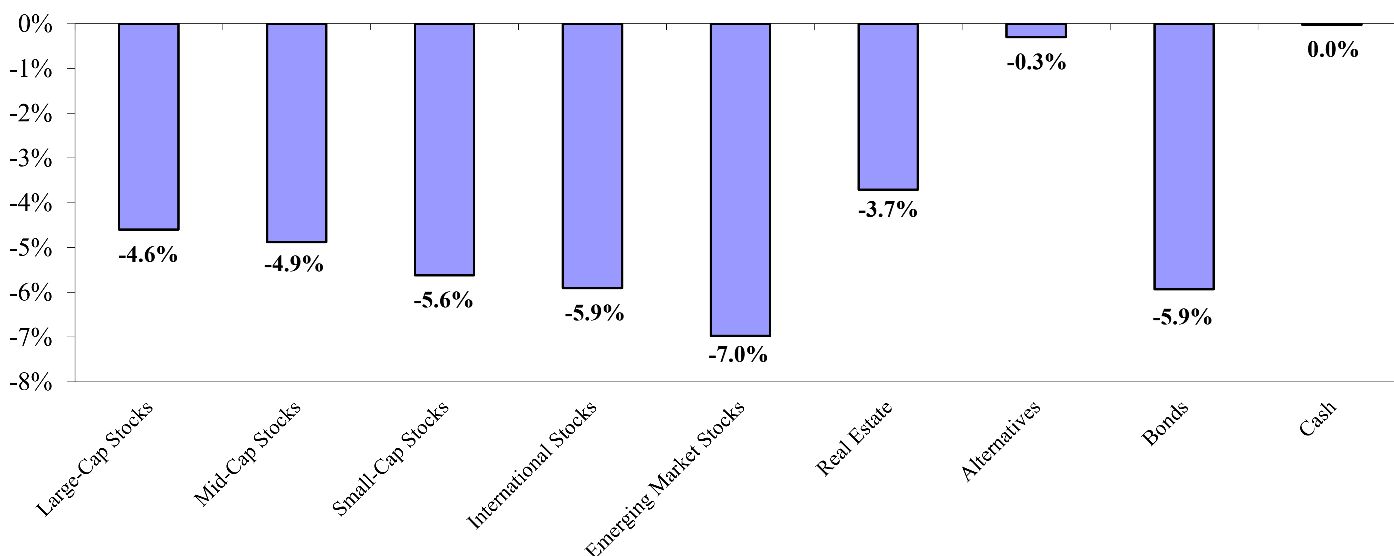
Concerns over high inflation and future interest rate hikes weighed on stock market returns. Year-over-year inflation rose to its highest reading since 1982 as consumer spending remained strong and supply chain disruptions continued. With the unemployment rate decreasing to 3.6% and year-over-year growth in average hourly earnings exceeding 5% for the last few months, the Fed adopted a more hawkish tone toward monetary policy. This includes a plan to shrink its $9 trillion balance sheet and raise interest rates for the first time since 2018.

The Fed started raising short-term interest rates, and further rate hikes are highly anticipated throughout the remainder of the year. Many believe the federal funds rate will end the year above 2%. Since inflation is shaping up to be a global phenomenon, interest rate hikes were not limited to the United States. The Bank of England has raised interest rates back to their pre-pandemic levels, and Russian interest rates skyrocketed in an attempt to stabilize the deteriorating ruble. The European Central Bank has not yet raised rates, but there is increased speculation that this will have to happen soon to mitigate inflation.

Stock market volatility increased with the Russian invasion of Ukraine and concerns over the impact it could have on the global economy. Crude oil spiked to a high of $130 per barrel during the period. Natural gas, wheat, and corn were among other commodities that saw prices surge because of actual or anticipated reduction in supply from the conflict.

The rise in oil and natural gas prices boosted energy stocks ahead of all other sectors, as the S&P Energy Select Sector Benchmark gained 39% in the first quarter. Strong results from energy stocks were also a catalyst

continued on page 2



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 3-month T-Bill.

