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Quarterly Insights

Should Investors Worry About Rising Geopolitical Risks?

By Jared Kizer, CFA

With the ongoing unrest in the Middle East, some clients have asked how geopolitical risk might impact their portfolios, how they should think about this risk and whether there are portfolio strategies that can mitigate it.

First, know that geopolitical risk is among the primary risks that globally diversified stock portfolios are exposed to and are generally compensated for. The historical record is replete with this risk in a wide range of forms — from regional to global wars to political unrest within and between countries — that had a negative impact on the global economy.

This means that there is both good news and bad news for markets. The bad news is that when you allocate to stocks, an unforeseen geopolitical event is one of the primary risks you take. The good news is that markets generally understand this, and it is one of the reasons that stock prices are lower than they would be otherwise.

Portfolio strategies to mitigate geopolitical risk

So, what can investors do? It is important to remember that this risk can be managed but not completely avoided. Below are the primary allocation strategies we recommend that can help protect your portfolio from political unrest across the globe.

1. **Don't take more stock market risk than you need to achieve your goals or exceed your tolerance for risk.** While one must keep in mind that markets can always surprise, the historical record is nevertheless helpful in assessing the risks of a given allocation to a diversified portfolio of stocks.
2. **Look for opportunities to reduce stock market risk after periods when stock market returns were above what was expected.** These periods usually correspond with substantial — and unexpected — improvement in the likelihood of achieving a particular goal.
3. **Make sure the fixed income allocation emphasizes higher-quality, government-backed fixed income.** While most federal governments including the U.S. are on unsustainable debt trajectories, it is still reasonable to expect that U.S. government fixed income (and likely higher-quality state and local debt) should do relatively well when geopolitical tensions impact global stock markets.
4. **Consider alternative investment strategies, which are different from conventional stocks and fixed income.** Because alternative investments have low correlation to traditional strategies, investors can expect them to be either minimally impacted by geopolitical risks or completely unrelated. Allocating some portion of a portfolio to alternatives that would have otherwise been allocated to stocks is one way to diversify against these risks. However, doing so does come with other considerations, such as higher expenses and more complexity.

