Q2 2023 Riverwater BLUE Update

By Connor Doak

Performance

The US stock market has maintained its torrid pace over the last six months, rallying 16.9% year to date. This rally, which began after the lows of Fall 2022, has now propelled the US into a new "Bull Market," defined as a rally of more than 20% from its most recent lows. With the strong momentum over the past nine months, the S&P 500 is now approaching its all-time highs set at the beginning of 2022, just before the Federal Reserve initiated its rate hiking cycle. On the surface, everything appears great: employment remains robust, inflation has moderated, the government agreed on a debt-ceiling increase, and bank failures have paused. However, beneath the surface lies the most concentrated market since the dot-com bubble.

This concentration does not bode well for diversified portfolios. The Nasdaq Index, typically composed of technology-related companies, has surged by 32% through the end of June. In contrast, the Russell 2000 Index, consisting of smaller-cap companies more sensitive to economic growth, has only risen by 8.1%, far behind the gains of mega-cap tech and AI-related stocks. If one didn't own mega-cap tech and AI-related stocks, their returns in 2023 are likely closer to 5% than 15%.

The bond market experienced a slight decline during the quarter as stronger-than-expected economic data reinforced the belief that the Fed will continue hiking interest rates, albeit at a slower pace than the past 18 months. Bond prices move inversely to interest rates, so the news of slightly higher rates exerted downward pressure on bonds. On a positive note, most core bonds are yielding around 4%, allowing the income generated by bonds to offset some volatility caused by interest rate fluctuations.

Despite positive returns generated by every model during the quarter and year-to-date periods, four out of the five BLUE models have underperformed their respective benchmarks, with the models having higher stock allocations underperforming significantly. Our BLUE models typically have lower exposure to high-flying technology and AI-related sectors. Many of the underlying managers we employ follow strict valuation criteria and are cautious about overpaying for overvalued stocks. The technology and

AI-related stocks that led this year's rally trade at very high valuations, which fail to meet the risk-reward criteria of many underlying managers. In such a concentrated market, not owning a few stocks can make or break a quarter. During Q2, seven out of the twelve equity managers underperformed their respective style benchmarks. However, when compared to the global equity benchmark, where US mega-cap tech stocks tend to have more influence, only two out of the twelve were able to outperform.

On the other hand, the bond managers in the BLUE models performed much better, with each bond manager generating positive excess returns relative to their benchmarks, primarily due to credit selection. The performance of the bond managers contributed to the BLUE Sustainable Income model outperforming its index over the entire quarter and year-to-date period.

These portfolios are designed with a high-quality and more conservative approach to risk-taking. Therefore, it is not surprising that many of the funds trailed their peers when the market rallied 8.7% during the quarter and 16.9% year to date, driven by only a few stocks. Although the most recent quarter has dragged down the year-to-date and trailing one-year returns, four out of five BLUE models have maintained their outperformance over the trailing three-year period, and all still exhibit positive relative outperformance since inception.

Social Impact

The Riverwater mission is to make the world a better place by growing wealth through sustainable investing. In that spirit, we like to highlight the positive impact made by mutual fund managers within our Riverwater BLUE models.

Calvert Research and Management has a long history of supporting the health and sustainability of global markets and improving investment returns through its active engagement with corporations. Throughout the year, Calvert continued its decades-long work with companies to address critical issues such as climate change, workplace rights, and managing the global energy transition.

Calvert has engaged with PACCAR for several years on greenhouse gas emissions reductions. In 2021 the company established science-based targets for GHG emissions reductions and, in particular, reducing the scope 3 GHG emissions from the commercial trucks the company sells. PACCAR has recently allocated significant capital to research and development for electric trucks. As seen with electric passenger vehicles, demand can increase quickly leaving automakers scrambling to catch up. Calvert is continuing its engagement to emphasize the value of leadership in zero-emissions trucks and to further align the business to achieve net-zero over time.

As always we appreciate your trust and confidence..

Connor Doak, CFA

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