INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 3RD QUARTER 2023

The ACM Journal

Dog Days of Fall

Life is busy. Outside of work, we have active kids and are constantly taking them to practices, going to their races or recitals, or scheduling social events. We have our own social obligations, and a labor-intensive property that requires hours of maintenance each week. Most of the time we're either running somewhere or worn out from all the activity. So, naturally, we decided to get a puppy.

When I say "we", I really mean my daughter Nyla. She is thirteen and has wanted a proper pet for some time. We haven't had a dog in seven years, and the barn cats that we have tried to placate Nyla with keep either dying or disappearing. Upon the mysterious permanent absence of our last barn cat, Nyla declared that she had had enough and that we were getting a dog.

There was resistance. Nipa and I tried using logic: we're already too busy, we travel too much, you're going to college in a few years. But it was no use. Nyla waged a psychological operations campaign against her parents. Every time I put on my shoes to go to work, there was a picture of a puppy at the bottom. The same was true when Nipa got a mug to make a cup of tea. Everywhere, all the time, the discussion turned to puppies and how life would be better with one.

We like to think we held strong, but the slippery slope must have kicked

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Portfolio Review

After three consecutive quarters of positive returns, stocks were unable to keep the streak alive and edged slightly lower in the third quarter. Most of the negative performance occurred in September, which was the worst month for the stock market this year. Bond returns were also negative this quarter, while liquid alternatives provided a welcoming boost to returns.

Tech Rally Slows

Returns in the first half of the year were dominated by a handful of well-known, mega-cap technology stocks, which contributed to large-cap stocks' vast outperformance over small-cap and international stocks. This trend reversed somewhat in the third quarter as returns were generally similar across asset classes. Emerging Markets had the best performance among stocks for the quarter with a loss of "only" 2.9%, while small-cap stocks fared the worst with a decline of 4.9%.

The return distribution between various factors and sectors was also not so wide in the third quarter. For the four factors we track (value, momentum, high quality, and low volatility), the domestic stock returns were within a few percentage points of each other. Quality continued to be the strongest performing factor, outpacing both the benchmark and the other three factors for the third consecutive quarter. Sector returns were also more narrowly distributed between each other compared to the first half of the year when technology, consumer discretionary, and communication services stocks greatly outperformed the rest of the market by a wide margin. Most sectors were modestly negative for the quarter, with the main outlier being energy stocks, which returned over 12% thanks to a $20 increase in crude oil prices.

The concentration of the top ten stocks in the US is currently at a level not experienced since the late 1800s, comprising more than 30% of the S&P 500. While this amount of concentration risk alone is concerning, the high valuation levels of these companies is cause for additional concern. The average Price/Earnings ratio for these ten companies is almost twice as high as the average for the overall S&P 500, which is significantly above its long-term average. Some of these companies, such as Amazon and NVIDIA, have P/Es over 100x. History has shown that when we have this combination of stocks that are highly concentrated and highly valued, the outcome for undiversified investors is usually poor. This was true in the aftermath of the Nifty Fifty stock era in the 1970s, the Dot-Com Bubble bursting in the early 2000s, and even as recently as the downturn in tech stocks in 2022, when the Magnificent 7 lost about 40% on average and unprofitable tech stocks fell even further. When these downturns occurred in the past, having a diversified portfolio helped to provide downside protection. Factor investing also outperformed in these market environments. So, while diversification has looked pretty foolish so far this year, being unduly concentrated in any one industry is a very risky approach.

