Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Third Quarter of 2022

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Executive Summary

- It was another awful quarter to be an investor, with declines in global equity markets averaging -5.0% in the U.S. to -11% in emerging markets. While the quarter got off to a strong start on the hope that inflation was peaking, the Federal Reserve squashed all optimism in late August and global markets sold off for the rest of the quarter.

- Unlike the first half of the year, growth managed to outperform value, and small-cap companies outperformed larger companies in the U.S. Both results hint at the idea that when the Federal Reserve does begin to pivot, these sectors may outperform.

- International markets underperformed the U.S. market in Q3, but only because of a strongly appreciating U.S. currency. For example, developed international equity returned -4.2% in euros, a better result than -4.9% return of the U.S. market, but the return was -9.2% when converted to US dollars.

- As for fixed income, most bond indices also posted solidly negative returns for the third straight quarter due to the same forces affecting equity markets, namely inflation concerns and rising interest rates.

- Finally, other so-called real assets, which tend to perform better when inflation is high, also had a rough quarter. TIPS (Treasury Inflation-Protected Securities) declined due to their interest rate sensitivity and a decline in inflation expectations. Also, commodities dropped sharply in Q3 as a combination of a multi-decade high in the U.S. dollar, growing fears of a global recession, and sharply rising real interest rates weighed on most segments.

- In light of the poor performance of a classic 60% public equity and 40% bond portfolio in 2022, this report focuses on the **'allure' of private markets** and concludes that private equity returns are subject to the same forces that drive public equity performance and so hiding in private markets is unlikely to help much. We also discuss why success in private equity investing requires a multi-year commitment of serious capital and comes with its own set of risks.

- **Artemis strategy.** We are deeply convinced that today's pain is setting the stage for robust performance for well-diversified, balanced portfolios. As one writer recently said – "Successful investing is a marathon, not a sprint, and even extended bouts of volatility like we have experienced this year should not alter a robust, diversified investment strategy. History shows us that markets do recover and move to meaningful new highs."

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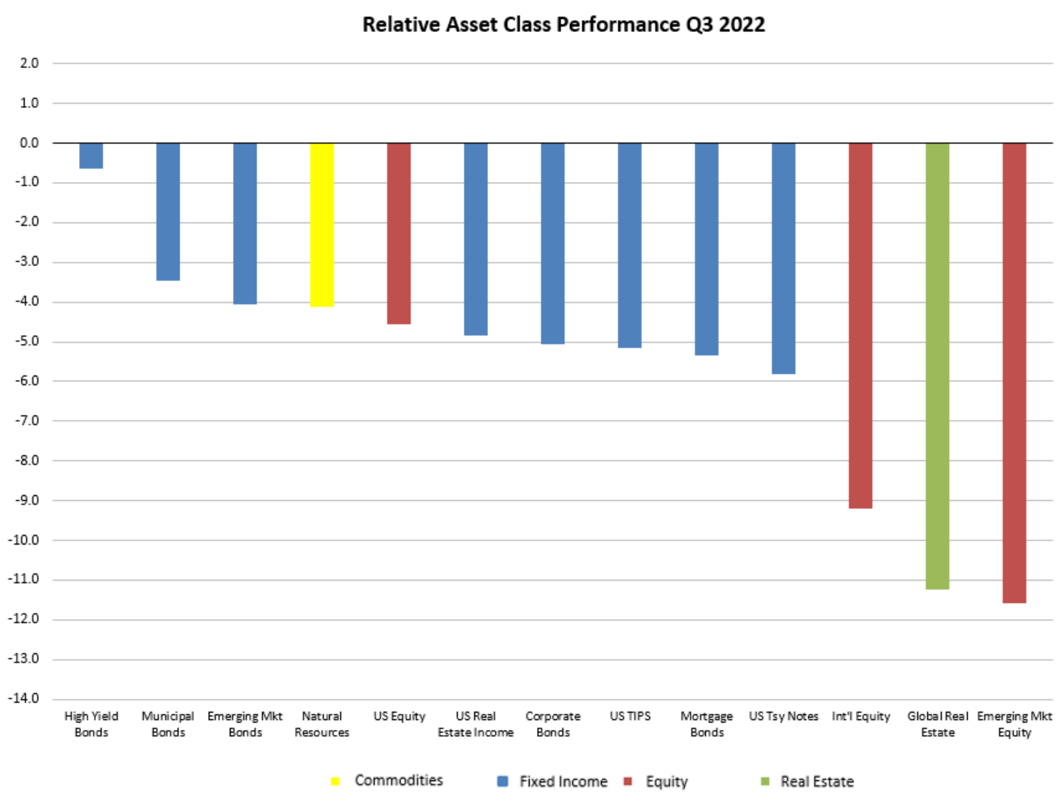
Markets in Review – Q3

