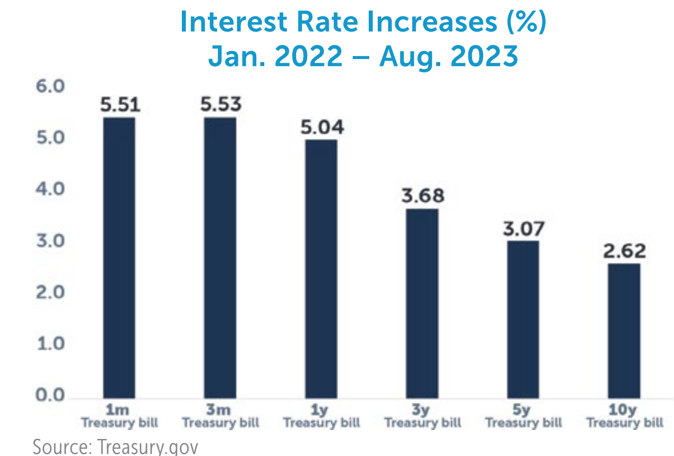
# Quarterly Insights

## Balancing Current Bond Yields with Future Rate Changes

By Jared Kizer, CFA

Following years of low returns, bonds are bouncing back. From 2022 to 2023, short-term Treasury bill rates have increased from near zero to over 5%. But when looking at the options in the fixed income market, investors are finding that the interest rates on bonds with more time to maturity haven't increased as much as those with shorter maturities. That is leading to a question for some investors: Why not invest my entire fixed income allocation in the shortest maturity investments, where the rates are the highest?

Interest Rate Increases (%)
Jan. 2022 – Aug. 2023




Source: Treasury.gov

This question is understandable. Given just how quickly interest rates have increased — and the consequently poor returns generated by fixed income in 2022 — some investors might expect that interest rates will simply continue to rise. Although we believe that keeping maturities on fixed income investments relatively short is typically the best approach, because it helps reduce a portfolio's exposure to the risk of unexpected inflation, we do not believe that limiting a portfolio exclusively to the shortest maturities makes sense. There are three reasons for this perspective.

1. **Interest rates are notoriously unpredictable.** There is no guarantee that short-term interest rates will stay at these levels over multiple years. Investing exclusively in the shortest-maturity fixed income investments exposes the investor to the risk that short-term interest rates fall more quickly than expected. This is commonly referred to as reinvestment risk, or the risk that rates will be lower than expected when you need to reinvest in the future. Said another way: Simply because you invest in the maturity with the highest interest rate today does not guarantee that this approach will generate the highest returns over a longer horizon. Short-term rates could fall enough that you would have been better off locking in a lower interest rate on an investment with a slightly longer maturity.

2. **Not all interest rates move at the same time and by the exact same amounts.** The 2022–2023 period is a good example. By diversifying across multiple maturities, an investor can partially mitigate the risk of being overly exposed to movements in a single interest rate. Although not a perfect comparison, this is the same idea as not being overly exposed to the risk of a single stock.

3. **The bigger risk is in the stock market.** For most portfolios, the greatest risk exposure comes from the stock market. This tends to be true because stock markets are significantly more volatile than fixed income markets. Investing only in fixed income with ultra-short terms amplifies this dynamic. Having some maturity risk in the portfolio can help better balance the overall portfolio.

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# How Investor Expectations Are Driving Stock Prices

By Daniel Campbell, CFA

> *"Expectations are like a debt that must be repaid." - Morgan Housel*

This year, there has been more optimism in the stock market compared to 2022. For investors only looking at the returns of the S&P 500, it may seem like the economy is in a boom. This dynamic may be surprising, given the rising interest rates and forecasts for slower growth.