The New Year Brings Big Questions for Markets

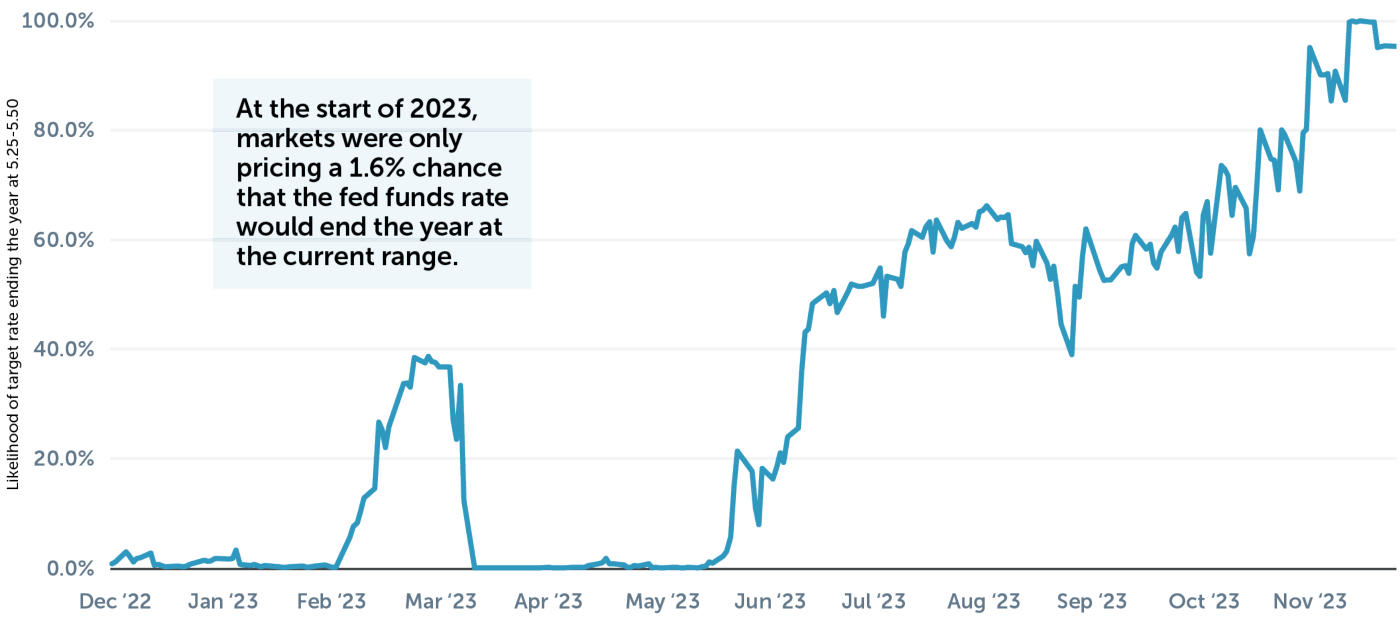
By Alex Kluesner, CFA

As we pack away the holiday decorations, we're reminded that every new year brings fresh opportunities and challenges for our lives and our portfolios. And 2024 is no different — with uncertainty surrounding future monetary policy and a looming presidential election. Let's look at the biggest questions ahead and the implications for your portfolio.

1. Will rates stay higher for longer?

Now that the Federal Reserve appears to be finished with its rate hike campaign, investors are focused on where rates will go from here. After the Fed's December meeting where rates were left unchanged, the federal funds rate futures markets were projecting that the Fed would start cutting rates this spring, ending in a target range of 3.75% to 4.00% by year-end 2024. But as the Fed concluded hiking rates in 2023, its official policy statement suggested that it was still premature to declare victory over inflation and that future rate hikes can't be ruled out yet. Although history has shown that the future path of interest rates is highly uncertain, we can analyze what such a scenario would mean for the stocks and bonds in your portfolio.

Monetary Policy Moves Are Difficult to Predict
Projected Federal Funds Target Range for 12/13/23 Meeting



Source: CME FedWatch Tool.

2. Will the comeback for bonds continue?

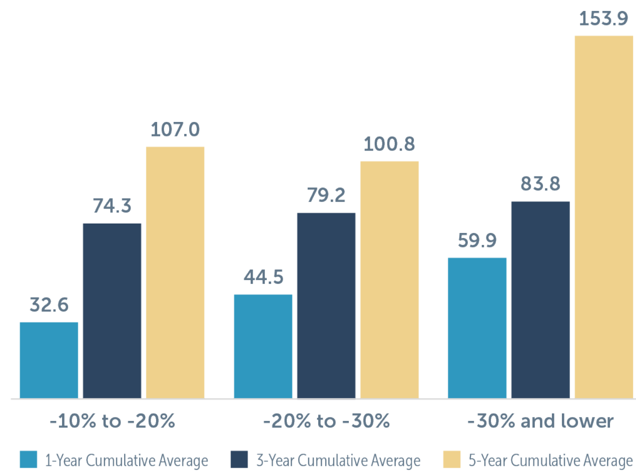
In 2022, bonds suffered stomach-churning declines as the Fed raised interest rates by a whopping 4.25%. However, for those who were able to stay the course, there are tailwinds to ride as a result. First, interest rates have risen and appear to be resting firmly higher relative to pre-pandemic levels, meaning both the expected return and expected yield are now higher for most bond portfolios. Both should provide for more capital growth opportunities for your portfolio relative to the past because proceeds from maturing bonds can be reinvested at higher rates, and it's more likely that portfolio withdrawal rates can be sustained over time.

3. Will stocks stay on a wild ride?

Interest rate movements also have direct implications for stocks. Even though the market was up almost 20% year-to-date through the end of November, we saw a 9% contraction over three months starting in August 2023 as the market accepted that the Fed will likely keep rates higher for longer.[1]

What caused this autumnal pullback? The same factors that drove markets upward earlier in the year—a resilient U.S. economy and better-than-expected GDP growth—led the Fed to dig its heels in further on keeping interest rates elevated toward the end of the year and beyond. Although markets are now turning toward the possibility for rate cuts this year, which contributed to a December rally in stocks, rates will likely remain higher relative to pre-pandemic levels.

U.S. Stock Market Returns Following Market Declines (%)
July 1926 - December 2022



Source: DFA Returns Web. Market Declines and Cumulative Average Returns following declines calculated using monthly returns of the Fama/French Total US Market Research Index.