It was another lousy quarter for global equity markets, with declines averaging -5.0% in the U.S. to -11% in emerging markets. (See Figure 1.)

Markets got off to a great start due largely to signs of a possible peak in inflation, resilient corporate earnings and hints from the Federal Reserve that its rate-hikes might end sooner than investors had been anticipating. The S&P 500, for example, increased +9.2%, in July alone. This optimism continued into August until Chairman Jerome Powell's remarks at the annual Jackson Hole Economic Symposium in which he dismissed any idea of a looming "pivot" to a less aggressive monetary stance. His remarks caused markets to sell off sharply in late August and September with the S&P 500 ending the quarter down -4.9%. This "false dawn" is a classic example of what is called a "bear market rally."

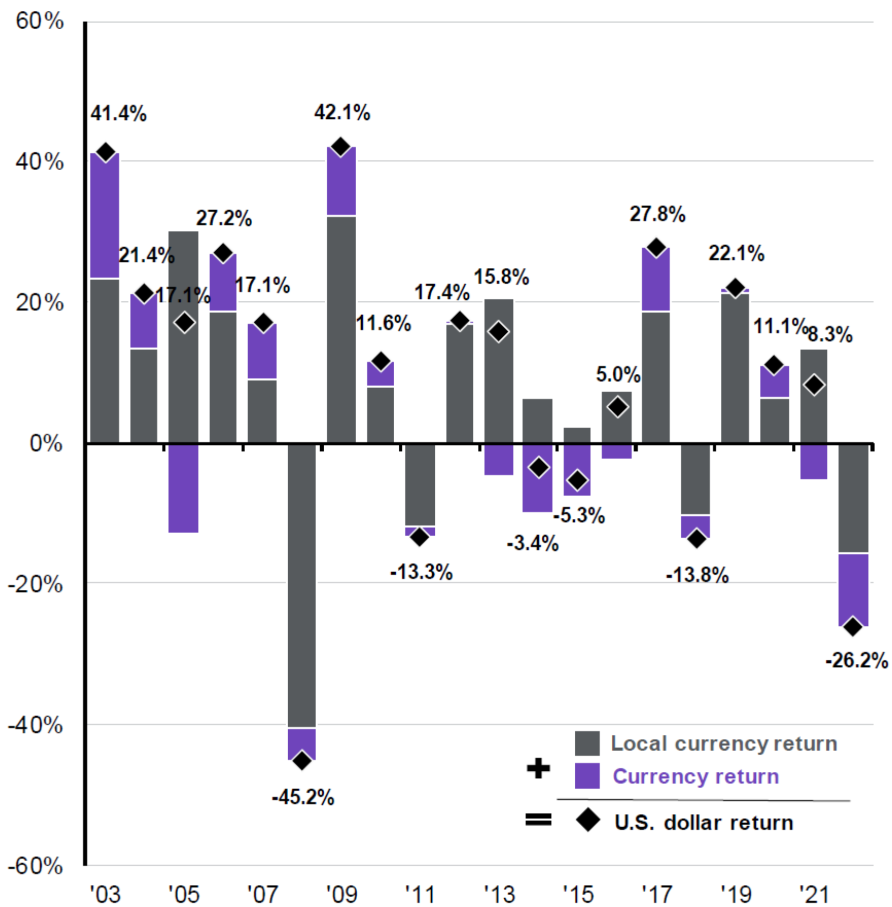
Figure 1. Asset Class Returns in USD for Q3 2022 (%)



Unlike the first half of the year, growth managed to outperform value, and small-cap companies outperformed larger companies in the U.S. over the quarter. Both results hint at the idea that when the Federal Reserve does begin to pivot, these sectors may outperform.

