January 2023

THE CAPSTONE QUARTERLY

Happy New Year! We are grateful for this new year and the sense of rejuvenation that turning the calendar brings. In this newsletter, Bryce discusses the volatility we've seen in the markets this year and Casey explains the relationship between stock and bonds. We've already welcomed a few clients to our new office space and look forward to welcoming many more in 2023.

BRYCE'S POINT OF VIEW

Bryce Pease, CFP®

Nasdaq Volatility

Volatility emerged as one of the key themes throughout 2022, as investors became used to large intraday swings in major domestic equity indices.

It became commonplace for financial pundits to discuss expectations of continued market turbulence as investors remained uncertain about geopolitical risks and central bank decisions. Some days certainly played out favorably this year, such as on November 10 when the Nasdaq 100 Index (NDX) gained a whopping 7.49% to mark its best single-day return since March 2020[1].

Even with the short-term rallies, the NDX still finished the year down over 33%, marking its fifth worst annual performance back to 1986[1].

The NDX saw 164 days this year post a gain or loss exceeding 1% in value, which equates to about 65% of the trading days in 2022. The only other years that have seen the NDX post that many 1% days came from 1999 through 2002, which each saw at least two-thirds of the market days gain or lose 1% in value[1]. It is worth noting that the second half of the year has not seen nearly as many extreme days as the first half, with 52 such days seen through June and 31 days seen in the last six months.

Every month this year saw at least 10 extreme days, which speaks to the consistent theme of volatility throughout 2022. Just over 30% of the days this year saw a 1% move to the upside, which is historically very high.

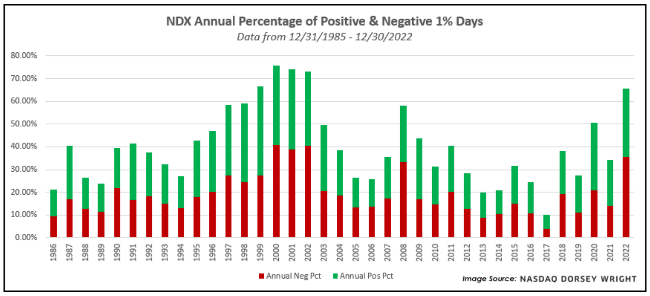
Unfortunately, we saw even more days show a 1% move lower at just over 35%[1]. That is a consistent theme for the Nasdaq 100 Index; large down years typically show extreme volatility to the upside and downside with more significant moves lower.

While it is not a great sign to be associated with the volatility of the Nasdaq 100 during the dot-com bubble in the early 2000s, we do want to point out some other major differences between those readings and the current market environment.

Prior to 2000, the NDX saw five consecutive years of at least 25% of the market days showing a 1% move higher, and each of those years showed more positive up days than down days[1].

Fast-forwarding to the current period, we saw extreme up days in 29% of the days in 2020 and 20% of the days in 2021. While we did see more extreme up days than down days in those two years, we have not been close to the extended run-up that was seen in the late 1990s, at least according to the count of extreme days for the Nasdaq 100 Index.

The chart below is a little small but it shows the volatility dating back to 1996. The far right bar represents 2022 and the higher than normal volatility that we experienced.



CASEY'S CORNER

Casey Morris, CFP®

Correlation

Ever since 2008 (and possibly before), when panic selling caused virtually all assets to quickly correlate, there has periodically been talk about the "death" of a balanced portfolio. Meaning, having both stocks and bonds in the portfolio.

Correlation is a term that refers to the relationship between two things. In our business, it is a statistic that measures the degree in which two things (ex. Stocks) move in relation to each other. For example, if Apple and Amazon stocks were highly correlated, when one goes up, usually the other would as well. When the value of one "thing" moves up, so does the other in a similar fashion. If the stocks were negatively correlated, when Apple moves up, Amazon would go down, and vice versa.

Typically, a person that wants to be more conservative would have some bonds in their portfolio. The bonds are intended to serve as hedge in case the stock markets were to go down. In years like we've just had, the bonds were not a hedge at all and have correlated (gone down) right along with the stock market.

If diversification breaks down when we need it the most, because assets become correlated during periods of high volatility, perhaps there is no benefit to including assets with low relative returns (like bonds).

Traditionally, we think of stocks and bonds as moving in opposite directions. When stocks go up, bonds typically go down, and vice versa - i.e., they tend to be negatively correlated. While the statistical relationship between stocks and bonds may shift during periods of market stress, having bonds in a portfolio has historically acted as a cushion during major selloffs. Bonds may have declined along with stocks, but the decline was smaller and the recovery often faster. We saw this scenario play out most recently in 2020 when there was a selloff in both bonds and equities, but bonds had a much shallower trough, softening the blow to a diversified portfolio.

However, that all changed in 2022 as the drawdown in bonds was very similar to that of the stocks, largely due to aggressive interest rate hikes to combat historically high inflation.

As a result of this correlated breakdown, traditional "balanced" portfolios containing both stocks and bonds were dealt one of the worst calendar year returns on record. Since 1999, portfolios of this type have posted a worse return in a calendar year only one other time – which was in 2008. Albeit a relatively short lookback period, in the past 20 years when these types of portfolios were both down more than -15%, the following calendar year was positive almost every time.

However, this year, the greater issue and talking point for most "balanced" investors was fixed income. Due to the velocity of rising rates and longer-term commitment to higher borrowing costs, bonds had one of their worst years in history. As rates rose, bond prices fell.

Did you know?

Contribution limits have increased for most retirement plans for 2023. If you are under age 50 you can now put up to $22,500 into your 401k/403b/457/Thrift Savings Plan. If you are over age 50, you can put up to $30,000 for the calendar year. Make sure you coordinate with your employer at the beginning of the year to spread your contribution out over all pay periods.

IRA limits have also been increased. Those under age 50 can now contribute $6,500 and those over age 50 can contribute a total of $7,500. These limits can be put into either a Traditional/Rollover IRA, a Roth IRA, or a combination of the two depending upon eligibility.

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It was a historic year for many reasons. And as history reminds us, we've seen this before and we will see it again. We've also seen significant recoveries from this position, although we know it is not an overnight process. We are optimistic for the year ahead as we continue to monitor the markets and our clients' accounts. We feel 2023 will bring some opportunities.

FINALLY…

We have added some new team members to the crew! Michael Marich joined us in late October, taking over for our last intern Alex, who graduated from Cal State Fullerton. Michael is a business major at Biola University on a year-round academic path. He is very detail oriented and eager to tackle new projects. We are happy to have him working with us and we think you will find him very courteous and professional.

It is about time that we also introduce our other "employee", John Morris. John (you guessed it!) is Casey's husband and has been working with us part-time since June. He left his job of 18 years in education and coaching basketball to have a better work/life balance. His new job allows him to come into our Brea office a couple times per week and learn the business firsthand. Although he's only been officially working with us for less than a year, he's been a part of the team behind the scenes for much longer.

If you happen to catch either Michael or John on the phone when calling in, please help us welcome them to the team!

Sincerely,

The Team at Capstone Pacific

P.S. If you ever run across anyone who could use our services or is unhappy with their current adviser's performance, we always appreciate it when you pass on our name.

[1]www.nasdaqdorseywright.com Daily Equity Report published 1/2/2023.