Bond Yields Rise Rapidly

Interest rates rose again this quarter, but this time it was long-term interest rates

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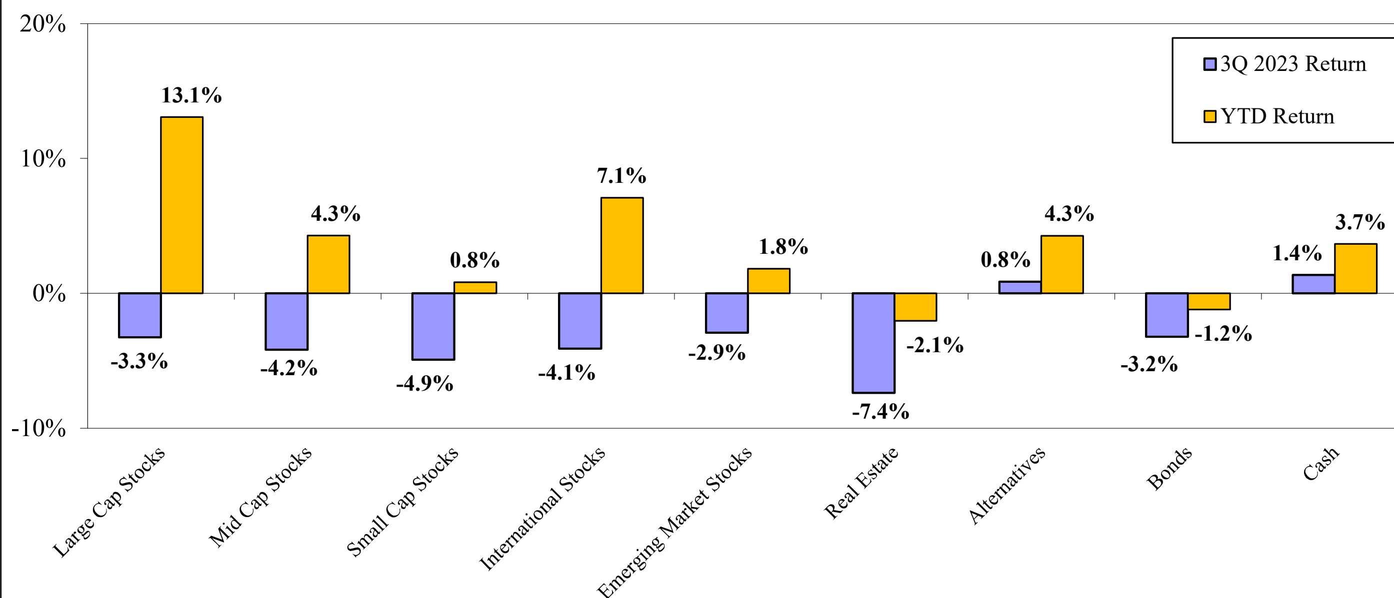
Third Quarter 2023 Asset Class Returns



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. Bonds are the Bloomberg U.S. Aggregate Bond Index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Cash is the yield on the 3-month T-Bill.

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that rose substantially while short-term rates were stable. The 10-year Treasury yield jumped from 3.8% to start the quarter all the way up to 4.6% to end the quarter and inched even higher to above 4.8% in the days after quarter end. Meanwhile, the front end of the yield curve barely budged, as the 2-year Treasury yield moved from 4.9% to only slightly above 5% at the end of the quarter. This is the opposite of what we experienced in previous quarters when the front end of the yield curve shot up as the Fed aggressively hiked interest rates, but longer-term rates held steady.

The Fed raised the Federal Funds rate by 0.25% during the quarter, a slowdown from prior periods. However, the notion that they may need to keep rates higher for longer to mitigate inflationary pressures is starting to permeate the bond market, and likely was part of the reason longer term rates rose so much during the quarter.

The rise in yields continued to put pressure on bond returns, as the Bloomberg Aggregate Bond Index was down -3.2% for the quarter. However, short duration bonds were able to avoid some of the negative price impact and posted a small positive return. Bond investors may feel further pain in the near term if rates continue to rise, but current yields offer expected long-term returns that we have not seen for over a decade.

Another Strong Quarter for Liquid Alts

While the bond market has posted lackluster returns over the past three years as interest rates rose, alternative investments have helped provide healthy returns that have been largely uncorrelated with stock market returns. The third quarter saw a continuation of this trend. Style premia rose by nearly 13% in the third quarter alone, bringing year-to-date performance up to 19.4% and three-year annualized returns to an impressive 23.5%. Catastrophe bonds continued to deliver positive returns as industry losses for reinsurers have been mild this hurricane season. Other liquid alternative strategies have also managed to outperform the aggregate bond market year-to-date. Investors who were able to endure the subpar returns of some of these strategies in the late 2010s have now seen the benefits of alternative investments. They don't outperform all the time, but they offer significant diversification benefits and have helped buffer portfolios when both stocks and bonds have been down.