Portfolio Review

continued from page 1

for the outperformance of value stocks this quarter since value tends to have a sector tilt towards energy.

Low volatility stocks also held up well during the quarter, as is usually the case during times of stress in the market. Growth stocks underperformed, especially unprofitable technology stocks, because of the prospect of more aggressive interest rate hikes. This can have an outsized negative impact on future cash flows of "longer duration" assets.

International stocks were slightly worse off than domestic stocks, as countries in Europe have closer trading relationships with Russia and Ukraine. Russian crude oil exports had made up 8% of all imported oil in the United States, whereas countries in Europe import roughly half of their oil from Russia. Reliance on Russian and Ukrainian agricultural goods is also much stronger in the Eurozone.

Emerging market stocks fared poorly in the first quarter as China reinstated lockdowns from rising COVID cases in several cities. The Russian stock market was crushed during the onset of war and even had trading halted for several weeks. Fortunately, most broad emerging market funds tended to have limited exposure to Russian stocks.

Examining the Yield Curve

Treasury bond rates increased substantially during the quarter, but the yield curve also flattened. The yield curve illustrates the interest rates on a given date for similar debt at various maturities. At the end of 2021, the yield curve was upward sloping with longer dated maturities trading at higher yields than maturities that were shorter. Inflation expectations

helped shift the yield curve higher at all maturities, but shorter-dated maturities saw an added boost as the Fed looks to raise short-term lending rates.

An important section of the yield curve monitored by economists is the spread between 10-year and 2-year Treasury bond yields. While the ten-year began the period 0.8% higher than the two-year, the ten-year ended the quarter only slightly above the two-year at rates of 2.35% and 2.31% respectively. In fact, the two-year yield did briefly exceed the ten-year yield during the period.

This yield curve "inversion" caused fear among investors since the last eight yield curve inversions in the U.S. were followed by recessions. However, this occurrence should be taken with a grain of salt despite the strong historical relationship with economic downturns. First, the relationship between yield curve inversions and recessions is not as strong in other countries, which suggests the relationship in the U.S. may be somewhat coincidental. Also, even if the relationship does hold, recessions normally occurred 18 months after an inversion first occurred, during which stock market gains continued. Finally, a recession does not always indicate a bear market, as the S&P 500 experience only modest losses during the recessions in the early 1980s and early 1990s.

Nevertheless, rising rates across the yield curve resulted in poor performance for bonds this quarter. The Bloomberg Aggregate Bond Index fell by nearly 6%, worse than the stock market's decline. Anticipation of ongoing rate hikes and inflationary pressures will likely challenge bond returns going forward. While some may assume inflation-protected securities provide adequate protection against inflation, TIPS lost 3.6% in the first quarter. This is better than the overall bond market, but a Pyrrhic victory given the negative return.

Strong Quarter for Alternatives

Despite a poor quarter for stocks and bonds, our preferred alternative strategies delivered very strong results this quarter. The funds we use for managed futures and style premia both generated double-digit returns for the quarter, while alternative lending and reinsurance also saw modest gains. The multi-strategy fund was the only strategy that was negative this quarter, but still outperformed the S&P 500 and overall bond market.

Ongoing Volatility

Inflation, interest rate hikes, and war were a few of the most notable factors driving volatility in the first quarter. This volatility has so far appeared directionless as investors continue to monitor and digest an influx of new information. For example, the S&P 500 was consistently negative in the week leading up to the war in Ukraine, yet it jumped nearly 4% during the two days immediately after the invasion began. Market fluctuations were wild intra-day during the latest Fed meeting to raise interest rates, but the movements had no directional trend.

Developments regarding the war and inflation will likely continue to cause volatility in the near term, but that does not suggest a bear market is imminent. There is certainly plenty to worry about, but fundamentals for stocks are showing relatively strong signals with earnings growth expanding at a rapid pace. Stock buybacks, which tend to occur when management believes the stock is undervalued, reached a record high in 2021. So, while the market faces various headwinds that threaten returns, there have been ample supports that have so far kept downside fairly limited.

