INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 4TH QUARTER 2023

The ACM Journal

Winning

The holiday season is a time to pause, to reflect, to give thanks, and in my house, a time to pursue victory.

It starts with Halloween. We live on a country road with not many houses on it, so we have always had to drive to a nearby neighborhood to take the kids trick-or-treating. Since we choose a relatively fancy neighborhood (they give out the best candy), the houses are spaced out quite a bit. When the kids were little and not able to walk so far without complaining, I used to egg them on by telling them they had to hurry up if they wanted to win Halloween. It has become sort of a joke in our house now, but much to my delight, our daughter still wants me to take her friends around that neighborhood, and everyone is warned in advance to wear running shoes so we can move fast and win Halloween. If we jog and get around the neighborhood quickly, like this past year, we sometimes drive to another neighborhood. That results in way more candy than any of the kids will eat, but that isn't the point. The real point is to win. Regardless of the candy, I feel like I win any year I can be a part of the activity since my Halloween days are numbered. As soon as the kids stop going out or stop allowing us to accompany them, Halloween is over for us since no one ever comes to our remote house for candy.

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Portfolio Review

Coming into 2023, there wasn't much to be excited about. The prior year saw dismal returns for both stocks and bonds, stock valuations were still high compared to their long-term averages, the Fed was still hiking interest rates, and multiple recession indicators were flashing red. Things didn't improve much from there, as several regional banks failed over liquidity concerns and the potential of a default on government debt increased as policymakers debated over the debt ceiling. Even worse, a war broke out in the Middle East, and the war in Ukraine continued to drag on. This is not the ideal backdrop for investors, yet despite these issues, stocks performed exceptionally well throughout the year. US large-cap stocks led the way, as small-cap and international stocks trailed but still posted double-digit returns for both the full year and the fourth quarter.

Performance Drivers for Stocks

The stock market behaved very differently in the second half of 2023 compared to the first half. Returns were quite narrow to start the year as overly exuberant investors flocked to technology stocks on the increasing potential of artificial intelligence. While a relatively small number of stocks, the so-called Magnificent Seven, boosted returns in the first half of the year, the remaining stock market in aggregate was relatively flat. This changed in the second half of the year as the market began to broaden. Much of the rally towards the end of the year can be attributed to a decline in long-term interest rates with investors expecting an easing of monetary policy in the near term.

Unlike in the first half of the year, diversification started to matter again in the latter half. Small-cap stocks finally outperformed large-caps in the fourth quarter. Value, quality, and momentum factors in US markets also slightly bested core benchmarks. International and emerging markets stocks continued to lag US markets, but the performance gap was narrower compared to earlier in the year.

Bond Rally

Bond investors finally received some relief to end the year after three years of negative returns. The aggregate bond market returned over 6% in the fourth quarter, elevating the annual return for the index to 5.5%. Despite the potential for interest rate cuts in 2024, we still see benefits to holding shorter-duration bonds. The yield curve is still inverted, meaning bondholders are earning a higher yield by taking less interest rate risk. And while inflation is currently slowing, there have been periods in the past (late 1970s) where monetary policy that was too dovish helped contribute to a second round of inflation. Along with a tight labor market and rising national debt, higher long-term interest rates are not out of the question. In a scenario where interest rates either rise or remain stable, shorter-term bondholders will benefit.