Overall, the third quarter wasn't a great one for investors. Returns for stocks are still strong year-to-date, but the tide feels like it is turning and leadership within the stock market may be changing. Diversification, which hurt returns early this year, will likely become increasingly important. The days of tech stocks heading straight up seem numbered.

Chris's Corner: Do I Owe Taxes on my Home Sale?

With persistent inflation driving up the cost of just about everything, particularly home values, people are often surprised when they receive a 1099-S and find out they may have to pay capital gains on the sale of their home. Today's rules are a result of the Taxpayer Relief Act of 1997.

According to the law, you can exclude up to $250,000 ($500,000 if married) worth of profit when selling your primary residence. Profit being defined as the sale price minus the price you paid plus the cost of any improvements made to the home (so keep receipts when you make home improvements).

However, there are some stipulations. You can only use the exemption on your primary residence and not a vacation home or rental property. There is a residency requirement as well where you must have lived in the home for two out of the past five years before selling. Using the exemption is also only allowable once every two years.

Qualifying for the exemption is important though, as capital gains taxes can take a large piece of your profit. Short term gains on ownership less than one year, can be taxed at up to 37% and long term gains up to 20% depending on your filing status and income.

It is also important to keep in mind that widowed spouses have an opportunity to claim the larger $500,000 exemption. If a widowed spouse sells a home within two years of the death of a spouse, hasn't remarried at the time of sale, neither the seller or late spouse took the exclusion within two years before the date of sale, and met the two year ownership and residency requirements, he/she can qualify for the larger exemption.

Widowed spouses should also be aware of stepped-up basis when calculating their gains. Most states are community property states, including New York, North Carolina, and Florida, meaning that you receive stepped up basis on half of your home value when your spouse passes. In non-community property tax states, including Arizona, California, and Texas the surviving spouse receives a full step up in basis on the entire value of the home. If you are having a tough time estimating the value of the home at the time of death, the IRS will accept a report from a qualified appraiser who can do a retrospective appraisal which determines the fair market value at a specific date in the past.

Most of us don't buy and sell homes that frequently, but keeping these rules in mind can help when making decisions about selling your family home. A big tax bill and the potential for a new mortgage at higher interest rates may have some thinking twice before moving.

What if we Don't Have a Recession?

Early last year, it was common knowledge that we were about to enter a recession. In fact, many in the media were calling it the most anticipated recession ever. Despite the certainty, we're still in an economic expansion, and now many prominent economists, including those in the Fed and Treasury, are saying a recession is no longer in the cards.

That certainly sounds like good news, particularly when you consider that past recessions have generally been accompanied by stock market downturns. However, we're not so sure we're out of the woods.

First, we think there will still probably be a recession, or at least a long period of economic stagnation. The huge increase in government debt globally over the past few years all but guarantees that GDP will not be able to grow as it has in the past. There are other headwinds too with high interest rates, still uncontrolled inflation, and longer-term demographic problems, to say nothing of all the political and geopolitical strife we are now experiencing.

However, let's say that we're wrong and that Jerome Powell and Janet Yellen are correct. The economy will continue to grow, inflation will be brought in check, and we'll all live happily ever after, right? Maybe not so much. We think that a mild recession is what the market is expecting currently and may be the best-case scenario for investors. If there is no recession, things could get ugly in the stock market.

The reason, primarily, is interest rates. Most days when weak economic data comes out, the stock market rallies in the hope that the Fed will stop raising short-term interest rates and may even cut them next year. However, strong economic data generally results in stocks retreating. Clearly the Fed and its impact on interest rates is having an outsized influence on stocks.

