jhh wealth advisory
wealth solutions

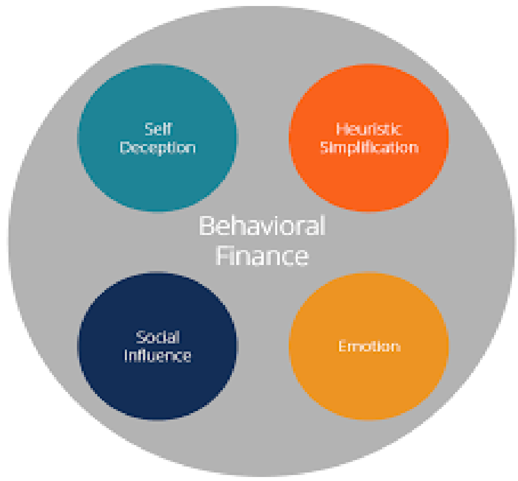
Letter to Clients
October 7, 2021

4th Quarter Letter to Clients

October 7, 2021

Introduction

As investment professionals, understanding behavioral finance is necessary to best serve clients. Behavioral finance is a branch of investment theory that tries to identify and explain biases that cause people to make irrational investment decisions or behave in financially detrimental ways.[1] Some common examples of detrimental behaviors include 'panic selling', making investment decisions based on emotions instead of facts, and following a herd mentality based on what others appear to be doing.



At jhh, investment portfolios tailored to each client's individual needs is only the first step. Part of our ongoing relationship includes recognizing detrimental biases and coaching our clients against making emotional and harmful decisions based on those biases.

Recap

Over the past couple of years emotions have run high, testing the viability of behavioral finance. Investors have been faced with a gauntlet of fear, uncertainty, and doubt – whether it be COVID and its variants, the unusually acrimonious election, political crackdowns in China, or a bevy of other concerns – the temptation to sell has been unprecedented. Despite these concerns, the market has shown amazing resilience. The market resilience has been so strong, in fact, that market valuations have reached historic highs.[2]

An investor wrongly succumbing to the negative elements of behavior finance would be baffled by this development. The prudent investor need only to study the facts to determine that the market rally was justified. The fact is that corporate earnings are a major determinant of stock prices, and the reported earnings since April 2020 justified valuations. For some perspective, the average earnings 'beat' over the last four quarters has been 18 percentage points above analyst estimates.[3]

Furthermore, historically low rates and stimulus were a perfect storm for a rise in equity prices. Simply put, investors had historic liquidity to invest, and with fixed income rates so low, equities became mandatory for investors needing to fulfill their growth objectives. jhh removed emotion from the equation and relied on facts to tell us that clients should have exposure to the equity markets. That is, until last quarter, when jhh began to go defensive.

Government Giveth, Government Taketh Away

Of course, hindsight is 20/20 and our true value to clients lies in **forward-looking advice**. jhh sees further evidence that a continued defensive stance is warranted. Firstly, the proposed Biden tax bill may dent the fact that corporate earnings and household liquidity justified the market rally. To help pay for the proposed $3.5 trillion bill, Democrats have drafted proposals to increase taxes across several areas like capital gains, corporate taxes, and individual income rates. Though no plan has been agreed to by Congress, the factions within the Democrat majority generally agree that raising taxes on high income earners and corporations is warranted.

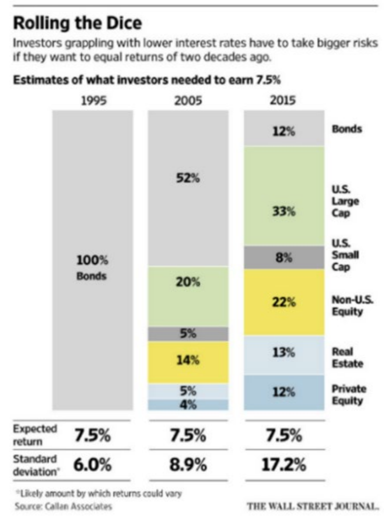


Figure 1

Stock Market Indicators

Predictive power in explaining the market's performance since 1909.

Indicator	Predictive power*
Household equity allocation	69%
Price/sales ratio	63%
Buffett ratio	49%
Q ratio	37%
CAPE ratio	29%
Price/book ratio	23%
Dividend yield	15%
Price/earnings ratio	12%
Change in top corporate tax rate	0%
Change in top capital-gains tax rate	0%

*R-squared correlation between indicator and stock market's trailing 10-year return.
Source: www.HulbertRatings.com

Figure 2

Secondly, tapering, and thus rising rates, is inevitable. As yields move higher, bonds will become more attractive to investors who thus far have reached out on the risk curve to satisfy return requirements as shown in figure 1 above. On the left, figure 2 shows how household equity allocation has been the most reliable stock market indicator.[4] The fact is that this indicator, which is at all-time highs, may be under assault by approaching headwinds that previously served as market tailwinds.