International markets underperformed the U.S. market in Q3, but only because of a strongly appreciating U.S. currency. For example, developed international equity returned -4.2% in euros, a better result than -4.9% return of the U.S. market, but the return was -9.2% when converted to US dollars. Figure 2 shows impact of US dollar appreciation and depreciation on international returns over the last 20 years and demonstrates the periodic importance of currency movements in international investing.

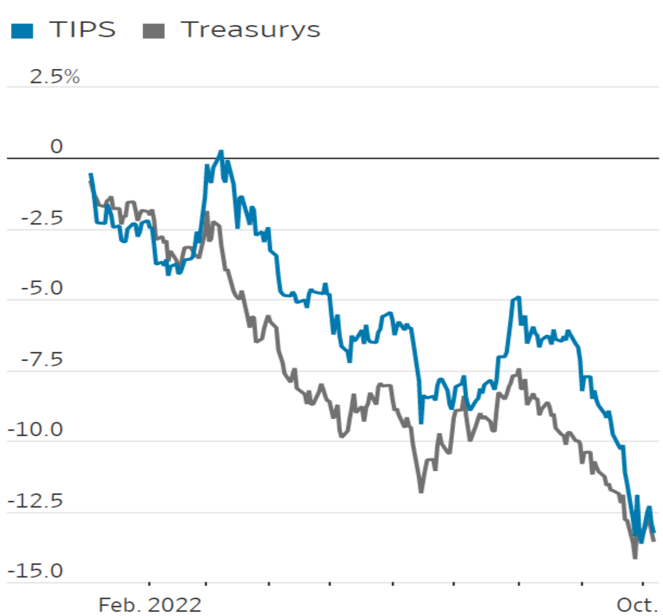
Figure 2. Impact of Currency Changes on International Returns (Source: JP Morgan)



As for fixed income, most bond indices posted solidly negative returns for the third straight quarter due to the same forces affecting equity markets, namely, stubbornly elevated inflation and continued rate hikes by the Federal Reserve and most other central banks around the world. (Turkey and Japan are notable exceptions, and for very different reasons.) The major bond market index in the U.S. declined by -4.8% in the U.S., and Treasury yields continued their march upward with the US 10-year yield rising from 2.97% to 3.83% and the two-year yield from 2.93% to 4.23% by quarter end. A fiscal spending package announced by Britain's new government at the end of the quarter (called ill conceived by many analysts) pushed yields higher, as lack of confidence in the British government's stimulus program in light of persistent inflation pressures led to a late-quarter sell-off in global government bonds, including U.S. Treasuries.

Somewhat counter-intuitively, TIPS (U.S. Treasury Inflation-Protected Securities) moved downward in Q3. (See Figure 3.) While current inflation is still elevated, inflation expectations notably declined over the summer, reducing demand for TIPS. (Inflation expectations are what investors think inflation will be in the future.) In addition, TIPS, like all bonds, were negatively affected by the Fed's pronouncement that it will continue to raise interest rates until inflation falls to its target of 2.0%. These movements underscore that TIPS are sensitive to both inflation and interest rate expectations and therefore can underperform even in an inflationary environment.

Figure 3. TIPS vs. Treasuries – YTD Returns 2022 (Source: ICE Index Data)



Finally, other so-called real assets (those that tend to perform better when inflation is high) also had a rough quarter. Commodities dropped sharply in Q3 as a combination of a multi-decade high in the U.S. dollar, growing fears of a global recession and sharply rising real interest rates weighed on most segments, including oil. Gold declined by -8.6% during the quarter and global real estate fell -11.6%.