Chris's Corner: New Rules for Retirement Plans

Just like the weather in Rochester, financial regulations are ever changing. Two recently proposed changes could upend your plan for drawing money from inherited IRAs and how you save in your 401(k) if they are approved later this year.

The Secure Act put new regulations in place in 2019 for drawing money from inherited retirement accounts, but the IRS just issued new "guidance" that could further change those rules. The 2019 law eliminated the ability to draw money out of inherited retirement accounts over the course of the beneficiary's life expectancy, the so-called stretch option. Rather, these accounts had to be fully drained over a ten-year period, with a few exceptions for spouses, someone less than 10 years younger than the decedent, a disabled individual, and a delay for minors until they reach 21. The vast majority of the time, this would result in larger draws from qualified retirement accounts, which results in greater tax liability.

The biggest reason for the change, unsurprisingly, was that it would raise revenue for the Treasury by accelerating taxable distributions. The Joint Committee on Taxation estimated that the elimination of the stretch option will raise an additional $15.75 billion in federal revenues from 2020 through 2029.

Even with the 2019 rules, retirement plan beneficiaries had the flexibility to take money out of their inherited retirement accounts at any time over the subsequent ten years. It could be one tenth each year, all up front, all in year ten, or any other permutation. You could decide what was most beneficial to you based on your financial needs and tax circumstances.

However, the new guidance reduces this flexibility by requiring inheritors of accounts whose original owner died after they started taking required minimum distributions (RMDs) to take at least some money each year. The annual distributions have to be at least as much as the original account owner's RMDs would have been. Nevertheless, the full balance of the account still has to be distributed within the ten-year period, even if the RMDs don't get you there.

If the original account owner had not yet started RMDs, then no annual draws are required for beneficiaries, but the account must still be fully distributed within ten years. Similarly, Roth IRAs may be liquidated however the beneficiary chooses over the ten-year period.

Think this is confusing? Wait, there's more.

A bill passed by the House or Representatives could change the way you contribute to and draw from your 401(k) plan and other retirement accounts. The Secure Act changed the age for RMDs from 70 ½ to 72, and now that age may be raised even further, to 73 next year, 74 by 2030, and 75 in 2033. There would also be a boost in catch-up contributions for some. Currently those over age 50 may contribute an extra $6,500 annually to their 401(k) plans. The new bill would allow those aged 62, 63, or 64 $10,000 in catch up contributions starting in 2024. Though, the catchup would have to be done with after-tax dollars in a 401(k) with a Roth provision. Further, all catchup contributions for anyone over 50 would need to be done in Roths after 2023.

Some of this is good news, as it builds in more flexibility. Much of it is bad news, as it accelerates the taxes you will owe on retirement account balances. However, all of it further complicates tax planning for retirement account owners and their beneficiaries. Depending on your circumstances, it may mean that IRA owners should accelerate some of their distributions before their RMD age, convert balances to Roth IRAs, or delay draws to the extent possible in order to reap the greatest benefits across generations. As always, we are happy to talk through the details of your situation to help minimize the tax bite and optimize your retirement savings.

Alternatives: An Idea Whose Time has Come?

None of us thought we would live long enough to see our group of alternative investments reverse their multi-year slump, but it is finally happening. Our alternative investment portfolio has outperformed stocks and bonds so far this year and over the past twelve months.

That may seem like no big deal after several years of relatively poor performance, but alternatives as a group are now ahead of bonds since we started investing in them. And that is why we bought them in the first place. Interest rates were already low several years ago, and it seemed unlikely that bonds would be able to generate sufficient returns in such an environment. The solution? Find new investments that could hedge the risk of stocks while also earning higher long-run returns than bonds. We did that. But it didn't start out so well.

That said, every investment has up and down cycles. It can be tough to ride through the down cycles, particularly when stocks are doing so well, but we kept reviewing our investment thesis (which seemed sound) and the longer-term historical data (which was supportive) and tried to tune out the short-term noise. It hasn't been easy, and not everyone has been happy investing in esoteric funds with higher costs and lackluster recent performance.

