RIVERWATERBLUE

Q3 2023 Riverwater BLUE Update

By Connor Doak

Performance

2023 has proven to be a continuation of several ongoing trends. In our previous quarterly letter, we discussed the historically high levels of performance concentration within the S&P 500 Index. While the stock market experienced a decline during the last quarter, this trend has slowed but not disappeared. The so-called "Magnificent 7" (NVIDIA, Apple, Microsoft, Meta, Amazon, Tesla, and Alphabet) continue to significantly contribute to the S&P 500's performance in 2023. These 7 stocks have accounted for 85% of the 13% year-to-date return. If these stocks were not included in the index, its return would be a much less impressive 2%.

In the third quarter, market weakness was more widespread, with the S&P 500 falling by 3.3%. The "Magnificent 7" contributed approximately 1% of this decline, which aligns with expectations considering their +25% weighting in the index.

Another notable similarity we observed this quarter, similar to the past couple of years (primarily since the Russian invasion of the Ukraine), is the outperformance of the energy sector. In 2022, only two sectors generated positive returns: energy and utilities. Once again, in the third quarter of 2023, only two sectors yielded positive returns: energy and communication services, with the latter driven by Alphabet and Meta, both members of "Magnificent 7." Energy's gains came from a simple supply and demand imbalance. OPEC has cut production, thus crimping supply, while demand has stayed relatively strong.

The bond market experienced a 3.2% drop during the quarter, pushing its year-to-date return into negative territory. As mentioned in previous quarters, rising interest rates continued to exert downward pressure on bond prices. The Federal Reserve has moderated the pace of rate hikes, believing that they are nearing their goal of controlling inflation. However, at least for now, they reiterated their commitment to maintaining higher rates for an extended period. With the yield curve now adjusted to this expectation and some positive economic data, the 10-year US Treasury yield increased to 4.6%, a level not seen since 2007. This increase in interest rates has adversely affected the prices of longer-dated bonds in the past 18 months; however, higher yields should result in higher bond returns going forward.

For those familiar with our previous letters, we've explained how this environment isn't ideal for our investment models. We focus on fund managers who prioritize valuation sensitivity and avoid overpaying for stocks, such as the "Magnificent 7." Additionally, all our fund managers adhere to strict ESG criteria, which can exclude high-carbon-emitting companies, many of which are in the Energy sector. This reduced exposure to the best-performing sector has impacted relative returns over the past couple of years.

The challenges of this environment were evident in the third quarter, with three of our five models underperforming their respective benchmarks, particularly those with higher stock allocations. The underperformance across our models was entirely driven by our equity fund managers. Of the 13 equity mutual funds employed in our models, all posted negative absolute performance, following the broader market, with the majority of the mutual funds falling more than their respective benchmarks. This performance falls short of our expectations, given our models' historical ability to protect capital in challenging market conditions. Not all of this underperformance can be chalked up to market concentration and lower energy weightings, some of it undoubtedly is due to difficult stock selection. While it's not unusual for fund managers to face challenges at various points, it's indeed exceptional to witness such challenges across many of them simultaneously.

However, despite a tough third quarter, all but three of the underlying mutual funds are in the top half of the peer group over the last five years, giving us validation to stay the course. In addition, all five of our models have achieved positive absolute returns in the 2023 calendar year-to-date, including our Sustainable Income (100% bond) portfolio which has generated a positive 1.6% return, outperforming the US Aggregate Bond Index (-1.2%) by a significant 2.8%. This is a welcome improvement following the difficulties of 2022.

Challenging market environments increase volatility, which is precisely when it becomes difficult to stay the course. Despite a tough quarter, this is when we need to remain vigilant in our roles as analysts and asset allocators. We continue to engage with portfolio managers and conduct due diligence to maintain our conviction that we invest with fund managers with distinct competitive advantages and the potential to enhance client portfolios over the long run.

With this approach in mind, we have been actively researching new mutual funds that can either replace existing positions or bolster our current models. We hope to have updates to share in our next quarterly letter.

Social and Environmental Impact

To underscore our commitment to creating a better world through sustainable investing, each quarter, we spotlight an instance of positive impact achieved by one of our fund managers through their sustainable investments.

This quarter, we turn our focus to the TIAA-CREF Core Impact Bond fund. Within this fund, an impactful investment was made in the form of a Blue Bond issued by the island nation of Barbados. The Blue Bond program is administered by the Nature Conservancy and receives support from the Inter-American Development Bank and the US International Development Finance Corporation.

These bonds were issued to refinance $150 million of Barbados' sovereign debt, and the proceeds from this initiative are directly linked to binding conservation agreements with the country's government. These agreements aim to safeguard the sustainability of Barbados' oceans, which are vital for protecting its tourism and fishing industries—both of which contribute significantly to the island's GDP and employment, with over 40% of the workforce reliant on these sectors.

By refinancing their debt at a lower interest rate, Barbados has unlocked an additional $50 million over a span of 15 years. This funding is earmarked for designating 30% of its marine territory as a Marine Protected Area. Investments like these demonstrate that it is possible for investors to achieve competitive returns while simultaneously making a tangible and positive impact on the environment.

As always we appreciate your trust and confidence.

Connor Doak, CFA

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