Conclusion

As previously mentioned, common examples of detrimental behavior include selling at inopportune times or succumbing to doomsayer herd mentality in lieu of investment advice based on facts. The reverse can be true as well. As markets get frothy, greed can replace fear and investors may ignore facts signaling it may be prudent to take your gains. By lowering corporate tax rates, extraordinary stimulus efforts, and injecting liquidity into the markets, government policy created an environment that resulted in unprecedented market gains. It appears increasingly likely that the government will now increase corporate tax rates, stop stimulus, and begin cutting back on liquidity injections.

At jhh, we are sticking to the facts and positioning portfolios accordingly. In conclusion, jhh is in 'wait and see' mode. Prudence dictates to wait for the final bill language, rise of interest rates, and/or tapering by the Federal Reserve before venturing back out on the risk curve.

jhh wealth advisory wealth solutions

Tactical Asset Allocation: Views and Rationale

5 – Strong OW | 4 – Moderate OW | 3 – Neutral | 2 – Moderate UW | 1 – Strong UW

Change from previous letter – Upgrade: ⇧ Downgrade: ⇩ Neutral: ▬

Asset Class	Views	Rationale
Equities		
US Large Cap	▬ (3)	Last quarter, jhh posited that equities still had little competition from other investments due to low rates and liquidity. That remains the case simply due to the fact that rates are still at low levels. However, that thesis is beginning to crumble as tapering talk gains steam and tax hikes appear certain (among other concerns such as the debt ceiling, inflation, ongoing COVID concerns, etc). jhh isn't changing our rating, but rather recommending a more defensive and/or opportunistic posture within this space. Financials in particular can benefit from rising rates (banks make more money when loans reap higher interest payments), and energy looks undervalued and in a prime position to benefit from inflation/supply shortages. Avoid spaces that benefited from the evaporating environment of unprecedented stimulus and low rates, as it appears that era is coming to an end.
US Mid/Small Cap	⇧ (3)	Small and mid-cap companies have fared well in the low-rate, high stimulus environment. Since August, smaller companies have experienced a sell-off due to concerns of rising rates and cutting back on stimulus. We upgrade to neutral - take this as advice to monitor the action in smaller companies and begin to speculate on this space if/when it becomes oversold (which it may be as of this letter).
Developed Equity	⇩ (3)	Similar dynamics as US Large Cap. Keeping our rating in line with domestic.

Emerging Markets	(2)	China dominates weightings in most emerging market ETFs. China's economy grew at a slower pace than predicted last quarter. This, combined with government crackdowns and the Delta spread, provides too much risk to recommend a sizeable position in emerging markets. With that said, much like our small/mid thoughts, the fact is many companies with solid fundamentals appear oversold. The political risk remains a wild card, hence, no upgrade, but this space is becoming more appealing as the overselling continues.

Fixed Income

US Fixed Income	(2)	Bonds still don't offer enough incentive to consider any sort of meaningful investment in passive vehicles, but this is subject to change as rates rise/fixed payments increase. Generally, jhh still believes this space lacks appeal, but opportunities are rearing their head for skilled fixed income managers to find value for their clients.
Developed Fixed Income	(1)	Investors continue to face zero-to-negative rate policies across the globe. Like domestic fixed income, investors should work with their advisors to find suitable risk-adjusted return elsewhere
Emerging Market Debt	(3)	Emerging Market debt typically has higher yield than our domestic counterparts due to the increased risk. We had previously recommended investors work with skilled managers to find yield in this space. Simply put, as domestic yields rise, risky foreign yields become less appealing. With that said, there is still opportunity for skilled fixed income managers to find value for their clients in this space.

jhh Investment Committee

Eric Hines
Portfolio Manager
Director of Asset Management

Sam Haskell, CFA®
Chief Investment Officer

Jeff Hines, CFA®
Portfolio Manager

Disclosure

This information should not be relied upon as investment advice, research, or a recommendation by jhh wealth, llc regarding (i) funds, (ii) the use of suitability of the model portfolios or (iii) any security in particular. Only an investor and their financial advisors know enough about their circumstances to make an investment decision.

The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

---

[1] Rambow, John, *Business Insider.* "Behavioral finance is a science…" Feb 4, 2021

[2] Pisani, Bob. *CNBC.com.* "Powerful corporate profits and forecasts of more to come have investors cheering," Feb 5, 2021

[3] Pisani, Bob. *CNBC.com.* "Earnings season starts with sky-high stock prices and soaring expectations," July 23, 2021

[4] Schwartzer, Lyn Alden. *Seeking Alpha,* "Record Household Equity Exposure," July 19, 2021