RIVERWATERBLUE

Market Review: What is True Diversification?

The S&P 500 significantly outperformed other major equity markets in 2024 and over the past 12 months. This trend extends further back: over the last three years, the S&P 500 has more than tripled the performance of these same markets. Even over the past decade, the S&P 500 has returned 12.8% per year, while other markets, like the Russell 2000 (small-cap US stocks), MSCI EAFE (international large-cap stocks), and MSCI Emerging Markets Index, have seen annualized returns of 7%, 4.3%, and 2.8%, respectively.

This exceptional performance is largely driven by a small group of companies known as the "Magnificent 7," primarily tech giants leading the AI revolution. Their dominance has led to high concentration in the S&P 500, similar to levels seen at the end of the dot-com boom. Following that period, the S&P 500 experienced a significant decline, and other markets, like small-cap and European equities, outperformed for the following decade.

While the current market leaders are highly profitable companies, relying heavily on them doesn't equate to prudent diversification. True diversification aims to reduce risk by spreading investments across various assets. Given our focus on risk management, we aim to maintain exposure to small-cap stocks and international equities to achieve adequate diversification and reduce risk over time.

In contrast to the equity markets, the bond market has behaved more rationally over the last year. Despite higher levels of interest rate volatility, bonds have remained relatively stable. The 10-year US Treasury yield has risen from 3.81% to 4.37% over the last year. The income generated by bonds has kept them in positive territory over the past 12 months, with the Bloomberg US Aggregate Bond Index up 2.6% during this period. Nonetheless, so far in 2024, rising interest rates have subdued bond market performance, resulting in a slightly negative return of -0.1%.

BLUE Review: Dedicated to Diversification

The BLUE models are designed to deliver competitive risk-adjusted returns throughout a full market cycle. To achieve this, we look for equity managers who invest in high-quality companies at reasonable valuations, providing capital protection during market downturns. Additionally, we diversify investments across all equity market sectors to help minimize volatility.

Our fixed income managers prioritize strong risk management as well. They aim to have their performance driven by selecting better performing bonds rather than having other factors, such as duration (interest rate sensitivity), drive the performance of the portfolio . Over the recent quarter, bond selection for the fixed income portion was strong, making the performance of the BLUE fixed income funds a relative bright spot during Q2. All five of the BLUE fixed income managers outperformed the Bloomberg Aggregate Bond Index during this period, providing important stability for the overall BLUE models.

On the equity side, diversifying into small-cap and international funds has not been beneficial over the last year, as markets were driven by a small cohort of companies. Additionally, our bias toward managers who protect on the downside and maintain lower volatility than the market hindered BLUE's ability to keep up with broader stock markets. Despite this, all BLUE models still achieved positive returns year-to-date, and we remain confident in our positioning should market leadership broaden or decline.
When markets revert to the mean, as they tend to do, we believe the Riverwater BLUE models should be well-positioned to capitalize due to our steadfast dedication to true diversification.

Social and Environmental Impact

To underscore our commitment to creating a better world through sustainable investing, we highlight a notable instance of positive impact achieved by one of our fund managers through their sustainable investments. The loan to the Elizabeth Seton Pediatric Center is a prime example of the type of investments that BLUE model staple, Community Capital Management (CCM), makes on behalf of our clients.

Established in 1987 by the Sisters of Charity of New York, the Center provides specialized clinical and rehabilitative services to medically complex children with multiple physical and neurological conditions and disabilities. In March 2012, the Center relocated from Manhattan to a new, state-of-the-art facility in Yonkers, NY. This 165,000-square-foot complex serves 137 of New York State's most medically complex children. The CCM loan helped finance the construction and expansion of the Center to accommodate 32 additional children who are dependent on ventilators. The three-story addition enables the facility to serve a total of 50 ventilator-dependent children, bringing the total number of children served by the Center to 169.

Additionally, the on-site John A. Coleman School added more classrooms to educate these new residents. With the expansion, the Center has hired over 100 new employees. The Center is also committed to environmental sustainability through its green initiatives and building design, and the Yonkers facility has been awarded a Leadership in Energy and Environmental Design (LEED) Gold Certification.

These efforts exemplify the tangible benefits of impact investment strategies touching multiple key themes such as access to healthcare, job growth, and sustainability.

As always, we appreciate your trust and confidence.

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Connor Doak, CFA
Client Portfolio Manager

See next page for important disclosures.

Disclosures: The information contained within this update represents the opinion of Riverwater Partners and should not be construed as personalized or individualized investment advice. Reader should not assume that investments in the securities identified were or will be profitable. Timing differences of purchases and sales may have a modest impact on the actual contribution numbers presented. The holdings identified do not represent all the securities purchased, sold, or recommended. The calculation's methodology along with details on all holding's contribution to the overall account's performance during the measurement period are available upon request. Past performance does not guarantee future results.

The performance presented is hypothetical and back-tested with the benefit of hindsight using similar holdings and portfolio asset allocation weights. This performance was generated using similar holdings and asset allocations but the hypothetical performance presented above assumes semi-annual rebalances whereas live BLUE models are rebalanced based off of fluctuation away from target weights. Actual accounts may be rebalanced more or less than semi-annually. The performance does not represent performance of a live account; it is provided for illustrative purposes only and not meant to be a representation of either future or historical returns.

Hypothetical performance information is subject to limitations and historical data may contain errors or be affected by omissions. Past hypothetical performance is not indicative of future results. Therefore, no current or prospective client should assume that future performance will be profitable, will equal the performance results reflected, or will equal any corresponding historical benchmark index. The performance presented herein reflects the reinvestment of dividends and other income. However, the performance returns do not reflect the impact that material economic and market factors could have had on the portfolio manager's decision-making process. For example, factors such as: 1) timing of purchases and sales of securities, 2) length of time positions are held, 3) market and/or sector trends, 4) client restrictions, and/or 5) other unforeseen factors that could have had a material influence on the performance results of a client's account if actual trading had taken place.

The Net Return was calculated using the highest fee of 60 bps annualized, applied on a daily pro rata basis. Live BLUE model fees are applied monthly at a rate of 60 bps annualized.

The historical performance results for all indices are provided exclusively for comparison purposes only with the intent to provide general comparative information to assist an individual client or prospective client in determining whether Riverwater Partners' performance meets, or continues to meet, his/her investment objective(s). Comparative indices may be more or less volatile than Riverwater portfolios. It should not be assumed that Riverwater Partners' account holdings will correspond directly to any such comparative benchmark index. For reasons including variances in the investment management fee, differing client investment objectives and/or risk tolerance, market fluctuation, the date on which a client engaged Riverwater Partners' investment management services, and any account contributions or withdrawals, the performance of a specific client's account may have varied substantially from the indicated portfolio performance results.

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