HFG
HARDING FINANCIAL GROUP
Discover the Value of Objective Advice

608 Office Parkway, Suite A
Westerville, OH 43082
hardingfinancialgroup.com

Ph 614.515.4722
clientservices@hardingfinancialgroup.com

Market Commentary
October 2022

Overview

The core points of our investment thesis of the past 9 months remain intact:

- Notwithstanding recent attempts to redefine the word recession, we are in a recession
- Inflation is moderating broadly across inputs and should begin to show in softer inflation data over the coming months
- Barring a severe global deflationary recession, energy prices will climb in the coming months which could partially offset moderating inflationary pressures
- Domestic job losses are likely to significantly increase over the next 6 months leading to meaningfully higher unemployment numbers
- The American consumer is increasingly stressed, and spending constrained, which will add to negative corporate earnings revisions in the coming quarters
- The two greatest risks to the economy are:
    - The Federal Reserve overtightening, creating freezing in the credit markets, and/or a European bank failure(s) due in part to dollar strength
    - Geopolitical: Russia & Ukraine and China & Taiwan

Against that backdrop, it’s no surprise the S&P finished the third quarter of 2022 down nearly 25% for the year. The index lost more than 9 percent in September alone, making it the worst single month since March of 2020 and the worst September since 2002 during the dot-com bust. In addition to the carnage in the equities market, mid and long-term bonds have lost 17.43% and 27.63%, respectively. I don’t think anyone needs a reminder of how bad things are so I will focus this commentary on what actions we are taking to navigate a perilous market, protecting assets while positioning portfolios for when the market begins to recover as in time this too shall pass.

Bond Ladders

Throughout 4th quarter 2021 and early 2022, HFG built substantial cash balances, eliminating positions that were especially susceptible to inflation and an economic slowdown. The repositioning of client portfolios resulted in many clients building cash positions in excess of 40% of their portfolio. In January of 2022, a 2-year United States Treasury paid 0.73% making holding cash good for defense, but not good for income creation. Fast forward 9 months and a 2-year treasury is paying 4.30%. There has been a paradigm shift and after nearly 14 years, bonds are now attractive again.

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Before I get deeper into our recent bond buying, a critical distinction needs to be made between bond funds and individual bonds. Investors who own bond funds have been getting crushed in the market for reasons I'll go into next. Though the process is extraordinarily laborious, HFG buys individual bonds for our clients rather than bond funds. When you hear the next person say "I lost 20% in my bonds" know they were likely in a bond fund and were not executing the laddering strategy HFG has chosen to employ.

Bond funds took a hard hit this year as interest rates climbed sharply - and are likely to keep rising. This is not just very bad news for bond fund holders, it contradicts the long-standing belief that equity portfolios can be effectively diversified with bond funds. To be sure, bonds can still be excellent investments; however, bond funds are not good proxies for individual bonds – at least not in the same way equity funds are good proxies for individual equities. This is a crucial distinction that has big implications when it comes to the construction of an investment portfolio.

Bond funds are pools of individual bonds. Unlike equity funds, bond funds are very different from the assets they hold. While an individual bond has a periodic, fixed payment and a stated maturity date at which the principal is repaid and the bond ceases to exist, bond funds operate in perpetuity and pay dividends that fluctuate over time. This means that while bond buyers receive a known yield when they buy a bond and hold it to maturity, bond fund buyers have no way of knowing what total return they might receive in any given period.

Take, for instance, a simple bond fund like the iShares U.S. Treasury 7–10-year ETF (-14.47% YTD). It contains 12 U.S. Treasury bonds maturing between 2029 and 2032. To maintain the 7–10 year range over time the fund will periodically sell the bonds that fall short of the 7-year maturity and purchase bonds that are closer to 10 years. As interest rates rise and time passes the fund will buy bonds at lower rates (higher prices) then when they sell them, sometime later, at higher rates (lower prices) they will lock in capital losses. That is, bond funds are forced to buy high and sell low.

With the Fed aggressively hiking rates, bond funds are doomed to continue their money-losing record. This may be hard to accept for some market participants because they have had a good run with bond funds for 40 years. Since 1982, the super-cycle of declining interest rates gave bond portfolio managers the built-in advantage of buying their fund constituents at low prices (high rates) and selling them at higher prices (lower rates). This trend has reversed and is turning the historically easy money maker of bond funds into a perpetually losing proposition, so long as the Federal Reserve continues to raise rates.

When investing in individual bonds it is crucial the positions be held to maturity to receive the promised yield. Otherwise, they confront the same problem as bond funds: uncertainty about the exit value, liquidity risks, and high vulnerability to rising rates.