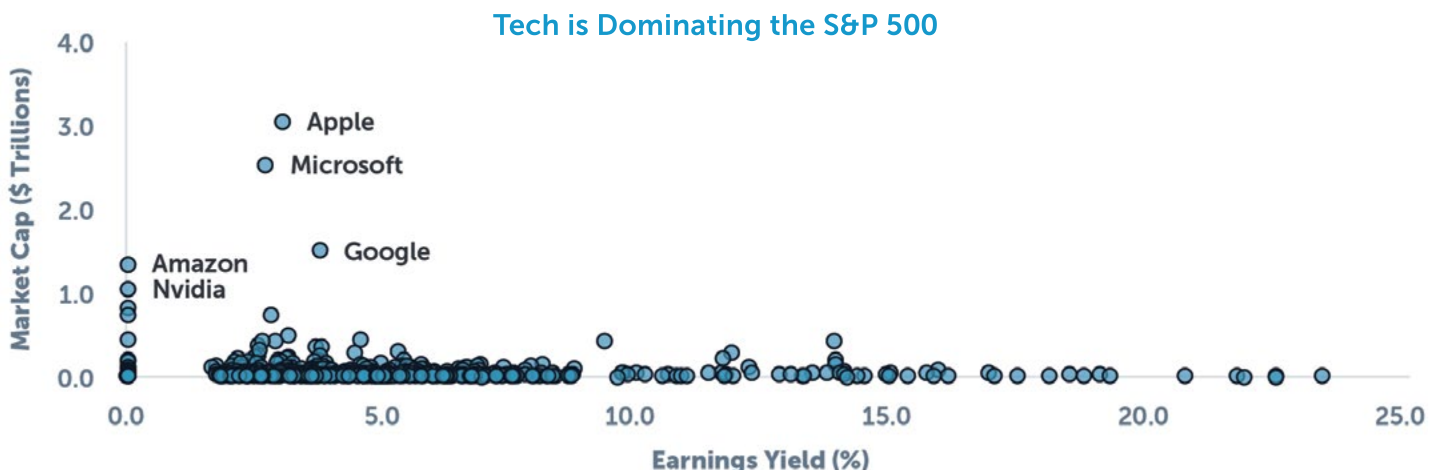
To make sense of what's happening with stock performance this year, let's start with some basics about stock valuations. First, know that expectations are built into every company's stock price. Valuation theory teaches us that a company's stock price is based on a combination of the company's current value and its expected future cash flows, or what investors expect the company will earn over time.

One of the more popular ways to measure investors' expectations is the earnings yield, which is simply a company's earnings expressed as a percentage of its market price. It's the inverse of the price-to-earnings (P/E) ratio, and just like with bonds, a higher yield suggests that the stock may earn more over time.[1] With that background, here are three insights from the earnings yields we see around the world today, which show why chasing the biggest returns in equity markets may not be the wisest choice.

## 1. The Big Companies Are Expensive

We generally see large positive returns from a stock for one of two reasons: unexpected improvements in business fundamentals or improved expectations for the company.

With technology stocks, we've seen a lot of the second scenario playing out. Nvidia, a maker of computer components that help artificial intelligence applications run effectively, nearly tripled in value through the first six months of the year. As of the end of June, the top five stocks in the S&P 500 comprised nearly 24% of the index value. On average, these top five companies are worth 10 times as much as the rest of the index, but they only yield about half as much. Warren Buffett offered sound advice when he said: "A business with terrific economics can be a bad investment if it is bought for too high a price."[2]




1 This is an imperfect measure: a stock with a low earnings yield could go on to outperform, assuming the company can exceed the current expectations or make unexpected innovations in its field. But comparing differences in yields can give an indication of how high investors have priced their expectations for different companies or segments of the market.

2 Warren Buffett, 2014 shareholder letter, https://www.berkshirehathaway.com/letters/2014ltr.pdf

## 2. The Price for Smaller, Less Expensive Companies Has Dropped

The optimism in U.S. stocks seems to be limited to large, established companies. Smaller companies in the U.S. are trading at significantly better yields. Specifically, companies that are inexpensive relative to their peers, what we call value companies, are seeing yields higher than during the 2008 financial crisis – they're trading like we are already in a deep recession. Although that part might sound concerning, the higher yields show these stocks may be a great opportunity for investors who are focused on the long term.

### Small Value Stocks Look Very Attractive

## 3. Investors Agree That International Stocks Are Risky

The U.S. has had a great 15 years of stock market performance. However, the outperformance in the U.S. has been driven by multiples expansion – investors have been willing to pay more per dollar of earnings from U.S. companies, at least partially because they are perceived to be safer investments than companies overseas. Compared to the latest earnings, international stocks are about one-third less expensive than their U.S. counterparts, meaning the yields on international stocks look quite a bit more attractive.

### Prices Reflect Higher Risk Internationally

## Good Years Will Come at Different Times

The media portrays certain indexes, such as the Dow Jones and S&P 500, so frequently that they have become the de facto barometer for how stocks are performing. However, these indexes only represent a portion of investable companies, and as we have seen, the largest companies can represent an outsized portion of the index returns. The earnings yield is one way to measure how good of a deal different stocks or regions are compared to their peers, and right now, the evidence suggests that leaning toward both international companies and small, less expensive companies offers an attractive opportunity for evidence-driven investors.

Sources: Returns data were retrieved from Morningstar. Earnings yield data are based on trailing 12-month earnings. U.S. stocks are represented by the Russell 3000 Index. International stocks are represented by the MSCI World ex USA IMI. Small Value stocks are represented by the Russell 2000 Value Index. Holdings and concentration calculations for the S&P 500 Index are based on the holdings of the Vanguard S&P 500 Index Fund ETF (ticker: VOO). All returns and valuation metrics presented are through June 30, 2023. In Chart 1, Tech is Dominating the S&P 500, four companies had an earnings yield greater than 25% and were excluded from the visual.