The steep drop across the board this quarter -- with almost all asset classes selling off -- came despite economic data remaining fairly strong. Unfortunately, inflation has remained persistently high as well, which is leading the market to increasingly believe that the Fed may need to overdo it to bring inflation down and, in doing so, cause the economy to slow down so much that it causes a recession.

There is a lot of uncertainty in the air and a slowdown of some sort is expected. That said, we understand the risks facing the economy and markets and are committed to helping you effectively navigate this challenging environment.

Is the 60/40 Portfolio Dead?

There is no mistaking that a balanced portfolio; i.e., one holding both stocks and bonds, is disappointing investors in 2022. The decade after the 2008-09 global financial crisis has been a golden age for the classic balanced portfolio with 60% equity (S&P 500) and 40% bonds (Bloomberg US Aggregate Bond Index). Stocks, especially those in the S&P 500, have had a stellar run, and bond prices (which move inversely to yields) continued their multi-decade upward trajectory. But as Figure 4 (next page) shows, 2022 is not the first time a 60/40 portfolio has disappointed. Since 1980, there have been nine instances in which a 60/40 mix fell more than 10% within a given year. In eight of the nine instances, returns the following calendar year were positive, with an average gain of over +17%.

One material change is that in the past 15 years it has been hard to find bond yields north of ~4%. Figure 5 (next page) shows that corporate bond yields have largely languished in the 3-4% range since 2011 before surging over the past year. Low yields limited outcomes for balanced portfolios and forced people up the risk spectrum to find returns. The sharp uptick has been striking (corporate bonds now have yields of 5-6%+). At these rates, bonds become a more attractive relative return option. In addition, the trade-off we have experienced in price this year will be, in part, compensated by the higher yields bonds will pay over the coming years. Should yields remain in this range or higher for longer, a balanced diversification approach will have stronger returns relative to the level of risk than was achievable over the past decade.

Figure 4. 60/40 Portfolio Intra-year Declines Vs. Calendar Year Returns (Source: JP Morgan)