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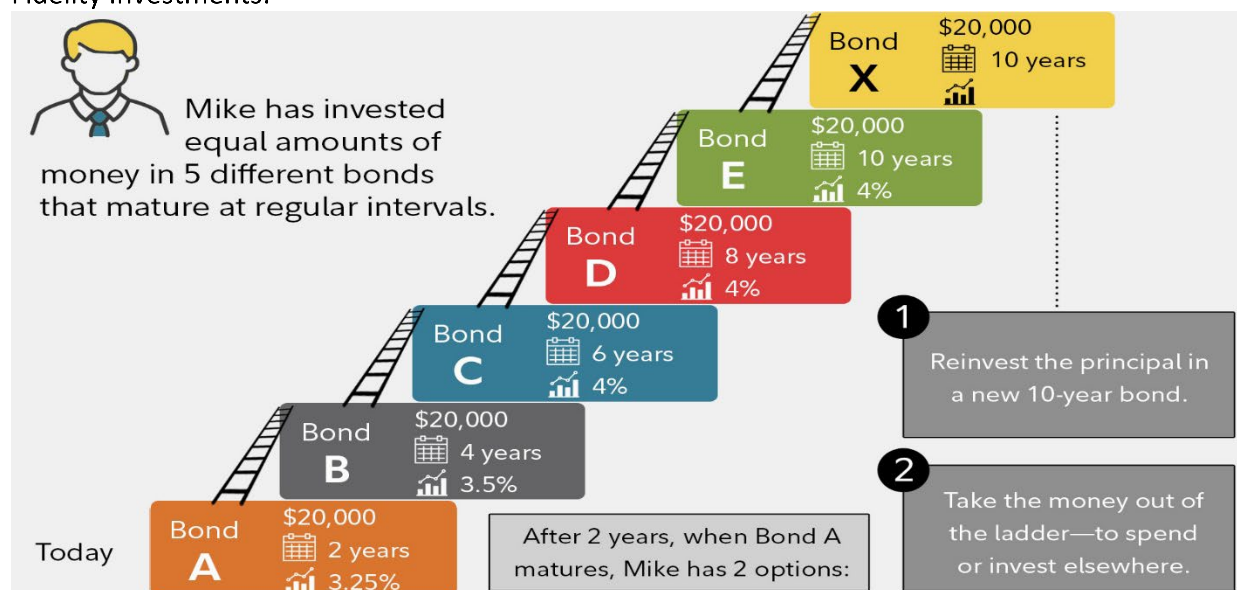
One way for investors to mitigate interest rate risk in their bond holdings is to build a bond ladder. Bond laddering was a common strategy during the first decade of my career, but during the financial crisis of 07-09, interest rates went to near zero and essentially stayed thereabouts until this year. The bond ladder strategy entails holding individual bonds like U.S. Treasurys to the end of their term. Holding an individual bond to maturity guarantees the investor will get back the face value of the bond plus the stated interest rate.

For example, an investor who puts $100,000 in a 10-year U.S. Treasury paying a 2% rate would receive $2,000 in interest payments each year. So, the investor would earn $20,000 over the decade and get back their $100,000 principal. But someone who locks their money away in one 10-year bond may miss out on higher-yielding bonds issued during that decade. Through a bond ladder strategy an investor holds many individual bonds, with different maturity dates, to the end of their term. When a bond expires, the investor re-invests the principal in a new bond at the end of the ladder, capturing a higher rate that may be paid at the time.

Here is a basic example: an investor has $100,000 and they put $20,000 into each of 5 different U.S. Treasury bonds starting in January 2022: a two-year bond with a maturity of January 2024: a four-year bond with a January 2026 maturity, and so on until a 10-year bond maturing in January 2032. When the first bond expires in January 2024 the investor uses the $20,000 principal to buy a new 10-year bond expiring in January 2034 — thereby adding an additional step to the end of the ladder.

The process would repeat each year for as long as the investor likes. Below is a graphic courtesy of Fidelity Investments:



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I don't want to get too far into the weeds of inverted yield curves, but in the current interest rate environment (short-term bonds pay higher interest than longer-term bonds – yield curve inversion), I have kept our bond ladders relatively short, rarely going past two years. If we begin to get stability in the interest rate markets, and a more normalized curve, meaning longer-term bonds pay higher interest than shorter-term bonds, I'll begin to stretch out the ladders to 5, 7, or even 10 years, hopefully locking in higher predictable income in the coming years.

Buffered Investments

With inflation running at over 8% annually investors need more than 4%-5% interest payments to maintain an investment trajectory that will allow them to accomplish their long-term goals. Though clients of Harding Financial significantly reduced their equity allocations nearly a year ago, long-term investors still need a percentage of equity exposure to overcome the inflationary drag on purchasing power.