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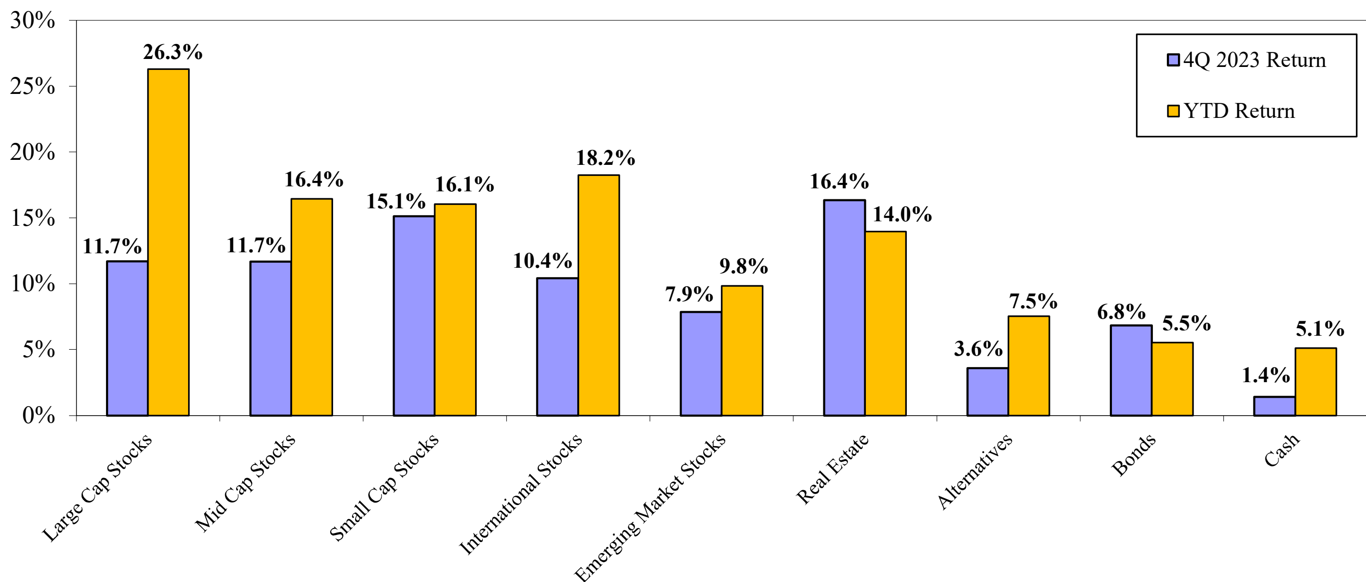
Fourth Quarter 2023 Asset Class Returns



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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Alternatives (Continue to) Rally

Liquid alternative investments posted a third straight year of exceptional returns. Catastrophe bonds were the MVP this year returning 44.6% for one fund we use. This was the result of both a quiet hurricane season and increased reinsurance rates. Even the more conservative catastrophe bond funds we use rose double-digits. Looking at some of the other strategies in the asset class, AQR's style premia fund returned 12.8% and the multi-strategy fund gained 6.4%. Managed futures and alternative lending did not do as well in 2023, but these two strategies still have annualized returns of around 10% over the last three years. We've discussed some of the drawbacks to alternative investments (high fees, tax inefficiency, and sometimes reduced liquidity), but they have proven strong performers and important sources of diversification the past few years.

Expectations for 2024

If 2023 is any indication, trying to time the market with any consistency is nearly impossible, especially over a short-time period. The market largely shrugged off the increasing geopolitical risks (wars in Ukraine and Middle East, increasing political polarization) and numerous economic risks (global debt overhang, tightening monetary policy, above-average inflation). Many of these risks remain going into 2024, and likely more will emerge, especially in an election year. Valuations for the broad market are high, but there are still pockets of attractive stocks with lower valuations, such as within value strategies, small-caps, and internationally. It is no guarantee that these strategies will outperform US large-cap stocks in the near term, but they certainly appear to be a more attractive part of the market to invest in over an extended time horizon based on their fundamentals.

For bonds, current yields offer investors a long-term expected return higher than what we have seen in over a decade. However, if inflation remains above the Fed's target or begins to rise again, we may see yields shoot back up, bringing further declines in bond prices. And for alternative investments, while it is difficult to predict the success each strategy will have, higher short-term interest rates benefit many of these strategies with a higher collateral return. While alternative investments are largely uncorrelated with a traditional stock and bond portfolio, the strategies are also uncorrelated with each other, which contributes to an enhanced level of diversification to the overall portfolio.

The Year Ahead

A year ago, we had a fairly pessimistic outlook on the economy and capital markets. The prospects and implications of inflation, rising interest rates, reckless fiscal policy globally, high stock market valuations, and increasing tensions around the world all seemed to pose significant head winds for future growth and investment gains. We were somewhat wrong of course. Much of what we anticipated came to pass and there was a lot to be concerned about last year, but the economy still hasn't entered a formal recession and stocks, bonds, and alternative investments all had solid years. At the risk of once again looking foolish, we're still not jumping for joy.

