Focusing on What We Can Control

"Patience is Bitter, but its fruit is Sweet"
– Jean-Jacques Rousseau

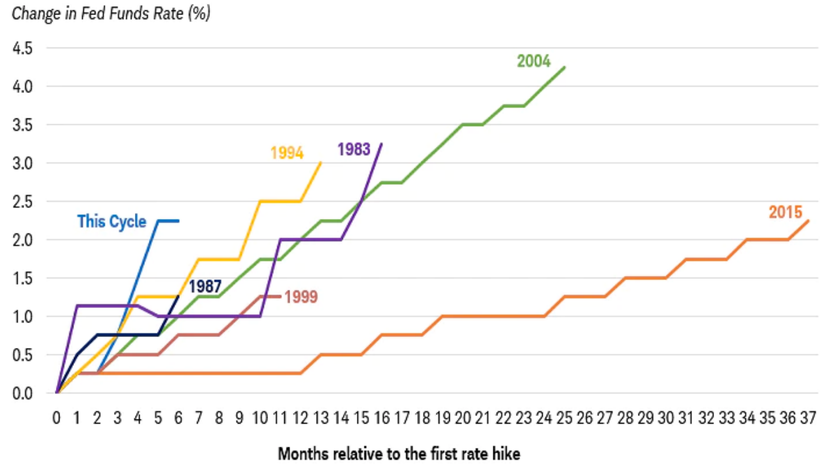
After the worst first half since 1970, the third quarter started out with a bang as the S&P 500 increased over 17% from June lows. However, elevated inflation reports coupled with a Fed determined to squash it, led the market to give up all its gains and then some, ending the quarter at the lows for the year (-23.9%). This was the worst first three quarters to start a year since 2002, and the fourth worst since 1926. International markets performed even worse, and bonds continued their plunge with a 15% total decline year-to-date.

The 60/40 portfolio, many investor's staple diversification, ended the quarter down over 20%, which is the worst first 9 months to a year since 1974. Gold is also down over 8% on the year, and the theory that gold is the ultimate inflation hedge certainly has not worked this year. The only thing that has worked on the traditional investment side is cash. Perhaps one of the few benefits of rising rates are that yields on Treasuries are now at levels not seen since 2007.

The shining light in investor portfolios in 2022 have been alternative investments, which consist of real estate and private credit investments. As this year has played out, it has been nice to see the positive returns and diversification benefits that the alternatives have provided. Our fear for many years was that bonds would have a tough time if interest rates were to increase substantially.

Regarding the stock and bond markets, we are seeing many signs that the selling is overdone and that we could be set up for a very strong 4th quarter. As we mentioned in our prior letter, there have been 19 previous quarters in which the S&P 500 declined by at least 15%, which is what happened in the 2nd quarter. Two quarters later the market has been positive 100% of the time with a median return of 13%. Below we discuss the cause of these declines, current actions and investor behavior.

Why Has This Happened?



The Federal Reserve and its' chairman, Jerome Powell, backed themselves into a corner last year when they repeatedly said that inflation was "transitory." Although there were signs that inflation was declining at year end, the war between Russia and Ukraine sent inflation back to highs not seen since the 1970s. We believe the Fed should have been raising rates a long time ago as the US economy and stock market were no longer in need of help

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because of the $5 trillion put into the economy from COVID-19 stimulus. Nevertheless, the Fed had no choice but to start tightening and has raised rates over the first 9 months of this year faster than any other rate increase in modern history, crippling stocks and bonds.

- **Interest Rates & Bonds -** When interest rates increase, bond prices decline in value as investors no longer prefer the lower rates on older bonds when they can buy new bonds at higher yields. This is confusing for many investors because the underlying bonds, in most instances, are sound, meaning that they are not in default and currently making payments on time. In fact, if held to maturity these bonds will continue to pay interest and will return their principal to investors. The bond market returns in 2022 is simply the reaction to higher rates.

- **Interest Rates & Stocks –** The stock market doesn't like uncertainty and 2022 has been full of it. Every monthly inflation report since May has resulted in massive swings in stock prices (see the chart below). If inflation reports come in elevated to expectations, markets have had big moves down and if inflation numbers cool, markets have rallied.

  The big question for investors is, will inflation subside enabling the Fed to stop raising rates? At some point, we are optimistic that inflation will return to more historically normal levels. Lower inflation will be a positive for markets as it will allow the Fed to stop raising rates, slow the pace of rate increases or potentially lower rates over time. Lower rates are very important for stock valuations because stocks will ultimately be valued at higher prices.

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What are we Doing Now?

Although we can't control markets, we can operate around them, below are some of the actions that we have taken this year:

- **Buy Quality Companies –** When markets correct, good companies are often thrown out with the bad, which creates opportunities for long-term investors. There are many great companies that are trading at large discounts and we have used the market correction this year as an opportunity to upgrade the overall quality of our positions. When markets recover, and they always do, these companies, we expect, should do well in the coming quarters and years.
- **Tax Loss Harvesting** – For taxable accounts, we have been actively tax loss harvesting throughout the year. If we have a position that is trading at a loss, we can sell that position to capture the loss, buy a similar holding for 31 days, and then buy back the original position. This tax loss can be used to offset future gains indefinitely into the future or used to reduce taxable income by up to $3,000 annually. Stocks tax losses can also be used to offset other types of profits, such as the gains from the sale of real estate and gains from the sale of an operating business. Research by Vanguard has shown that tax loss harvesting can add 1.5% to after tax returns annually.
- **Rebalance** – We have actively rebalanced accounts throughout the year. This is one of the most basic concepts in investing and rhymes with the old adage of buying low and selling high. For example, if one had a 60% weighting to stocks to start the year, that allocation has most certainly declined, so rebalancing buys more stocks to get the portfolio back to its target weight. When markets recover, the additional weighting to stocks will help us get back to our high-water marks faster.
- **Diversify** – We have been significant investors into Diversifying Strategies since inception and they have been the bright spots of portfolios in 2022. While diversification benefits have fallen apart between stocks and bonds, our alternative investments have performed quite well, delivering returns when we need them the most. We currently have a real estate fund open to new investors that is finding great opportunities in a somewhat dislocated market.

