# CLIENT LETTER H1/Q2 2023

CAVALOT CAPITAL

## GOING PAPERLESS

If you still find yourself getting a lot of paper mail from Schwab, we may need to adjust your paperless settings. Please give us a call at the office for assistance or if you have Schwab Alliance online access setup, you can watch the video here to update the settings yourself.

## SCHWAB ALLIANCE ONLINE

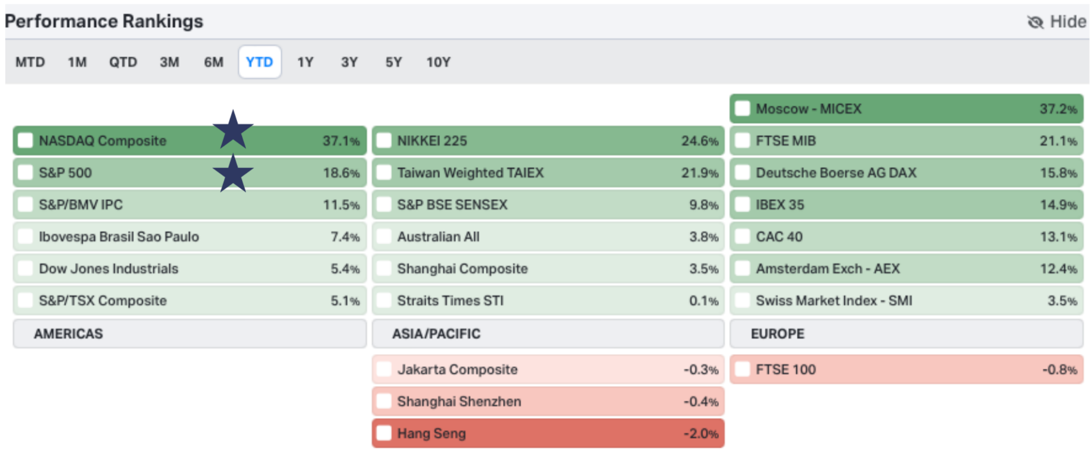
Everyone should have received an invite to create your Schwab Alliance online access profile where you can view your accounts, update account settings, view statements and sign forms without having to go through the text verification system that Schwab uses via Docusign. If you can't see all of your accounts let us know and we will see if we can find the issue.

## CAVALOT CLIENT PORTAL

We have upgraded to a new client portal that is separate from Schwab Alliance above. Our portal allows you to link all of your financial accounts - banks, credit cards, loans, investments (including those held outside of Schwab), 401ks, etc. and also acts as a Financial Planning tool and Document Vault. You will be receiving separate login instructions to your email on file later this month. If you are not interested in using the portal no action is required.

# FROM BANK MELTDOWN TO TECH EXPLOSION

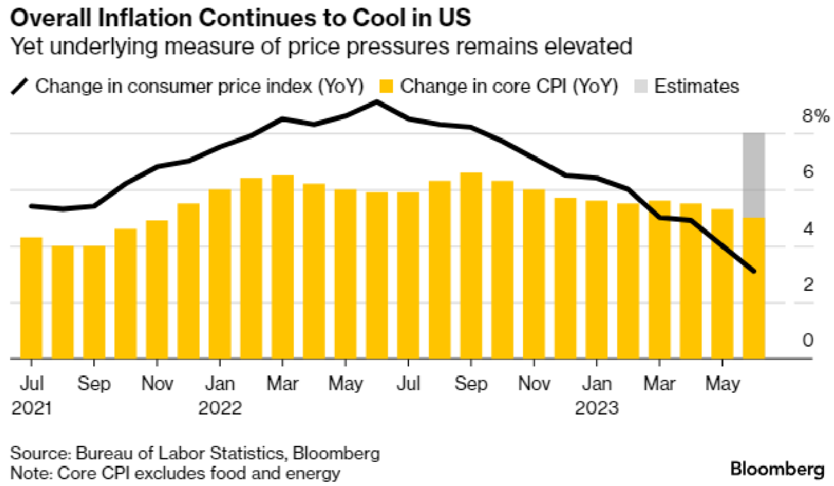
Despite all the attention on bank failures, recession fears and political bickering over the debt ceiling just a couple months ago, markets have been generally resilient thus far as the weather begins to warm up and we head full on into summer. Although, as can be seen below, the NASDAQ is overwhelmingly leading the charge and largely responsible for the majority of returns YTD (as of close last night Tues July 18):




As we discussed in March, the financial system and regional banks were under significant distress to start the year due to Fed tightening for 12 consecutive quarters and poor risk management throughout the financial sector. Many expected this to bleed into the broader economy and calls for a recessionary environment into the middle to latter part of the year were considered all but assured. Fortunately, that didn't transpire and with the combination of dropping inflation readings and the Fed signaling and end to rate hikes the markets have responded rather enthusiastically.

