

Q4 2022 BLUE Quarterly Review

By Connor Doak, CFA

Performance

The fourth quarter of 2022 finally gave some reprieve to investors following an extremely volatile first three quarters of the year. The S&P 500 Index and Bloomberg Aggregate Bond Index returned 7.08% and 1.87%, respectively, each posting their first positive quarter of 2022. Despite the moderately positive fourth quarter, the S&P 500 still had its worst calendar year since 2008 with a loss of 19%.

As painful as it may be, most investors are accustomed to high levels of volatility in the stock market. Bear markets (measured as a drop of 20% from recent highs) tend to happen every 4-5 years on average with stocks. But what made 2022 unique was that bonds suffered their worst year since the Great Depression, a loss of 13% in the portion of the portfolio that is supposed to provide “ballast”. This backdrop made 2022 one of the worst years on record for traditionally diversified portfolios.

As Riverwater’s main letter states, 2020 and 2021 were driven by speculation, fear of missing out (FOMO), and easy access to money. 2022 was driven by the Fed raising interest rates at a breakneck pace to combat inflation. The Fed’s rate hikes are noteworthy because as interest rates rise, stock valuations and bond prices tend to fall. But what caught the market off-guard was the absolute size and the speed at which the Fed moved. The current rate hiking cycle has been the fastest since the 1980s, and with a starting point of 0%, the absolute changes have been staggering. We are in uncertain times, indeed.

Performance for the BLUE models this quarter was solid as four out of five models achieved excess returns relative to their respective benchmarks. The only model that underperformed in the quarter was the BLUE Sustainable Income model, which is designed to have very low risk. The lack of risk taking in the portfolio wasn’t beneficial during the only positive quarter for riskier investments in the year. Despite the difficult quarter, the BLUE Sustainable Income model was our best overall performing model during 2022! This portfolio was designed with the intention of helping protect capital when markets are negative. So, in a year when the “ballast” (bonds) of the market falls 13%, and our most conservative model falls 8.5%, it technically outperforms the benchmark, but that doesn’t make the pain from a negative year hurt any less.

The other four models all slightly outperformed during the quarter and had mixed results over the full 2022 calendar year. The highlight for the quarter was the performance of the actively

managed mutual funds. In our Q3 letter, we discussed a few changes that were made to enhance our BLUE models to perform in an uncertain environment. One of the largest changes we made was to reallocate our already small passive (index) investment exposure to actively managed funds. The portfolio managers of these funds select stocks and bonds based on intensive fundamental analysis, which we think will deliver good results in a difficult environment. This rebalance was beneficial as twelve of the seventeen actively managed funds outperformed their respective indices during Q4.

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 one of the mutual fund managers within our Riverwater BLUE models.

The TIAA-CREF Core Impact Bond Fund invests in fixed income investments that have the potential to generate a market rate of return or better, and to maximize environmental and social impacts as aligned with the UN Sustainable Development Goals. One example from 2022 was TIAA's investment in bonds issued by the Massachusetts Clean Energy Cooperative which operates the Gas and Electric Department for Holyoke, MA. The Cooperative obtains 80% of its electric supply from renewable sources, primarily hydro and solar. Proceeds from the bonds will be allocated to finance repairs and improvements at the Hadley Falls hydropower facility as well as refinance old debt. This hydropower plant provides 35% of the electricity supply to Holyoke's 17,000 electricity customers.

Investments like this provide continued funding to companies and institutions that are helping make the global transition to clean energy and, ultimately, net-zero carbon dioxide emissions.

Thank you for your ongoing support of Riverwater Partners and the Riverwater BLUE portfolios.

Cheers to 2023!

Connor

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