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Monthly Market Commentary
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The stock market is having a terrible year and the bond market is the worst in history.[1] This month we are focusing on risk and volatility management because it's playing a significant role in account behavior. We think you will be pleased with what you learn.

Commentary Summary

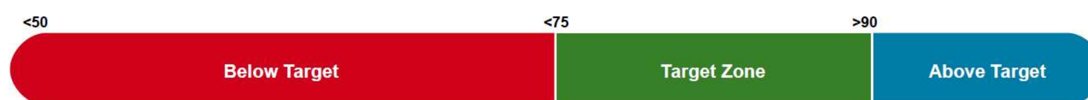
- In investment management, we view risk through three lenses: Risk Tolerance; Risk Need, and Risk Composure.
  - Risk Tolerance: measured using our scale from 1 – 9 where 1 = 100% cash, CDs, and US Treasuries, while 9 = 100% stocks. This is the least subjective and we ask clients this question directly in every meeting.
  - Risk Need: measures whether a client should consider accepting more or less risk to meet their goals. This is a function of client assets, spending needs, goals, and other considerations.
  - Risk Composure: measures the difference between a client's stated risk tolerance and how they actually behave under stressful market conditions. Quoting Mike Tyson, "*everybody has a plan until they get punched in the mouth.*"[2]
- Downside Capture Ratio: compares how well an investment manager's strategy (i.e. your financial advisor) performs relative to an index during periods when the markets are dropping. We actively monitor the performance and behavior of our investment strategies, and Downside Capture Ratio plays a significant role in difficult markets. We think you will be pleased with what we present.

Risk Tolerance; Risk Need, and Risk Composure

1) Risk Tolerance: Clients should be very familiar with this because it's a direct question that is on the Meeting Agenda and presented in several formats, specifically account stock/bond composition (pie chart), positions on the Efficient Frontier, and risk/return figures. The scale should be familiar: using a range from 1 to 9, where 1 = 100% cash, brokered CDs, and/or US Treasuries, while 9 = 100% stocks and everything else falls somewhere in between.

Of the three risk measures, Risk Tolerance is unique because it's measured directly on a scale while Risk Need and Risk Composure are inferred from the planning and discussion process. Risk Need and Risk Composure are derived over time from thoughtful meeting discussions, active listening, and financial advisor experience.

2) Risk Need: In our view, the Holy Grail of planning is to deliver the best client outcomes with the least amount of risk. Does a client *need* to accept higher risk, and if not, what is the lowest risk they need to accept to produce investment returns that meet their goals?
   This is why a client's Envision® Plan outcome is so important. Per the chart below, the scale is measured from 1 to 100. , a plan score below 75% is "below target" and colored red. Plan scores in between 75% and 90% are in the "target zone" and colored green. Plan scores greater than 90% are "above target" and in colored blue. This is critically important because, in our view, the further a client's plan score is to the RIGHT (i.e. closer to "above target" or greater than 90%), the greater resiliency their plan has against significant market shocks (i.e. 2022), and recessions.



Source: Envision® Investment Plan Result

   The higher than plan score (closer to the right, blue color), generally the lower the risk need in our view. A client doesn't necessarily need to have a higher weighting in stocks and can afford to focus more on volatility and risk management versus achieving outsized returns. Stated differently, we feel that we can hit client goals with more modest returns.

   a. During the meeting process, we feel that it is our responsibility to align a client's investment strategy to their Risk Need while also acknowledging a stated Risk Tolerance. You may hear something like "*your risk*

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tolerance is an 8, but you don't have to accept that much risk. It is our recommendation that we align your accounts closer to a 6. The returns may be more modest, but you'll likely accept less risk and volatility and it looks like you may still meet all of your planning goals at this level".