It is important to note that we don't change portfolio strategy based on our short-term views of the economy and capital markets. Last year is a good reason why. No one can time the market and forecasts of economic growth are notoriously wrong, worse than coin flipping according to some studies. Rather, we rely on long-term data to build long-term portfolios that should provide market-beating returns with acceptable levels of risk over multi-year periods. That said, we are frequently asked what we think about the state of the world, at least as relates to financial matters, so here are our thoughts for the coming year.

It may lack credibility at this point, but our outlook for 2024 is similar to what we thought going into 2023. We still see potential for financial, economic, and political unpleasantness that could roil portfolios.

The much-anticipated recession of the past couple years has not materialized, but the warning signs are still there. The yield curve remains inverted. Historically that has been almost a flawless predictor of coming recessions in the U.S. Is it different this time? Maybe. But it would not be surprising to see an economic slowdown, if not an outright recession before long. Many of the economic data releases show seemingly positive headline numbers, but if you scratch beneath the surface, the news often isn't so good. For example, the unemployment and job creation numbers have looked solid lately. However, when you look at the quality of the jobs created, you see that many of them are part-time jobs for low wages. This means that people are taking second or third jobs to keep up with the rising cost of living. That is far less rosy than new full-time jobs with a healthy labor participation rate. There has also been a new wave of layoff announcements in the past couple of weeks from the large technology companies. They have been the stalwarts of growth in recent years, but it seems even they may see dark clouds on the horizon.

Speaking of the rising cost of living, the Fed and other government entities have all but declared victory in the fight against inflation. While it is true that inflation has come down quite a bit from the 9.1% rate it hit last July, it is still running almost twice as high as the Fed's target. That doesn't sound like victory to us. We're also concerned about historical precedent. In the 1970s inflation rose to 5% early in the decade, receded to 2.7% in 1972, then spiked to over 12% in late 1974. It fell again to 4.9% in 1976, but reached an astronomical 14.7% in 1980. Even over fairly short periods, inflation can ebb and flow. Governments globally, and particularly in the US continue to print money and run large budget deficits. Those practices are inflationary, and the Fed often can't contain inflation by itself. If one arm of government is trying to rein things in while the other still has its foot on the accelerator, it makes the job much harder. We would not be surprised to see inflation rise again in the relatively near term, and we believe that may be the new normal as longer-term demographic trends shift. Population is declining in much of the world, which will ultimately mean fewer workers supporting relatively more retirees. Retirees consume and workers produce. If there is more demand than supply, inflation rises.

Rising inflation also likely means rising interest rates. Yes, the Fed is talking about cutting rates this year, but longer-term rates are set by the markets, not the Fed. The 10-year Treasury rate has moved quite a bit higher the past 2-3 years, and it is not unreasonable to assume it will keep climbing for some time. Historically interest rates have moved in 25–40-year cycles. It seems clear that the last cycle ended in 2020 when the yield was only 0.50%. A new rising interest rate environment for the next couple decades could significantly change the way our economy functions. Businesses won't be able to borrow at the same low rates they have enjoyed for years, which means lower profitability. That likely means lower valuations for stocks. Mortgage rates may not ever return to the 3% we grew accustomed to, which raises the cost of living for individuals and families. All of that results in a slower growing economy and will likely put pressure on stock market valuations.

Then, there is the election elephant in the room. The nation is historically divided and the two front runners for President bring a lot of baggage with them. Primary season is just heating

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The Year Ahead *continued from page 3*

up, so maybe there will be a surprise before the general election, but if we have another Trump vs. Biden choice, it seems likely the shenanigans will be unprecedented. That creates a lot of uncertainty, which is never good for the stock market. In fact, if you remember in 2016 when it was announced that Trump won the election, the stock market futures were down more than 1,000 points over night. Once the market opened, stocks reversed course and gained 800 points. This election is poised to be even more bitter and partisan, so extreme stock market volatility is a strong possibility.

All of this sets up an interesting backdrop but what makes it worse is the fact that the overall US stock market is still trading at a historically high valuation. There are a number of ways to look at valuation, including the price-to-earnings ratio, the CAPE ratio, price-to-sales, etc. Regardless of the metric used, the S&P 500 looks frothy. The S&P is dominated by large-cap growth stocks, predominantly technology companies. Those stocks, which the financial media now calls the Magnificent 7 (Apple, Google, Microsoft, Amazon, Meta, Tesla, and Nvidia), seemed overvalued a year ago, but continued to move higher. It is possible that will recur this year, but the odds are increasingly slim. I think back to the 1990s during the Dot Com Boom. The market, also dominated by tech stocks then, looked expensive in 1996, but it continued to move higher until 2000 when it ultimately came crashing down. We may not see the same dramatic end to this tech stock rally, but there are signs that the market will at least rotate away from the most expensive stocks, particularly as their growth slows.