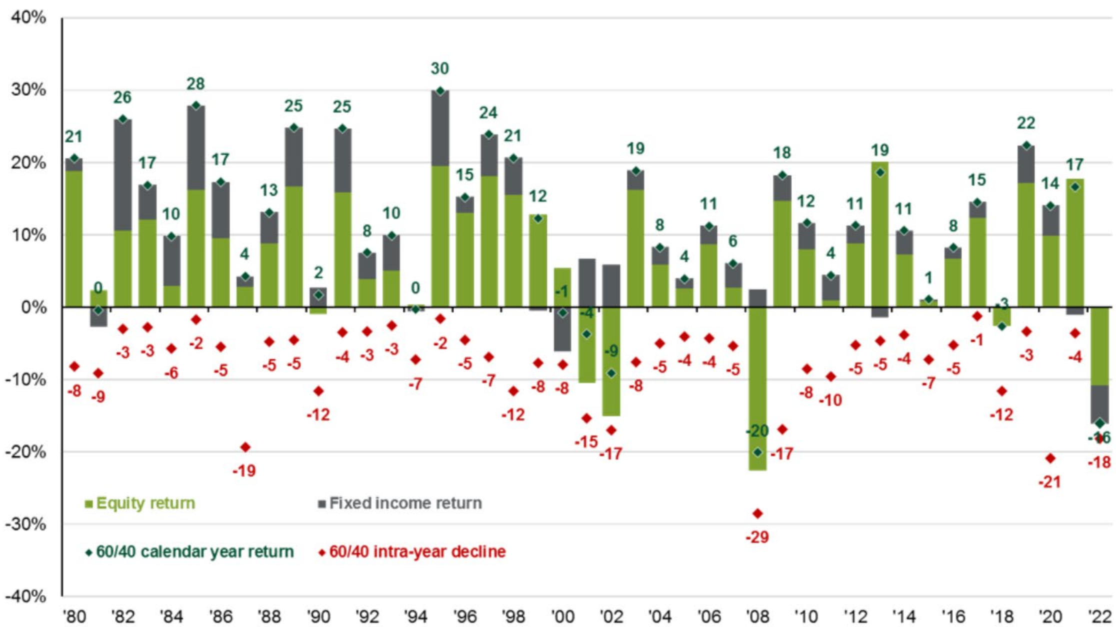


Figure 5. 10-Year High Quality Corporate Bond Par Yield (Source: U.S. Dept. of Treasury)

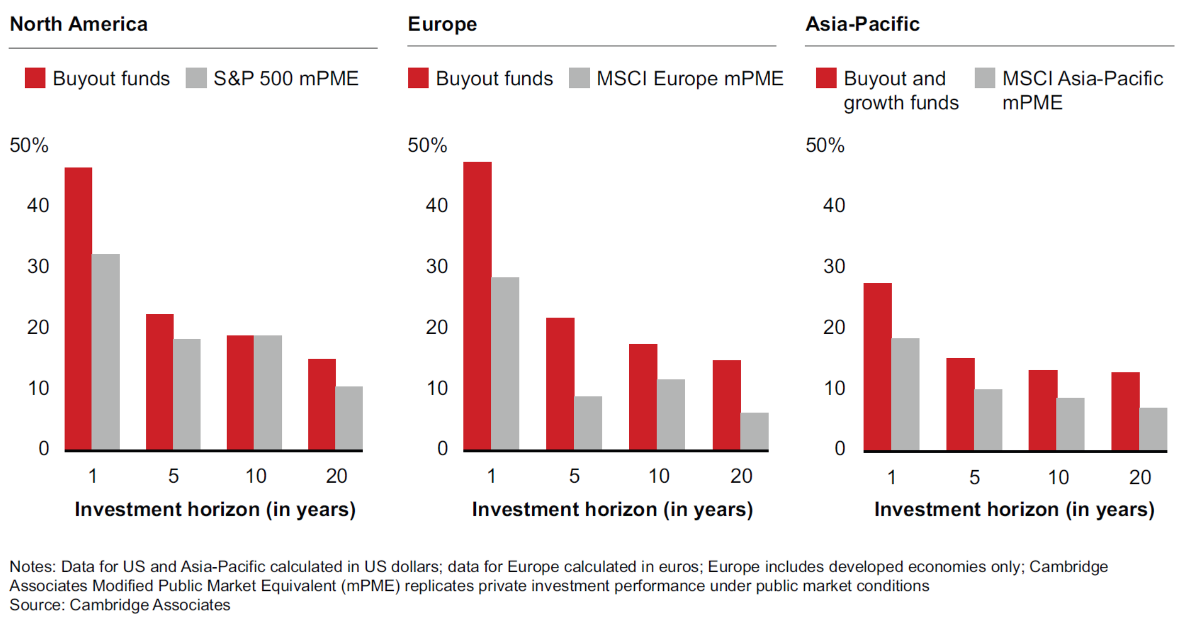
The Allure of Private Equity

Nevertheless, a marketing pitch we are increasingly hearing these days is to place more money with private equity managers. Such prognosticators claim that doing so will help avoid what may be a prolonged period of sub-par returns for balanced portfolios due to the prospect of continued inflation (and investors' expectations about inflation), lower corporate profits over the next decade and high starting valuations. Private equity managers place capital with typically smaller companies whose shares are held privately and not available for purchase on a stock exchange. Such companies can be little more than an idea (so-called angel investing), all the way to $1B+ companies poised to trade on a public stock exchange. In return, private equity managers take a large share of the profits when investments work out (about 20%) and charge a higher management fee than a mutual fund (about 2% per year).