So, what would higher rates mean for stocks? It will increase the cost of financing for companies that need to issue new debt or refinance to support ongoing operations. This could have a negative impact on corporate earnings and stock prices. However, given how difficult future developments are to predict, altering your stock portfolio in response to this scenario is unwise because expectations of future performance are ever-changing. And even if stocks decline, research shows that gains can add up after big declines.

4. How unpredictable will the election year be?

In addition to potential monetary policy changes, the upcoming presidential election is also top of mind for many. With 34 Senate seats up for grabs along with all 435 House of Representatives, control of Congress also hangs in the balance. It's important to remember that partisan control of Congress and the White House has had little impact on the economy and markets; U.S. GDP growth has continued to climb through each of the last 46 presidencies, and stocks have trended upward over the long term.[2]

Markets can be susceptible to elections through policy changes. When a candidate's proposed policies target specific market segments or regions and are expected to be impactful, affected company stocks will respond positively or negatively based on the likelihood of those policies being enacted. In 2024, candidates are likely to use the growing federal budget deficit as a platform to engage their constituents, but the likelihood of significant policies being enacted in any meaningful way is low because of competing spending priorities and prior failed attempts to raise government revenues through tax increases.

5. Will your portfolio be prepared?

As we become acquainted with the new year and the changes it brings, it's important to view our portfolios through a long-term lens and not limit our decision-making to the next 12-month window. Like every year, one of the most important decisions you can make in 2024 is to ignore the noise and stay invested along the way to meeting your financial goals. If you're still concerned that market events may affect your portfolio strategy and long-term plan, then you may want to have a conversation with your advisor to consider other options that would bring you more peace of mind.

1. Market returns represented by the Russell 3000 index.

2. J.P. Morgan. "2024 Elections: 3 thoughts on the year ahead." Nov. 10, 2023.

For chart 2, the decline thresholds are defined as 1.) -10% or lower without exceeding -20%, 2.) -20% or lower without exceeding -30%, and 3.) -30% and lower. The 1-year, 3-year, and 5-year cumulative average return calculations begin in the month following the period in which the decline threshold was breached. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Total return includes reinvestment of dividends and capital gains.

What's Behind the Rising Popularity of ETFs?

By Daniel Campbell, CFA

As the popularity of exchange-traded funds (ETFs) surges, investors and advisors are increasingly moving money from mutual funds to ETFs. Here's why ETFs are attracting so much attention.

You can think of ETFs as simply mutual funds that trade throughout the day. Although they differ in design, pricing and how they trade, both ETFs and mutual funds pool investors' money to purchase a set of securities — whether stocks, bonds or something else — and the investors in the fund own a fraction of that portfolio. The primary difference is that ETFs trade on an exchange, just like stocks.

The benefits of ETFs

Lower costs

Trading flexibility

Tax benefits

When an investor sells shares of a mutual fund, the fund manager may need to raise cash to meet the redemption, incurring trading costs that will be borne by the remaining investors and potentially realizing capital gains. In contrast, when an investor sells shares of an ETF, the transaction typically happens on a stock exchange, meaning they sell directly to another interested investor. This is one reason why ETFs tend to have lower capital gains distributions at year-end compared to similar mutual funds, giving investors better control over when they realize capital gains. In addition, due in part to the simpler operational structure, ETFs can have lower internal trading costs and often have lower expense ratios compared to similar mutual funds.

The potential limitations

Valuation

Trading risks

One limitation is that the price of the ETF can deviate from the value of the underlying holdings. But the impact is often mitigated by groups of institutional investors, called Authorized Participants (APs), who are eager to capture the difference in value. For example, if demand for the ETF pushes the price significantly higher than the market value of the underlying stocks, the AP will buy shares of those stocks and exchange them with the fund manager for shares of the ETF. The AP will sell the ETFs on the exchange, capturing the difference in value as a profit, and pushing the price of the ETF closer to its underlying value. Another potential limitation is the bid-ask spread, which represents the difference between the selling (ask) price and buying (bid) price. This is common with all publicly traded securities, but during periods of market volatility, the spread can get wider. If it widens even a few cents, the additional cost to trade a high number of shares can add up.

Does financial research support ETFs?

In recent years, the range of strategies an ETF structure offers has expanded significantly. Portfolios constructed with ETFs can now closely resemble those built with mutual funds. By knowing how ETFs trade, investors can benefit from lower costs and better control over capital gains, making ETFs an advantageous choice for long-term investors.