Q4 2022 QUARTERLY COMMENTARY – JANUARY 1, 2023

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We hope the New Year will allow us to turn the page on a difficult period in the global securities markets. Notwithstanding strong performances in the fourth quarter of 2022, the S&P 500, Dow Jones Industrials and NASDAQ Composite indexes ended the year lower than its outset by -18.13%, -6.86% and -32.51%, respectively, including dividends. Global equity indexes also suffered in 2022, with the MSCI ACWI Ex-USA and EAFE indexes down by -16.00% and -13.92%, respectively.

The most important driver of investment results in the past year, we believe, was the significant and rapid rise in interest rates, following more than a decade of low and declining interest rates. That dramatic reversal, driven by the market's reaction to a spike in inflationary pressures, led to a repricing of securities across the investment spectrum. We saw the effects in all markets and investment strategies that we pursue at Summitry on your behalf.

The most direct and obvious effect of interest rate changes is on bond values since the change in price of a bond with a fixed-rate coupon is inversely related to the change in market interest rates (higher rates lead to lower prices and vice versa). The longer the "duration" of the bond, the larger the effect[1]. The Bloomberg Aggregate Bond Index, an industry standard to measure investment grade bond performance, with a duration of roughly 6.2 years at present, began the year with a yield of 1.8% and ended the year with a yield 4.6%. That's a dramatic shift, closely mirroring the rise in the Fed Funds target rate from 0.25% at the outset of 2022, to 4.50% at year-end. Consequently, the benchmark ended the year lower by -13.0%. Similarly, the Bloomberg Municipal Bond California Exempt Total Return Index fell by -8.2%.

Because of the large and rapid increase in interest rates, bonds did not serve their traditional role as a safe harbor amidst choppy equity markets in 2022. We did what we could to mitigate the damage by limiting the duration of our bond exposures closer to 4 years on average, based on a composite of client accounts in our Balanced, Balanced Income and Income strategies. In our municipal bond sleeves within clients' taxable accounts, we have built "bond ladders" that distribute the maturities of our holdings across shorter and longer-term bonds, but with a goal of constructing a relatively short overall portfolio duration to protect clients from a rise in interest rates. In September, we also responded to the flat and inverted yield curve (the unusual circumstance when short-term interest rates exceed long-term interest rates) with a change in our approach to investing in bond ETFs to target what we felt were the most favorable points on the yield curve. The bonds and preferred securities held in our Sustainable Income strategy mostly had floating rate features designed to reduce their duration. Despite these efforts to protect, our bond holdings still lost value during the year. We take some solace in the knowledge that while bond prices move up and down with changes in interest rates, they are contractual obligations to return one hundred cents on the dollar to their holders at maturity. Barring a default or restructuring, something that occurs very rarely in the investment grade bond arena in which we operate, the total return of a bond over the period in which we hold it is determined the moment that we purchase it.

Beyond fixed income, the shift in interest rates also rippled through the equity markets. As bond yields rose, investors saw an increased probability of a recession in the near term, prompting them to revise downward their expectations of future corporate earnings. Further, higher interest rates lowered the valuation multiples investors would pay for those future earnings, particularly for growth companies whose value is largely derived not from the level of current earnings, but in the earnings they are expected to generate many years in the future. In their flight to safety, investors generally favored those stocks that are valued on current earnings and dividends in 2022. Even these investors tended to finish the year with losses, albeit to a smaller degree than those investors whose exposures were weighted to growth companies.

Lost in the forgoing, and amid a generally sour mood that prevails in the financial press focused on large corporate layoffs, war in Ukraine with no clear path to its conclusion, expected gridlock in Congress in the New Year, a hawkish Federal Reserve, and more, is the message that markets generally performed better in the final quarter of 2022. We should remember that stock and bond markets tend to be forward-looking and are less concerned with the present than they are with the future. They may be sending a signal that inflation—the main culprit driving interest rates and market uncertainty—has peaked. We believe that the tough medicine we're taking now, in terms of a Central Banks around the world tightening credit conditions, will dampen inflationary pressures as classical economic theory posits.

While we may feel somewhat more optimistic about the prospect of a return to more normal levels of inflation (and the market may agree based on recent results), we have no crystal ball that tells us where the markets will go next. Given this uncertainty, what is the right approach for you to take when investing? On one level—an important one for any investor—you need to determine the right asset allocation for your portfolio. After going through a difficult year, you should take stock of your appetite for volatility in your portfolio and consider the level of return you need over multi-year period to meet your personal financial goals. While doing this, be careful not to let the most recent experience color your expectations too much. It is a tendency for human beings to anchor their expectations of the future on the most recent past. Summitry's Financial Advisors have the expertise to guide you through this important self-evaluation process. At another level, it is important to embrace an investment philosophy when executing your appropriate asset allocation that focuses on quality and value. Understand the difference between a quality asset (stock, bond or otherwise) and its alternative, and know the difference between a bargain and a speculation. We believe that owning quality and value will allow investors to ride through the uncertain periods like the present and position themselves for growth when the pendulum swings in the other direction. This philosophy is timeless and provides the discipline to avoid the temptation to chase investment fashions that have no basis in common sense.