In normal times, one should expect private equity investments to outperform public ones. Private equity investing involves locking up money for long periods of time in products that are illiquid; i.e., they cannot easily be sold. Investors therefore expect to earn what's called an "illiquidity premium." A second reason why one should expect private equity to outperform is the use of leverage in the form of both equity and debt to purchase companies. Using debt magnifies positive (and negative) returns. A good example is taking out a mortgage to buy a home. Say you purchase a home for $1.0M, put down $100k, and borrow the rest. Now assume the home value rises to $1.1M the following year. While you might be tempted to say the return on your investment was ~10%, it was actually 100% as your original $100k down payment doubled to $200k (less the mortgage servicing costs.) If you remember speculation in Florida properties prior to the housing crisis, that type of leverage is exactly what was driving the market – and with disastrous results. But this is the power of leverage when interest rates are low.

In general, private equity returns have outperformed public equity returns over the last 20 years, and so investors have been rewarded for the extra risks undertaken. (See Figure 6, next page.) Interestingly, however, the outperformance gap in the U.S. has completely disappeared in the last 10 years, thanks largely to the stellar performance of the S&P 500 over the same time period. Put differently, private equity investors did not get paid to lock their money up and leverage didn't help. One needed to be invested heavily in international private funds to consistently outperform public markets.

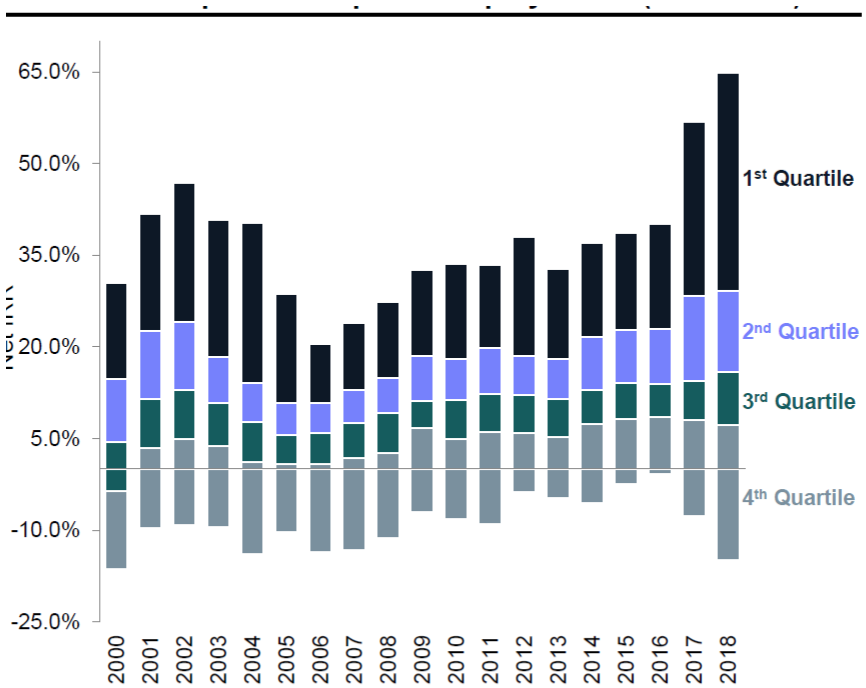
Figure 6. Private Equity Returns Over the Last 20 Years (Source: Bain and Co.)



But these are average returns. As Goldman Sachs, one of the largest global private equity investors, points out, there is a much wider dispersion of returns in private equity and so picking the right funds and the right managers is paramount. (See Figure 7, next page.)

Goldman Sachs also points to two other critically important principles to successful investing in private equity. One is consistency. Private equity is a long-term asset class. Since it's always difficult to predict market cycles, investors need to be in the market on a consistent, annual basis to mitigate the risk of poor market timing. The other core principle is diversification: that it takes a well-balanced private equity program that diversifies across sectors, industries, and geographies to achieve enhanced returns. In summary, achieving a well-constructed private equity portfolio means making a multi-year commitment of significant capital to build out a robust, diversified exposure.