Performance thus far has been solid, but regarding both the NASDAQ and S&P 500 it is worth mentioning that a handful of companies are carrying both indexes. The S&P500 concentration of the top 9 stocks was at 31% at quarter end, while the NASDAQ 100 (the 100 largest growth companies in the US excluding Financials) will be doing a "special rebalance" in order to rebalance the index on July 24 as the 6 largest companies now account for over 50% of the entire index. Fortunately these are some of our largest positions but include Microsoft, Amazon, Apple, Alphabet (Google), Nvidia and Tesla plus Berkshire Hathaway, United Health and Exxon Mobil in the S&P500. The "special rebalance" may put downward pressure on the above names and could dump water on the current rally in big tech but then again this might not be a bad thing for markets overall. Is this is the beginning of a new bull market and can we expect further moves upward through the end of the year? We can dream, but it is more likely that US equities, generally speaking, may have have pulled most of their returns from the future meaning being particularly selective will continue to be the name of the game. This provides a good lesson in why passive, index investing isn't always what it purports to be as there can be far less diversification in a broad index than one might suppose.

All eyes continue to be on the Federal Reserve which has indicated that they are expecting 2 more rate hikes this year in their efforts to stem inflation, and it seems to be working. Headline Inflation as of June 30 came in well below estimates as can be seen to the right with Year over Year being the black line showing around 3%. This is a far cry from the 8% we hit last year and should bode well in our everyday lives as hopefully the cost of goods and services continue to decline. The tightening credit markets are something worth keeping an eye on moving forward through the fall as some signs of weakness are showing up in things like SoFi reporting a 46% increase in personal loan originations since the same quarter last year, a common solution to people facing short to medium-term cash shortages. The most recent Federal Reserve Bank of NY quarterly report on household debt noted that for the first time since 2001 we didn't see consumer credit card balances drop in Q1 (people typically pay off holiday purchases after the new year) and auto loan balances increased as well which typically drop in Q1. They found mortgage originations and refinances dropped to the lowest level since 2014 - and remember this is the biggest determinant of the money supply. Student loans didn't drop much either but that was primarily due to a 3yr moratorium on repayment which is lapsing These are pretty strong indications that the consumer is starting to feel the bite as pandemic era subsidies and programs begin to lapse. It isn't how much will consumer spending drop but when and by how much.The labor market obviously plays another huge role in economic activity and that, contrary to the Federal Reserve's best explanations, is rather strong. How much of that will offset the aforementioned credit issues at the household level remains to be seen. Interest rates will likely have an outsized role in economic activity for the remainder of the year and despite the current market jubilation that the Fed is pausing rate hikes we still continue to maintain our base case that rates will continue to remain elevated for at least another 12 months unless something unexpectedly derails the US economy. Commercial Real Estate is often singled out with jumbo commercial loans having turned into ticking time bombs for many lenders and banks. Residential Real Estate has held up rather well despite high rates but this is due in large part to many people not wanting to sell since they would then likely be looking at a new mortgage in the 6-7% range which is no small consideration. The homeowners insurance market is starting to get interesting with several large underwriters pulling out of CA due to the unique structure of rates and regulations in the state and increased fire losses making the state unprofitable for most if not all insurers. This will be seen in increased premiums around the country and something worth keeping an eye on.




## THE PORTFOLIO GARDEN (+ POSITIONING UPDATE)

A concept we have been using with some clients around portfolio performance is thinking of an investment portfolio as a food garden. If you were to grow all of your own food, having ample variety all year round would be rather important. While maybe you could get the most food yield with the least amount of work out of an apple orchard, come winter you would have nothing fresh and would only be able to eat what you were able to preserve the previous season - plus you'd probably be sick of apples.

It can be helpful to think of an investment portfolio in the same way, in that while our overall goal is to generate a positive, real rate of return it doesn't mean that everything goes up all the time and on the same time horizon. One important concept is Liability Matching where we attempt to pair different assets that appreciate (or blossom) at around the same times as when the money will be needed (buying a house, paying for college, renovating the kitchen, retirement income). With something like a bond that matures at a specific date this is fairly straightforward (referred to as bond immunization), but with stocks there is a lot more subjectivity and guesswork involved since we can't necessarily control when the price is going to go up. However, in this way, the girations of the market on a weekly, monthly, or even annual basis are of little consequence and each component of the portfolio serves a different purpose like tools in a toolbox.