It is too early in this new cycle to declare victory, but our alternative funds are holding up quite well as stocks and bonds decline. There is also reason to expect a brighter future as the overall stock market and economic landscape is changing. Since 2008 diversification hasn't really worked. The best bet, in retrospect, would have been to put all your money in large, U.S.-based, technology stocks. They have outperformed virtually everything else, just like during the Dot-Com Bubble of the 1990s. However, that cycle ended quite badly for tech stocks and the power of diversification was once again revealed in the 2000s. We expect a similar outcome this time around.

In some ways it is already happening. Unprofitable tech stocks have been some of the biggest losers in the stock market recently. Value stocks have held up fairly well, and the overall stock market so far has been more tenacious than many would have guessed. Still, there are plenty of reasons to worry. Diversifying into lower, or uncorrelated, alternative asset classes can help reduce large stock and bond market losses.

In terms of our alternatives group's construction, they were selected because they have low correlation to stocks, and therefore can make excellent diversifiers. As expected from a diversified group, we have had some funds that haven't performed great, such as the BlackRock Systematic Multi-Strategy Fund (BIMBX) and the reinsurance and catastrophe bond funds we have bought. However, as a group the alternatives have done quite well during a volatile time for stocks.

There is still ground to make up, but we have seen impressive gains for our "style premia" funds, our managed futures funds, and the alternative lending fund we use. In some cases, these funds still have anemic returns since we first bought them, but they are making up ground quickly with double digit returns so far this year.

For those holding private real estate, returns have also been strong. The former Broadtree fund (we'll probably never stop calling it that since the new name is so cumbersome) was up almost 50% last year. Residential real estate is a solid hedge against inflation since leases can renew at higher rates each year.

The macro environment continues to create a solid backdrop to seek additional diversification, and we hope for further gains in our group of alternatives. Historically these funds have held up well during stock market drawdowns. Although every market cycle is unique, we're happy to see them finally working as prescribed.

Country Mouse

continued from page 1

ultimately disappeared behind the stove. After a while when Nipa had regained composure, which I assume was measured in hours, she proceeded to disinfect the kitchen.

I happened to call that evening to check in and was told of the day's events. I helpfully mentioned that it is accepted custom when a mouse chases after the farmer's wife to merely cut off its tail with a carving knife. I was the only one who found that funny.

Upon my return home a couple days later, I was greeted by a kitchen full of all manner of mouse traps. We had the gluey kind, the snappy kind, and the kind where the mouse runs in, but can't run out. I'm not sure how much we spent that month on mouse traps, but I assume it was a lot.

Interestingly, while the traps didn't actually work, they did seem to have a deterrent value. We didn't catch the mouse, but it seemed to stop coming around.

We're not really sure how to explain the absence. Perhaps with a little warmer weather, the mouse decided to move back outside. Maybe it found more comfort in the basement than the kitchen. Maybe it was overly sensitive and decided not to live someplace with negative Chi. Or, just maybe, this mouse was a presidential historian and knew that it was best to back off when someone spoke softly and carried a big stick.

Whatever the reason, we were mouse-free, albeit with some unease and a whole lot of mouse traps still scattered around the kitchen, for a few weeks. Then, one day Nipa noticed some very small tooth marks in the butter that had been on the counter overnight. At that point, I decided to engage.

My wife made a valiant effort, but with her urban upbringing, she was less well equipped to deal with such a crisis. I recalled that peanut butter is like crack cocaine to rodents. So, I grabbed one of the more nefarious traps, dabbed a bit of peanut butter right in the middle, and put in on the counter near the scene of the previous night's crime.

That's all it took. I'll spare you the details but suffice it to say we no longer have offending fauna roaming wild in our house. At least until next winter.

Armbruster Capital Management, Inc.
(585) 381-4180
info@armbrustercapital.com | www.armbrustercapital.com

© Copyright Armbruster Capital Management, Inc. 2022. Reproduction in whole or part without permission is prohibited.