Figure 7. Quartile Dispersion of Private Equity Funds (Source: Goldman Sachs)



Most importantly, investors need to remember that private equity is subject to the same market forces as public equity, and these forces are changing rapidly. Notably, the favorable financial conditions, driven by ultra-low interest rates that powered the market-beating returns in private equity in the past decade, are fading very fast. In addition, IPO activity (i.e., the process of taking a private company public to pay off the original investors) in the U.S. has declined to its lowest level in 20 years this year, meaning that funds are finding the door shut tight on a way to pay back their investors. Finally, the amount of dry powder (i.e., money that has been raised but not invested) is at a record-breaking $3.4T globally. This amount of capital chasing the same deals in a rising interest rate environment is a recipe for disappointment over the next decade.

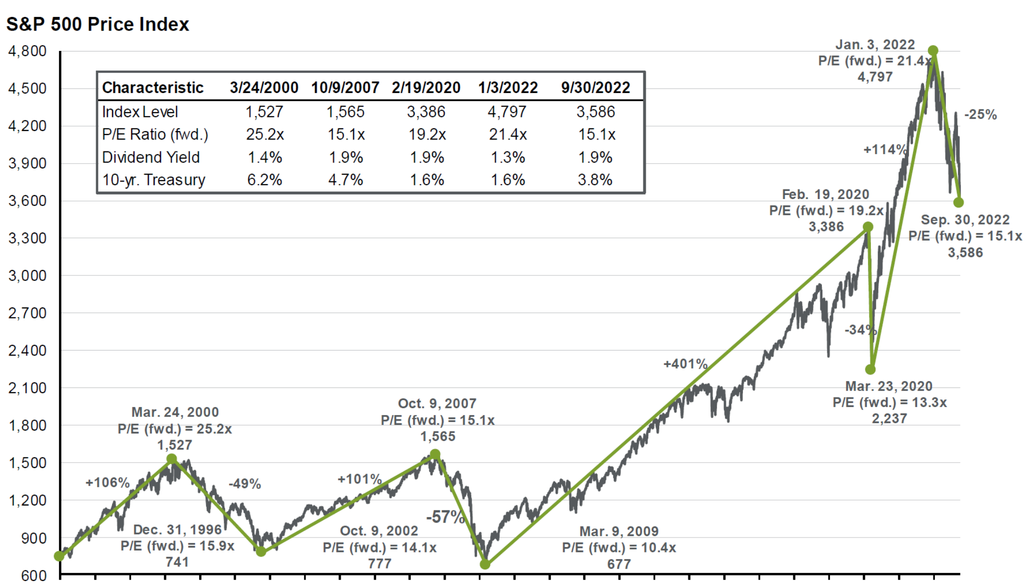
Artemis Outlook and Strategy

For all of the above reasons, we are not abandoning a balanced approach focused on public markets allocations. Goldman Sachs recently published a four-part series called *Balanced Bear Despair* in which they review the performance of the classic 60/40 portfolio over the last 100 years and dissect the drivers of underperformance and outperformance. They also painstakingly searched for assets that have historically provided a better real risk/reward profile during what they call “lost decades” for 60/40 portfolios, one that they claim we risk entering over the next 10 years. Their conclusion: "a combination of commodities, real estate, infrastructure, more international diversification as well as value, high-dividend yield and convertibles would seem to help." (And these opportunities are available in both public and private markets.)

For those of you following our moves, we have made several recently in line with this thinking as we have more value, and now a higher allocation to quality, dividend-paying stocks than we have had in a while. We have also maintained an overweight to real estate, painful as that has been this year. The only thing we are shying away from is commodities as the near-term trajectory is far too volatile and we don't like investing in dirty energy. (Separately, we have also been a bit active in the bond portion of portfolios, reducing duration, holding some cash, and more recently, purchasing short-term Treasuries).

