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Third Quarter 2023 Commentary

Dear Clients,

Please find enclosed your Third Quarter 2023 Investment Reports.

The third quarter saw the first quarterly dip in U.S. large cap stocks for the year with the benchmark down 2.7% for the quarter. All the other major stock asset classes posted negative results as well, as shared in the table below. Broad bond indexes, both in the U.S. and overseas, were also negative for the quarter (down 3.2% and 3.6% respectively). A negative quarter across both stocks and bonds is reflective of where investor sentiment is at this moment. To highlight the areas of concern, consider a recent Federal Reserve Bank survey of U.S. Chief Financial Officers (CFOs). The polled CFOs listed their top two concerns as "monetary policy" and "labor quality / availability."

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	-2.7%	23.7%	10.5%
US Mid Cap Stocks	-5.1%	12.6%	6.5%
US Small Cap Stocks	-4.6%	12.4%	4.6%
Developed International Stocks	-4.1%	25.6%	3.2%
Emerging Market Stocks	-2.9%	11.7%	0.6%
US Bonds	-3.2%	0.6%	0.1%
Global Bonds	-3.6%	2.2%	-1.6%

Data source: YCharts. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

In other words, CFOs are anxious about the two topics that also concern the Federal Reserve the most: inflation and unemployment. On the one hand, the U.S. labor market has proven remarkably robust, and it remains difficult for companies to hire quality candidates at profitable (for the company) wages. On the other hand, U.S. CFOs are expressing anxiety about how high (and for how long) short-term interest rates might need to be raised to cool inflation.

When CFOs are concerned about profit margins, so are stock investors. When CFOs are concerned about how long short-term interest rates will stay elevated, so are bond investors. When the value of stocks and bonds fall at the same time, it means everyone starts to feel less wealthy. When investors feel less wealthy, sentiment turns sour. There is a complex reflexivity to human moods, both at the individual level and in communities; we have all experienced moments when negative feelings snowball.

If we look at the benchmark returns table to the left over a slightly longer time window, we see that stock investors have not yet felt much of a pinch. The "last five years" column shows annualized returns, where "annualized" just means the average annual return that, when compounded each year, would have produced the actual five-year total return (for example, $1 invested in U.S. Large Cap Stocks would have produced a $1.65 in total return at the end of five years; or, an "annualized" 10.5 cents per year, compounded). So, for five years, U.S. Large Cap stock owners have enjoyed average "annualized" returns of 10.5% (which is above historical averages), while more diversified stock investors have enjoyed less stellar, but still solid stock portfolio returns.

However, long-term buy and hold bond investors have earned almost nothing over the same five-year period. Low bond returns should not come as a total surprise though, as bonds purchased three to five years ago offered historically low yields at the time of purchase. Long-term bond investors have a reasonable estimate of what they will earn when they buy a bond (for most types of bonds, the only variable factor is whether the issuer makes all the promised payments). The good news for bond investors today is that they are being paid more for lending their money. When we look back at this newsletter five years from now, bond investors are likely to have enjoyed solid investment returns at levels commensurate with today's higher yields.

Looking at the five-year column on the benchmark returns table, rather than the one quarter column, is part of why we encourage our clients to avoid placing undue weight on short-term news. In fact, it is an interesting observational truth that the shorter the time frequency that one observes the market, the more likely one is to observe a negative result. For example, if one were to randomly choose any day in the past one hundred years or so and invest money into a broad U.S. large cap stock index on that day, the frequency of seeing a positive return on the investment one year later would be about 75% of the time. If one instead only looked three years later, that positive observational frequency would improve to about 85% of the time. This same pattern of improvement holds over many time horizons. (i.e., one will see a positive stock return more frequently over an hourly frequency than say a shorter five-minute interval).

What are the implications of this return frequency distribution in stock markets? We are not going to suggest only looking at your statements every ten years (though that has to a degree explained why institutional investors like private equity so much), but we would encourage you to avoid fixation with "constant" financial news channels like CNBC (our recent appearance on their network notwithstanding). Short-term stock market performance is simply more frequently negative than long-term stock market performance.

That said, there is more to the stock market's performance than feelings and sentiment. As the value investor Benjamin Graham once famously observed, "in the short-run the market is a voting machine, but in the long-run it is a weighing machine." Our cultural images of weighing machines usually include a blindfolded statue of Justice impartially holding her scales. What items should we place onto the stock market's impartial scales? Primarily the timing of and probability of producing future cash flows. Producing future cash flows is driven by a company's ability to anticipate and usefully serve customer needs. Success in usefully serving customer needs is the domain of the entrepreneur, though sometimes we are lulled into thinking that it is the domain of the government.

There is a short video floating around the internet that shows a young man (foolishly) approaching parallel to an incoming subway train from the subway platform. He grabs hold of a subway car and slows his run at the speed of the train in such a way that it appears he is applying the force that actively causes the train to slow (like Superman). The train pauses and the doors open in a largely empty station for a moment, and then the man resumes his efforts by pushing against the back of a subway car, increasing his speed in tandem with the now departing train in such a way as to appear to be the force causing the train to accelerate out of the station. This man, in our estimation, represents many of the government's efforts to move the economy along. We encourage you to not be overly distracted by such intervention, whether it originates from campaign trail promises or from an economic committee's "dot plot" guess of the future.

Rather, remain focused with us on the fundamental sources of long-term future cash flows. Human innovation powers the economic train, not a politician or bureaucrat running alongside it. We have confidence that market forces will continue to deliver a long-term investment return to the owners of companies that successfully serve the needs of consumers.

As always, we remain grateful for your trust.

Leavell Investment Management, Inc.