In fact, if you strip out the Magnificent 7, much of the stock market appears reasonably priced. Value stocks, smaller-cap stocks, and international stocks all trade at historically low valuations. Many of these stocks don't look great when viewed in the rearview mirror, but looking forward, it would not be surprising to see a recurrence of the 2000s when large growth companies lost money every year on average for a decade while other sectors performed quite well. We expect diversification will continue to matter again, and if we're right about economic softness and election nuttiness in 2024, a stock market rotation may not be far off.

We hate to be the bearers of bad news, but it is hard to be overly optimistic in the current environment. Throw in other non-economic issues like our open borders, the war in Ukraine, and tensions in the Middle East, and we have the makings of a tough road ahead. That doesn't mean it will erupt into a full-scale 2008 type of financial crisis, nor warrant any changes to our long-term investment strategy, but investors should brace for the possibility of a wild ride ahead.

Chris's Corner - New 529 Plan Rules

Using 529 plans to save for college education can be low-cost and tax efficient. However, some people have shied away from using them because there is a lot of uncertainty about how they will be used.

Determining how much to save for college is always a bit of a guessing game. How do you really know how much to save when your child or grandchild is still in diapers? Will they be attending an expensive elite private university, a more reasonably priced state school, a vocational school, or maybe they are a young entrepreneur (or rebel) and skip the post-secondary education thing entirely? As silly as it sounds, the risks of saving too much for college can deter many from saving at all.

Now, there is some relief to that concern thanks to the SECURE Act 2.0 of 2022.

Starting in 2024, beneficiaries of 529 plans will be able to move unused assets from their 529 plan to a Roth IRA, allowing for tax-free growth and tax-free withdrawals in retirement. Historically, if you overfunded and wanted to disburse the funds back to yourself, you had to pay taxes on the earnings at ordinary income tax rates plus a 10% penalty. Though, as you would expect with any government benefit, there are some rules and strings attached, which include:

- The 529 plan account needs to have been in place for 15 years.
- There is a lifetime maximum conversion limit of $35,000.
- Conversions are subject to the beneficiary's annual Roth contribution limit of $7,000 for 2024 ($8,000 if over 50), meaning it will take 5 years of conversions to reach the lifetime limit.
- Contributions, and the corresponding earnings on those contributions, within the last 5 years are ineligible to be converted.

You can now, in a tax advantaged way, take care of your child's education and jump start their retirement savings (if giving them life wasn't enough). But what if you were still too responsible

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IRS 2024 COLA - Inflation Adjustments

Unified Tax Credit	2024	2023	Change
Annual gift tax exemption per person	$18,000	$17,000	$1,000
Federal estate tax, generation skipping transfer tax, & lifetime gift tax exemption	$13,610,000	$12,920,000	$690,000

401(k) Defined Contributions Limits	2024	2023	Change
Maximum employee deferral	$23,000	$22,500	$500
Employee catch-up contribution (age 50+)	$7,500	$7,500	-
Defined contribution maximum (employee + employer)	$69,000	$66,000	$3,000
Defined contribution maximum (employee + employer age 50+)	$76,500	$73,500	$3,000
Employee compensation limit for calculating contributions	$345,000	$330,000	$15,000
Key employee top-heavy plan compensation test threshold	$220,000	$215,000	$5,000
HCE nondiscrimination testing threshold	$155,000	$150,000	$5,000

HSAs & High-Deductible Health Plans		2024	2023	Change
HSA contribution limit (employer + employee)	Self	$4,150	$3,850	$300
	Family	$8,300	$7,750	$550
HSA catch-up contributions (age 55+)	Self	$1,000	$1,000	-
HDHP minimum deductions	Self	$1,600	$1,500	$100
	Family	$3,200	$3,000	$200
HDHP maximum out-of-pocket expenses (excludes premiums)	Self	$8,050	$7,500	$550
	Family	$16,100	$15,000	$1,100
Health Care Flexible Spending Accounts (FSAs) Max salary deferral		$3,200	$3,050	$150