Q4 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.

During the quarter we initiated new positions in Universal Music Group and Moody's Corporation and exited our position in Northrop Grumman.

Universal Music Group

Universal Music Group (UMG) dominates the music record label industry. Record labels invest in promising artists early in their career in exchange for the rights to their recorded music and the publishing rights to songs and compositions. These rights allow UMG to collect a royalty fee when the music is being played. UMG represents prominent stars such as Drake, Justin Bieber, and Taylor Swift and owns the rights to the music of legends such as the Beatles, Rolling Stones, and Marvin Gaye.

The music label industry is consolidated. The top three players, UMG, Sony Music, and Warner Music Group hold over 70% market share. UMG is the largest label with over 30% share of all recorded music and 20% share of the publishing market. While the market for new talent is competitive, UMG's moat stems from the ownership of intellectual property rights that generate royalties for decades.

Music is a growing industry driven by consumption. In the early days of the internet, music piracy was a major headwind, but the trend has reversed due to growth in streaming. Today, streaming is a major contributor to unit and price growth for both labels and artists. In addition, social media is a relatively new vertical for the music industry, expanding consumption beyond the traditional use cases.

The stock declined during the recent market sell-off as investors contemplated the impact of rising interest rates and mounting recession concerns. We took advantage of the market volatility to establish a new position in this exceptional business at an attractive valuation.

Moody's Corporation

Moody's is one of the two rating agencies that dominate global debt markets. Thousands of organizations, corporations, and governments rely on its ratings to access funding for their operations. Individual and institutional investors rely on Moody's ratings for their investment decisions and risk management. Moody's charges a small fee for rating a new security and a fee for maintaining the rating through maturity or retirement. In addition, Moody's owns an analytics business that offers essential data for risk management, compliance, and financial analysis.

Moody's moat stems from the mission critical nature of its services to borrowers and creditors. Moody's benefits from significant switching costs and barriers to entry due to its entrenched position in government regulations, industry common practices, commercial contracts, executive compensation packages, and investment mandates. Moody's is a critical factor in the proper functioning of debt markets and is well positioned to maintain its dominance in the foreseeable future.

The stock came under pressure during the quarter after rising interest rates led to lower debt issuance. We view this as a temporary slowdown in activity and we expect debt issuance to recover once interest rates stabilize. Over the long run, it is likely that the level of debt in the global economy will keep rising in line with GDP, which will be a long-term tailwind to Moody's. As the market became overly concerned with short term trends, we concluded that the stock offered an attractive risk-adjusted return to long term owners.

Northrop Grumman

Northrop Grumman is a prime defense contractor with leading positions in aerospace and cyber security. The industry benefits from stable demand, limited competition, and pricing discipline. As a result, Northrop Grumman generates attractive and stable returns on invested capital.

We purchased the shares in early 2021, after concerns of lower defense spending under the Biden administration led to weakness in the stock. Our thesis was that any cuts to defense will come from other programs and not from Northrop's solutions which are critical to our nation's defense.

Shortly after buying the stock, the Biden administration signaled that competition with China would prompt investments in the type of solutions that Northrop specializes in. The war in Ukraine added to the urgency of investing in aerospace defense and cyber security. Investors took note of both developments and the dire projections for defense were quickly replaced by buoyant outlooks. Fear made room for greed and Northrop Grumman stock has appreciated by over 80% since Biden's inauguration.

When we make a new investment, we are delighted when we can own the stock for years and earn a satisfactory return. But when the stock price moves much higher very quickly, future returns compress into a short period of time. After hitting record highs in the quarter, Northrop Grumman stock traded at what we considered the best-case valuation. After 20 months of ownership, we concluded that we are best served looking for future return in other names.

New to Summitry

During the quarter, we welcomed Daniel Spector-Franson to the firm. Daniel comes to Summitry from an independent Bay Area-based retirement planning firm, offering advice and solutions to retirement plan sponsors and participants. Previously, Daniel worked for the Los Altos Hills-based non-profit, Hidden Villa, where he rose to leadership positions in donor and volunteer outreach, marketing and strategic planning. With this wealth of experience, we are delighted that he joins Summitry as an Associate Financial Advisor and CFP® professional, providing financial planning support to the firm's Financial Advisory team and to the firm's clientele. Midwestern by birth, Daniel is a graduate of Indiana University, where he earned a bachelor's degree in Spanish and Latin American Studies and pursued studies with the University's Lilly Family School of Philanthropy. He lives in San Ramon with his wife and 9-month-old daughter. Please join us in welcoming Daniel to Summitry.

The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. Investments in securities market can be risky, and investors should be prepared to lose some or all of their invested capital. There is no guarantee that Summitry will be successful in its investments and readers should not interpret this as an indication to buy or sell any securities discussed herein.

[1] “Macaulay duration” is the weighted average time to receive all of a bond’s cash flows and is expressed in years. A bond’s Macaulay duration can be used to determine a bond’s price sensitivity to changes in interest rates (“modified duration”). In practice, the concept of duration can be applied to any asset that generates cash flow. In general, longer duration, i.e., further in the future an investor receives her cash flows -> higher sensitivity in that asset’s price to changes in interest rates.