**Stocks** = Grains, a staple of any diet for the long-term

- We get Equity exposure primarily from 4 different strategies with varying contributions from the 3 different return types we talked about last letter (Cash Flow, Capital Appreciation and Total Return). The primary risk we are attempting to mitigate with stocks is Inflation Risk.
  - **Great Companies** - these are typically companies that are good at making money, whether they distribute it to shareholders (dividends) or use it to grow the business.
  - **Event-Driven** - Also known as Special Situations, these are companies or securities undergoing some type of change that is external to the overall market direction and is often related to
  - mergers or acquisitions, spin-offs, divestitures, new management or various restructurings.
  - **Income Producers** - Companies that pride themselves as producing reliable dividends over time, such as REITs.
  - **Broad Indexes** - For more broad stock exposure or to play a specific theme or sector we often utilize Exchange-traded Funds or ETFs.
- **Depending on the objective of your account, your portfolio will have varying allocations to some or all of these strategies.**
  - For accounts primarily used for income and capital preservation, equity exposure is primarily Great Companies and Income Producers.
  - For accounts with a primary objective of maximum capital appreciation, you will likely find a significant amount of Event-Driven stocks and Broad Indexes.
  - For accounts that are more Balanced or fall somewhere in between you may see some of all 4 types.

**Fixed Income** = Vegetables, consistent and nutritious

- The primary risks we are attempting to minimize in bond investing are Credit Risk, Interest Rate Risk and Reinvestment Risk.
- Default risk is risk that you won't be paid back in full at maturity and varies with the creditworthiness of the borrower. US Treasuries are considered guaranteed, "risk-free" debt rated AAA which minimizes default risk.
- Interest Rate Risk is when fluctuations in interest rates increase or decrease bond yields and inversely affect bond prices, like a teeter totter. The effective duration of a bond is the percentage drop in the price of a bond for every 1% change in interest rates. That is why longer term bonds were utterly decimated in 2022, if you had a bond with a 20yr duration it dropped 20% 5 times since February 2022 when the Fed began aggressively raising rates.
- Reinvestment Risk is the risk that rates will be lower when a bond matures and thus require you to reinvest at a lower yield.
- Our primary current positioning is a Straddle strategy for rising or dropping rates. Our view is rates will likely stay high for the next 12 months or so and therefore are investing heavily in the 3mo to 2yr Treasury market with yields to maturity (YTM) of 4.5-5.5% readily available.
- With rates likely much closer to the top than the bottom we have also been adding long dated treasuries which will go up in value if rates drop, offsetting lost interest income if we are forced to reinvest maturing bonds at lower coupon rates.

**Alternatives** = Fruit, bright, sweet and delicious but can rot quickly

- Real Estate, Commodities, Crypto, and other highly cyclical asset classes.

# TAX PLANNING

Now that tax season is mostly behind us, we have begun checking client tax returns for any errors and tax planning opportunities. Knowing your tax brackets and carryover losses from previous years are particularly important for those with taxable accounts to ensure we are minimizing taxes as much as possible and not making any costly mistakes. Another area we tend to focus on is tax efficiency in accounts held away and verifying if you are paying unnecessary tax on assets held in mismatched account types (such as putting REITs in taxable accounts - we see this often).

For small business owners, we can help with estimated payments, choosing a retirement plan, plan contributions, S-Corp elections and various other situations. If we haven't already requested your 2021 and 2022 returns we will be reaching out over the summer to do a quick check-in. Please upload via email with the link provided, do not email tax returns as they contain sensitive, personally identifiable information.

# FINAL THOUGHTS

Although the recession talk has subsided for now, something always comes up that throws a wrench in the most well thought out plans. Our job is to attempt to navigate your investments through a broad range of potential outcomes and meet the goals and objectives you have established. With that said, our base case is that markets will be range-bound for the rest of the year and interest rates will remain high. The higher markets move, the more nervous we get and have already begun shifting our focus towards risk management across portfolios. Most accounts have been completely rebalanced into our current porfolios but you may continue to see grouped transactions as we consolidate our holdings. It has been a good year so far, let's hope it continues but at the same time make contingency plans just in case.

Thank you for the trust you have placed in us. Please contact us with any questions you have about the information in this commentary or your portfolio.

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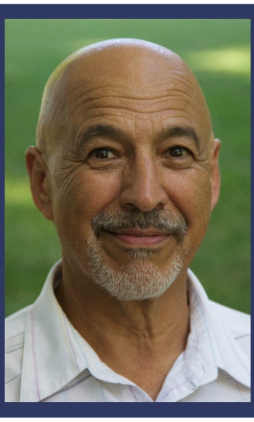

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Investing in small- and mid-size companies can involve risks such as less publicly available information than larger companies, volatility, and less liquidity. Investing in a more limited number of issuers and sectors can be subject to greater market fluctuation. Portfolios that concentrate investments in a certain sector may be subject to greater risk than portfolios that invest more broadly, as companies in that sector may share common characteristics and may react similarly to market developments or other factors affecting their values. Investing in special situation and event-driven equities can be subject to several risks including the failure to execute proposed deals or transactions, changes in management or corporate strategy, large shareholders exerting pressure on management and higher than average portfolio turnover.

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