Earnings Subject to Social Security Payroll Tax	2024	2023	Change
Max earnings subject to 12.4% FICA tax (6.2% employer, 6.2% employee)	$168,600	$160,200	$8,400

IRA Contributions Limits	2024	2023	Change
Traditional or ROTH IRA Contribution Limit	$7,000	$6,500	$500
Catch-Up Contribution (50+)	$8,000	$7,500	$500

IRA AGI Deduction Phase-out Starting at	2024	2023	Change
Joint Return	$123,000	$116,000	$7,000
Single or Head of Household	$77,000	$73,000	$4,000

WINNING *continued from page 1*

Next up is Thanksgiving. We host a turkey trot in our small town. There had been an organized race several years ago, but it folded, and I decided to pick up the pieces. We invite just about anyone to join us for a pre-gluttony 5k run. We advertise it as a very informal event, and we don't even have proper timing. It really is just a way to get families out doing something active, fun, and social. This year we had around 125 runners, many of them were college kids who used to be on my ski team, so it is always a nice reunion. But, despite the fun and lack of official timing, to all the high school and college runners, this is as competitive as the Olympics. The kids all have GPS watches and post their results on the Strava social media app. They know to the tenth of a second how fast they ran, what their pace per mile was, and which of their friends they beat. Putting on the race is a lot of work, but I love this event. Just like Halloween, I feel like I'm the real winner every year, regardless of who runs the fastest.

Christmas might seem like a tough holiday to build competition around, but somehow my kids have done it. It isn't exactly the Festivus feats of strength, but the sentiment is the same. Two years ago, after all the presents were opened, my son Amer declared that he won Christmas. He of course meant that he thought he got the best gifts. It happened again this year. Amer declared himself the victor, and I think his older brother may have agreed with him. Poor Omar got gifts he wanted, but many of them were the wrong size and we had to spend the next two weeks dealing with returns and exchanges. By "we" I of course mean Nipa.

I'm not sure where this competitive spirit came from, other than my early Halloween exhortations. Though, I was also reminded recently that when the kids were very young, we used to make fruit smoothies. They liked the idea of making the smoothies but were never terribly focused when it came to drinking them. So, I would drop two or three straws in, and we would all drink the same smoothie through our own straws. I told the kids they had to focus because we were having a smoothie race. It worked, but after a while they asked how you would know who won. I replied: "whoever finishes first of course". They seemed to accept my illogic, and the smoothie races continued for several more years.

In the end, maybe it was my duplicitous, if well intentioned, ploys that caused the kids to always want to win. Maybe they still feel that pressure and think they need to win in order to gain their mother's and my affection. Maybe that will carry long-term psychological implications and give them something to talk with their therapists about in the future. Or, on the plus side, maybe this will be the spark for weird traditions they one day create with their own families. Who knows? Either way, I get to be part of the holiday celebrations.

CHRIS'S CORNER
NEW 529 PLAN RULES
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and your 529 plan is overfunded by more than $35,000? Here are some other strategies to consider:

- Change the beneficiary. You can change the beneficiary to another family member, including yourself, other children, nieces, nephews, in-laws, step siblings, etc. Maybe you want to go back and obtain a graduate degree, or take a basket weaving class at trade school? It counts.
- Save for future grandchildren. There are no deadlines on when funds need to be disbursed, so you can let the money grow and when a new grandchild is born change the beneficiary at that time.
- Funding up to $10,000 per year for private elementary and secondary education. Unfortunately, this does not qualify in New York, California, Illinois, and a handful of other states that you would expect. These states don't follow Federal tax law regarding 529 plans and will tax the distribution. They really want your children to attend their public schools.
- Penalty free non-qualified withdrawals. Although you will still be required to pay taxes on the earnings in the account, there are circumstances where you can distribute the funds but avoid paying the 10% penalty. These include the death or disability of your beneficiary, or if he/she attends a U.S. military academy. Also, if the beneficiary receives a scholarship, you can withdrawal up to the scholarship award amount penalty free.

Having a 529 plan continues to be a great way to save for education, but it's always prudent to have a backup plan in case you have saved too much money.

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