To mitigate volatility, and increasingly risky markets over the past 12 months, we have increasingly included buffered investments in client portfolios to achieve equity exposure, but also downside protections should another 2000-2002 or 2007-2009 unexpectedly materialize.

Buffered investments seek to limit downside losses from equity-market exposure while capping upside returns. These investments have exposure to the S&P500, Nasdaq, and occasionally gold or the European exchanges. A core holding of one of the previously noted indices is combined with a standard options collar to limit downside risk. The idea is to provide a shock absorber against a certain level of market losses over a defined outcome period (typically one year). In down markets, shareholders are only exposed to losses that exceed the buffer. Upside caps vary depending on the issue date and generally increase along with market volatility. One example is the following: If a buffered position has a 9% cap then the investment returns a max of 9% even if the market is up 15%. Alternatively, if the investment has a 10% buffer and the S&P500 loses 15%, the investment will experience a loss of 5% (15% total loss minus 10% buffer). This is but one example as there are many variations of the buffered investment opportunity. Because of increasing uncertainty across all markets these hedging strategies over the past 9 months have become increasingly common in client accounts.

Overall Strategy

Our strategy of defense first-prioritizing the preservation of capital during difficult markets and providing reasonable growth during better times, allowed HFG clients to successfully navigate the 2000-2002 tech correction and the 07-09 mortgage crisis, many returning to all-time portfolio highs long before the market recaptured its highs. That is not to suggest those periods weren't challenging. Certainly, watching a portfolio go down 14% in 9 months is scary, but if that 14% decline is during a

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period when the market is down 25% or more, the mathematics of loss, through a strategy of defense first works very much in the favor of our clients. Please consider the following chart:

The Impact of Volatility: A Comparison

	Portfolio A: Market Indexed	Portfolio B: Managed Volatility
Beginning Balance	$1,000,000	$1,000,000
Year 1 Return	26%	8%
End of Year 1 Balance	$1,260,000	$1,080,000
Year 2 Return	-35%	-10%
End of Year 2 Balance	$819,000	$972,200
Year 3 Return	17%	10%
Ending Balance	$958,253	$1,069,420

As demonstrated above, the investor who focused on defense and reasonable portfolio growth, rather than capturing every percentage of upside ended the 3-year cycle in a much stronger position. Though portfolio B "only" had positive returns of 8% and 10% respectively versus 26% and 17% for portfolio A, portfolio B outperformed over the 3-year period. It likely didn't feel like it at the time, but the period during which defense was played is where the money was made.

Both bond ladders and buffered investments allow HFG clients to remain involved in the market so they don't miss powerful moves like we had the first two days of October when the Dow rallied nearly 2,000 points in two days! I've been professionally managing money for more than 20 years and have never met a single investor (professional or amateur) who had enough foresight and was nimble enough to liquidate a portfolio with the objective of reentering the market at a more "opportune" time. The reason: the most powerful up days in the market are typically interspersed with the most painful down days. A perfect case in point was the brutal last week of September leading into a 5% two-day rally the first two days of October.

JPMorgan Asset Management put an exact price an investor would have paid if they attempted to time the market from the year 2000 – 2019 and missed only 10 or 20 days. If you invested $100,000

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into the S&P500 on Jan. 3, 2000, and left it completely invested until Dec. 31, 2019, you would have received an average annual return of just over 6%. Your $100,000 would have grown to $324,210.

This 20-year period includes roughly 5,000 days during which the stock market was open. If you missed just the 10 best days out of those 5,000, your annual return would drop to 2.44% ending up with less than half as much money. Miss the best 20 days, and your annual return drops to 0.08%. Missed any more than the 20 best days and you would have *lost* money over two decades!

The discipline to strategically plan predetermined actions to be taken during various market scenarios followed by executing that plan, without emotion when the time comes, is the determining factor in a market participant's long-term success. For a year we have rotated portfolios into a defensive posture and there will be a time, maybe only 3-9 months in the future, when we begin to rotate to a more growth-focused positioning, buying up unfairly beaten-down stocks of great companies that were emotionally sold off by those who came into 2022-2023 without a plan.

Client meetings and commentaries have been focused on our strategies as we approached and move through the current market environment. We are executing, without emotion, the strategies as determined during calmer times. Our defense is working, and we will remain focused on the strategic 3-, 5-, and 7-year objectives for each individual household.

If you feel anxious, have any questions or concerns, or hear something in the news you'd like to discuss, I'm available for a meeting or a call at your convenience.

We have clients at HFG who I have been working with since the first year of my career, over two decades ago. I am sincerely grateful for the long-term nature of our client relationships. I wish you and your family the best during this final quarter of 2022.

Michael R. Harding, CFP®