THE CLIENT LETTER
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"Modern Portfolio Theory"

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Well, if that title doesn't grab your attention, I don't know what does (appropriate sarcasm intended). But before your eyes glaze over, just hear me out.

Professor ***Harry Markowitz*** authored a paper in 1952, which was the basis for a new way to build and manage portfolios. Prior to this, diversification was important, but it just meant owning different types of investments that did different things at different times - and that was about the extent of it.

What Markowitz did was assign specific correlations to different types of investments. With this notion, he set out to measure how closely the returns of different investments mirrored each other. As perhaps a more relatable example, let's say you wanted to compare the differences between various football players. Comparing two NFL quarterbacks would show subtle differences between the two athletes, but they would have more similarities than say, comparing a quarterback with a 330-pound defensive lineman. Therefore, a football team made up of 12 quarterbacks, while having some slight diversification, would not be diversified enough to handle all facets of a complete football game. Hence, different levels of ***correlation*** are necessary.

Markowitz determined that by understanding the level of difference and similarities between investments, one could build a more efficient portfolio in order to maximize the level of return for a given level of risk. This became the grounds for what my industry called Modern Portfolio Theory, or MPT.

BORING! (I promise to make a point here shortly).

In the early 1990s, we used a simple computer application that would tell us the best mix of various investments in order to achieve a target rate of return. Of course, we had to assume and estimate future returns for every possible investment using historical performance. It may have looked something like this:

Cash: 3%
Bonds: 5%
Stocks: 8%

This is obviously a crude example, as there are many other asset classes in portfolio construction and past performance has never been a guarantee of future results - but by using these three assets as an example, we could design a portfolio with a certain amount of "expected return" for a given level of risk. Easy cheesy lemon squeezy, right?

However, this theory breaks down when interest rates are near zero as they were for much of the past decade. In this scenario, cash and bonds simply do not generate the desired income and return necessary for the model portfolio to achieve its targeted return. Consider the same three investments above, but what if they're actual returns were as follows:

Cash: 0%
Bonds: 2%
Stocks: ???

In this scenario, investors are forced to reach for return and perhaps invest more of their portfolio in riskier stocks in order to achieve their desired return. This is exactly what happened, as more investors shifted money out of cash and bonds because the yields were not sufficient. This had the self-fulfilling effect of driving stock prices continually higher as investors “reached” for returns.

So here comes the good news…

In my opinion, 2022 went a long way towards correcting these imbalances and ushered in a return to more normal investment correlation. Yes, it was painful and perhaps there is a little more to come - but I expect the recovery may look more like normal investment performance going forward. Folks, I know it may not feel like it at the moment, but such a scenario would be a better, more healthy and sustainable investment environment going forward in my humble opinion.

And I do expect a recovery, perhaps in the second half of 2023. Why? Because investments do not go up or down forever, they simply adjust to the new current expectations going forward. And the expectations now are for higher, albeit more normal, interest rates, and a mild recession as well.

But bear markets, in my opinion, price investment assets such that ***forward-looking*** returns are more attractive. ***And if there is a little more downside to come, the forward-looking returns will be even better.*** That’s not an opinion, that’s just math. Remember, market risk goes down as prices fall, not up. This is because investments don’t move in the same direction, forever, future returns are simply a function of your starting point today. When I played sports as a youth, I was rarely a candidate for “**Most Valuable Player**” award at the end of the year, but I often received “**Most Improved**”. This is because my starting point was much lower than the most valuable players on the team. Investment performance works the same way.

In other words, I am more optimistic about a balanced portfolio’s total performance now that all aspects of the portfolio can perhaps generate more normalized returns based on historical data and contribute to overall performance. Simply put, when interest rates were zero, one’s portfolio performance was a function of how much exposure they had in high growth stocks. This made aggressive investors look smart - and is a strategy that works… until it doesn’t. There’s an old, saying on Wall Street: “**Never mistake intelligence for a bull market**”. When stocks go up, a monkey can do my job. But when balance and diversification start to matter again, as I feel the case is now, we can add true value.

With yields and interest rates on fixed income investments finally being attractive again, it means the stock market doesn’t have to do all of the heavy lifting. We’ve already noticed the benefits of diversification impacting portfolios so far this year. And while we had to deal with a little pain last year to get to this point, I believe Harry Markowitz would be pleased with the prospects going forward.

RMD’s

For clients over the age of 72 (now age 73 as of the passing of Secure Act) they are familiar with the **required minimum distribution** from IRAs. This is the IRS mandated amount that must be withdrawn each year in order for *Caesar* to receive his revenue from these tax deferred retirement accounts over one’s lifetime.

Many of you are set up to have this amount calculated annually by Raymond James, and automatically adjusted to send only the minimum amount each year. Because of the decline in markets last year, these minimum required distributions are slightly lower in 2023. If you would like a higher amount of distribution, we can certainly adjust this, just let us know.

In addition, if there have been any changes or life events, please let us know. This could be address/phone number changes, beneficiary or bank routing information changes, etc. Please keep us apprised of any material updates - you can let Edie know at: edie.reeves@raymondjames.com

Final Factoid: NFL games made up a record 82 of the 100 most watched TV broadcasts in the US in 2022. Of the top 100 broadcasts, 94 were sports related, and for the second straight year not one single scripted TV show made the top 100. (SOURCE: SPORTS BUSINESS JOURNAL)

As always, we thank you for your business, your friendship and the trust you place in us. Feel free to share this letter with anyone you feel may benefit – we appreciate the many referrals we have received over the years. Edie, Cole and I are happy to answer any questions you may have. Until then, wishing you health and happiness.

Regards,

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