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# Why Investors Should "Mind the Gap"

By Alex Kluesner, CFA

When it comes to our portfolios, we constantly receive advice from all corners of our social networks on what we should — or shouldn't — be doing. As a recent study by Morningstar suggests, ignoring those urges to make changes may be the key to meeting your financial goals. Let's look at the study's findings.

Morningstar's annual "Mind the Gap" study examines the difference between the total returns of different mutual fund and exchange-traded fund (ETF) categories and the corresponding investor returns for those investment categories over the trailing 10-year period. This year's study shows that on average investors earned 6% per year on their portfolios over the last 10 years. However, the funds in which they invested earned more, at 7.7% per year. In dollar terms, assuming a starting portfolio value of $1 million, investors lost out on just over $300,000 in potential gains.

This is the negative performance gap, and it is generally due to investor behaviors such as panic selling in volatile markets, chasing performance or other attempts to time the market. Morningstar is careful to note that "even perfectly reasonable approaches to managing a portfolio, such as investing a portion of every paycheck or shifting more assets toward fixed income as you approach retirement, can open a gap between investor returns and reported [fund] total returns." So, it's not always because of bad decisions. Sometimes we make trades in our portfolios to lower overall risk levels or raise cash to meet an unforeseen liquidity need. Even so, the chart suggests that there is room for improvement.

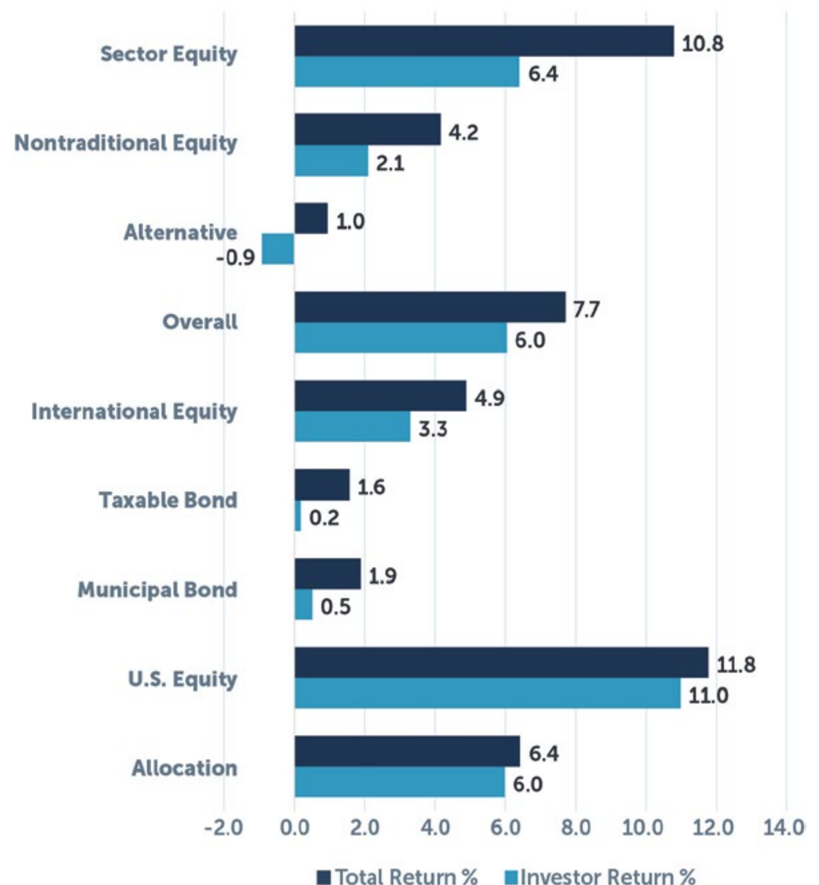
### Key Findings from the Gaps by Category

Overall, the results are intuitive. The largest performance gap, sector equity, is prone to performance-chasing behavior. For this category, investors often buy an industry fund after a great earnings season with hopes of future outperformance only to dump the fund after signs of weakness.

Conversely, the smallest performance gap, allocation, which commonly takes the form of target-date retirement funds, allow investors to purchase a fund and not have to monitor the asset allocation or be overly worried about lagging performance in any one portion of the fund due to increased diversification of holdings.

### How Can Investors Prevent the Gap?

Data show that a buy-and-hold approach often rewards investors who can look past news headlines and disregard urgent calls to action. Remember that sticking to your strategic, long-term plan is expected to serve you well.




Source: Morningstar. "Mind the Gap 2023. A report on investor returns in the United States through December 2022." Aug. 2, 2023.

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