We are confident that our mix bodes well for the longer term. But unfortunately, the near-term outlook for equity and equity-like assets remains challenged and will remain so until a clearer direction for the trajectory of inflation reveals itself (and/or the Russian-Ukrainian war ends). But from where we stand now, it would seem the market has priced in a fair bit of the bad news. In the U.S., the valuations of many quality companies are quickly approaching pre-pandemic levels, while the S&P 500 is now trading at almost one standard deviation below its 25-year average. (See Figure 8.)

Figure 8. S&P 500 Valuation (Source: JP Morgan)

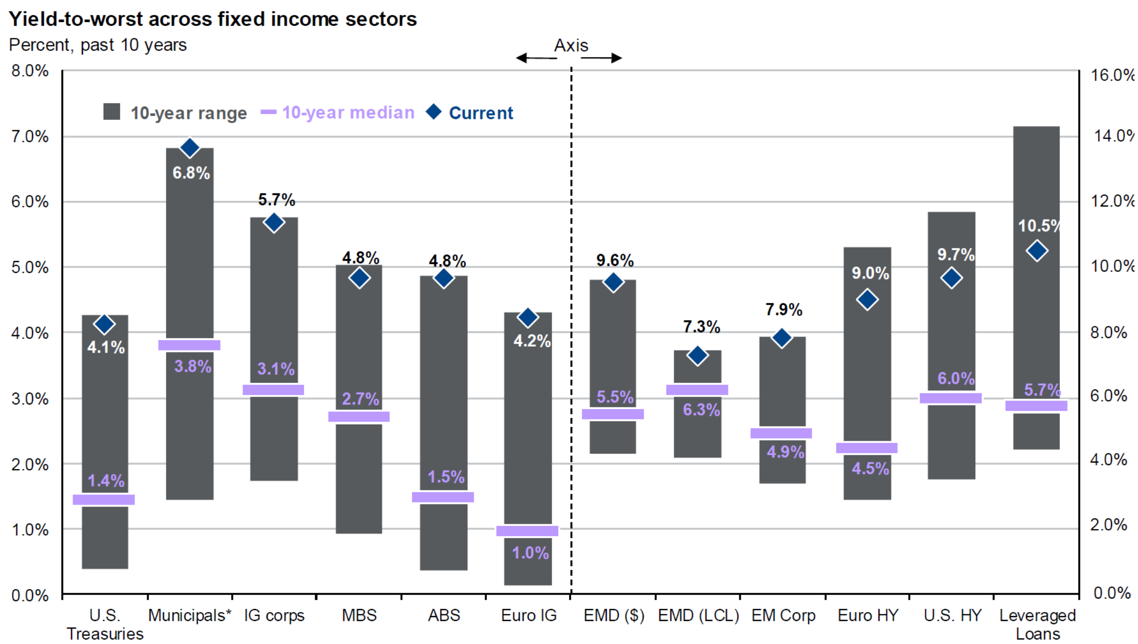


Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2022
Index Level	1,527	1,565	3,386	4,797	3,586
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	15.1x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.9%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

Bonds appear to be even more attractively valued at current rates. Figure 9 shows current yields vs. their 10-year average and suggests that if the Fed is successful in reducing inflation back or near to the 2% target, the potential for a powerful bond rally is enormous.

So we need to patient at the moment. We are deeply convinced that today's pain is setting the stage for outperformance of well-diversified balanced portfolio. As such, while returns this year have been dismal, now is precisely the wrong time to bail. As one writer recently said – "Successful investing is a marathon, not a sprint, and even extended bouts of volatility like we have experienced this year should not alter a robust, diversified investment strategy. History shows us that markets do recover and move to meaningful new highs."

Figure 9. Fixed Income Valuations



Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **MSCI Emerging Markets Net Total Return** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

ICE US Treasuries 7-10 Year measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years**.**

The **Bloomberg US Mortgage-Backed Securities** Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Bloomberg Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities.

The **Bloomberg US Corporate** measures the performance of U.S. dollar denominated investment grade rated corporate debt.

The **Bloomberg EM USD Aggregate** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays US TIPS (Series-L)** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.