If we don't have a recession, then the Fed is unlikely to cut short-term rates. That's bad news for stocks, but we believe it is far worse than that. Currently the yield curve is inverted, meaning longer-term bonds yield less than short-term bonds. That usually only happens just before recessions. If it becomes clear that the economy will keep chugging along, it is likely that the yield curve will normalize.

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What if we Don't Have a Recession?

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That means that the ten-year Treasury yield will have to rise. The Fed won't cut rates in a strong economy, and the Fed Funds rate is currently targeted at 5.25% to 5.5%. Historically the spread between the ten-year Treasury yield and the Fed Funds rate has been more than 1%. That implies the ten-year Treasury yield would have to rise from 4.6% at the end of the third quarter to something closer to 7%, particularly if the Fed continues to raise interest rates this year as it is signaling.

Can the economy handle long-term rates at 7%? That would probably put mortgage rates close to 10%, raise the cost of financing operations for corporations significantly, and consume far more of the government's budget just for interest expense on its debt. People would not be able to pay as much for cars, and debt across all categories would become more expensive. That would slow consumer spending and reduce capital expenditures for corporations, restraining potential GDP growth.

High interest rates also impact the way investors value stocks. Lower rates equate to higher valuations and higher rates generally compress stock valuation multiples, such as the Price/Earnings ratio. It is unlikely that the tech sector would be able to sustain its lofty Price/Earnings ratio, and that would impact the pricing of the S&P 500, which currently has a lot of exposure to the largest technology stocks.

All of this suggests that a Fed-engineered soft landing or "no landing" scenario could be close to the worst-case scenario. But don't worry, we'll likely have a recession. That might not be great for stocks, but slow growth is probably less damaging than a big, unexpected spike in interest rates.

Dog Days of Fall

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in, because here we are with a dog. To her credit, Nyla did a lot of work. She researched breeds and decided that a Chinook was the right dog for us since they are smart, easy to train, family oriented, and tend not to be aggressive with other people and animals. They also have a bit of sled dog heritage, which means our dog could join us in the winter sports we enjoy. Nipa and I raised questions with the goal of subverting the process, but Nyla was prepared. She found a Chinook ambassador program where families would allow you to come meet their dogs. She arranged appointments in both Buffalo and Ithaca, and we set out to meet our destiny.

I think the owners were a little surprised to find they were corresponding with a teenager, but they were welcoming and answered a lot of questions we had about Chinooks. Much of what Nyla researched turned out to be true, which unfortunately meant that a lot of the objections Nipa and I raised were falling in the face of Nyla's barrage. The last step was finding a dog, which we were told could take a year or more. Folks interested in breeding get priority, and those merely looking for pets go to the back of the line. We took some comfort in that.

Alas, things didn't go as planned. Nyla found a breeder in New Jersey, and we discovered through our discussions with Chinook owners that this breeder is sort of the grand poohbah of the Chinook world. When we did a Zoom call with her, it turned out that she had a puppy currently available. This little guy had some lab in him but was mostly Chinook. Nipa and Nyla couldn't resist the wagging tail and undeniable cuteness, and the next day we drove down to Pennsylvania to meet the breeder and pick up our new family member.

We named our new dog Oslo, after the ski wax[1]. Omar wanted to name him Star Crusher Devourer of Worlds. Amer favored Barkimedes. This time however, Nyla got most of the input, and she thought Oslo was a nice mix of cuteness and a nod to our Nordic sporting activities.

Life now is busier than ever, except we aren't sleeping much and we're constantly training, correcting, taking things away from, or cleaning up after the dog. Rugs have been soiled, shoes have been chewed, plants and other assorted items have been destroyed. Tempers have been short in some cases, but all of us have fallen in love with our new critter and are willingly suffering the consequences. Nyla is thrilled, but perhaps that is mostly because she gets to cuddle with the dog while Nipa and I do all the work. Who would've guessed?

[1]For any potential readers in the Nordic ski community, I am aware that Start kick wax is not that good and that no self-respecting skier would advocate its use, much less name their dog after it. However, the Start Oslo line is an exception, and I have a team that became state champions using it.

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