  

  We also have a diversifying strategies fund that invests in Venture Capital, Private Equity, Private Credit, and Hedge Funds. Historically the best time to be making these investments is in times of distress and we are finding plenty of opportunities, which should be accretive to returns over time.

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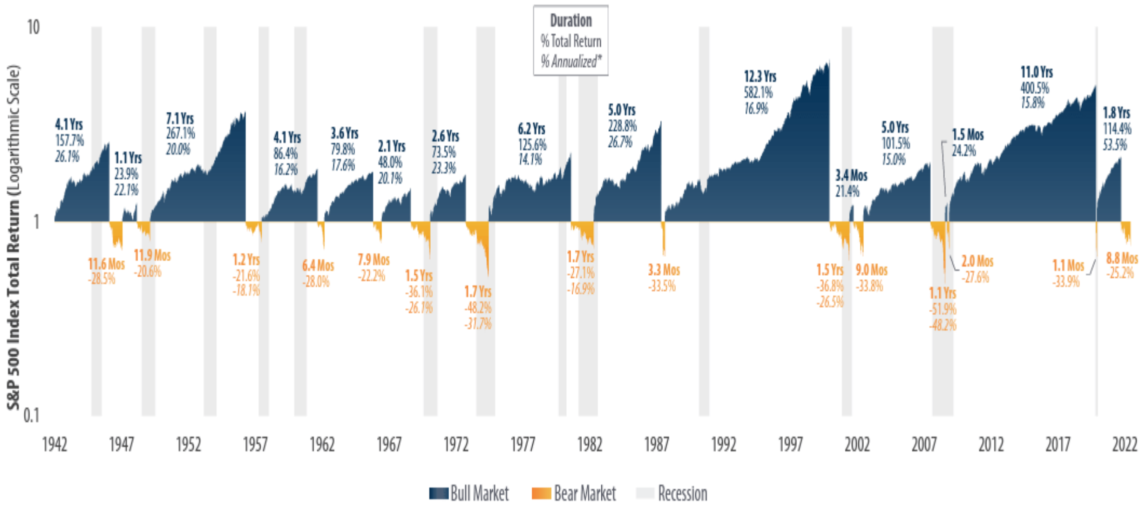
What Should Investors Do Now?

While we have been active on the investment management side this year, perhaps our single biggest impact for clients revolves around investor psychology. Investing can be very emotional, but letting emotions dictate behavior can be disastrous. In times like this, we encourage more frequent and more in-depth conversations, which helps keep the daily news events in perspective with our longer-term strategy. Any good plan will be tested by bear markets which happen frequently but are mostly unpredictable. The average bull market lasts 4.4 years and has an average total return of 156%. The average bear market lasts 11.1 months and has an average total loss of 31.7% (chart below). Fortunately, we spend far less time in these bad markets, but that time is far from enjoyable.



Here are a few behavioral instincts that have proven to help investors through down markets:

- **Invest Cash** – Dollar cost averaging is one of the most basic concepts in investing. However, every time the market declines, many investors lose their discipline and don't want to invest in a falling stock market. If one has a long-term perspective, there is no better time to invest in stocks than in a down market. Although short term rates on cash holdings are the highest since 2007, cash will not be how investors recoup bear market losses. As can be seen from this chart, large declines are typically followed by large gains. In this example, when 95% of stocks drop below their average price of the prior 50 days for over 2 days in a row, stocks are higher 100% of the time by an average of 24% over the next year. We are not calling a market bottom, but we are seeing many indicators like this one that indicate we are working toward a bottom, which will most likely be a process and not an event.

95% of Stocks below their 50 day Moving Average 2 days in a row
S&P 500 Index Performance following events

Summary	3 Months	6 Months	9 Months	1 Year
Average Final Return	**5.3%**	**9.3%**	**15.5%**	**23.6%**
% Positive at End	66%	76%	89%	100%

**Since 1988 (25 occurrences)*

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- **Play Dead** – If you meet a bear in the woods, the best thing you can do is play dead as fighting back would be disastrous. The same rules apply in a bear market, don't do anything that would prohibit you from the ultimate recovery.
- **Don't Peak** – Research has shown it is not helpful to continually look at one's portfolio in tough times. As mentioned earlier, negative emotions can lead to very bad behaviors.
- **Revisit Your Plan** – Now is a great time to update your overall plan, which includes reviewing cash flow needs, tax opportunities and estate planning opportunities. We will be sending out our year end planning opportunities in the coming weeks, stay tuned.

Conclusion

Thank you for taking the time to read this letter. No one can predict the future, but it is times like these that having a solid financial plan and investment policy are most important. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time to setup a review meeting.

Sincerely,

Canal Capital Management

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