3) Risk Composure: How does a client respond to significant sell-offs and volatility? My dad, Bill Tryon had a great phrase: "*clients don't understand their risk tolerance until they're losing money*". Stated more directly, a client who panics during a bear market has, unfortunately, conveyed a breakdown in risk composure. This is one of the most dangerous events that can happen to a client because often a client's emotions take over at the worst possible time and can cause significant damage to plan outcomes, and investment returns that often can take years to repair.
   Clients may not be aware of this but we are asking controlled questions throughout meetings to pick up on signals on whether a client's Risk Tolerance (the scale from 1 to 9) differs from their Risk Composure. We are trying to decide whether a client who says they are a 7 out of 9 is really a "7 out of 9"!
   i. A client who says, "well, I like making money and watching my accounts go up. When the markets drop it gets really scary and I wish I didn't have to go through that". In our view, this client's Risk Composure is lower than their stated Risk Tolerance (i.e. their investment strategy should be lower than a 7).
   ii. A client who says, "well, I like making money and watching my accounts go up. When the markets drop, I don't like it, but I'm not going to do something that I might regret". These clients likely have a Risk Composure that is aligned to their Risk Tolerance (i.e. their investment strategy is correct at a 7).
   We close every newsletter with the same mantra: never, ever make investment decisions based on emotion. Stated differently, don't lose your risk composure!

We have commented in several newsletters that, year-to-date, EVERY client has stayed with their plan, not panicked, and not acted emotionally. In our view, client Risk Composure is generally aligned to their Risk Tolerance! We legitimately want to commend clients on this track record. We do talk to our financial advisor peers and hear terrible stories about clients panicking, deciding to sell at the wrong time, or getting upset. We have universally *not* experienced this. We're in a terrible market and we think clients are doing a terrific job.

Now that we've laid the landscape, we'll discuss very directly how this has translated to account performance and managing risk in these market conditions.

Downside Capture Ratio

Downside Capture Ratio: evaluates how well an investment manager performed relative to an index during periods when that index has dropped.[3]

$$\text{Downside Capture Ratio} = \frac{\text{Account Performance}}{\text{Index Performance}} \times 100$$

A downside capture ratio of less than 100 means that the account (or financial advisor) is losing **less** money than the indexes. This may not sound intuitive, but it also means that the financial advisor is outperforming the markets.

Case study: a consolidated plan account composition is 60% stocks, 40% bonds, and has a YTD performance of -15.5%. What is the downside capture ratio of the investment strategies?

1) First we need to be careful of measuring "index performance". In our view, you shouldn't compare this account to a 100% stock index like the S&P 500 because the account isn't 100% stocks! Instead, we replace"Index Performance" with "Weighted Index Performance". In this case, how does a weighted performance of 60% stock index and 40% bond index compare to the account or portfolio? Below is a weighted average of YTD performance through 10/15/2022 for two significant indices:

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	YTD	Account Weight
S&P 500 stock Index	-24.7%	60%
Bloomberg Barclays US Aggregate Bond Index	-17.0%	40%
Weighted Index Performance	**-21.6%**	

2) Now we feel that we can use the Downside Capture Ratio to make an accurate comparison of the portfolio performance versus the weighted indexes.

$$\text{Downside Capture Ratio} = \frac{\text{Account Performance}}{\textbf{Weighted}\text{ Index Performance}} \times 100 \Rightarrow \frac{-15.5\%}{-21.6\%} \times 100 = 72.1$$

Conclusion: The Downside Capture Ratio of a client's accounts is 72.1 meaning that the accounts have only declined 72.1% as much as the stock market. Equally important, the accounts are *outperforming* the weighted indices by 27.9%. It can be difficult that accounts are down -15.5% in 2022, but when compared to the broader markets, the alternative could be *much* worse.

Instead of a hypothetical situation, below are average actual performance of our strategies along with the Downside Capture Ratio. This is real data, with real client money, in real accounts as of market close 10/15/2022.[4]

	Avg Equity Weight	Avg Bond Weight	Weighted Avg YTD Performance	Weighted Avg Index Performance	Downside Capture Ratio	Conclusion
Rising Dividend Stock Strategy	75.8	24.2	-16.5%	-22.8%	72.4	Strategy has declined 72% of the weighted market indexes.
Mutual Fund/ETF Strategy	63.2	36.8	-15.5%	-21.9%	70.7	Strategy has declined 70.7% of the weighted market indexes.
Exceptions	64.9	35.1	-16.9%	-22.0%	77.0	Strategy has declined 77.0% of the weighted market indexes.
Grand Total	**68.2**	**31.8**	**-16.2%**	**-22.3%**	**72.6**	Strategy has declined 72.6% of the weighted market indexes.

- Accounts that invest in mutual funds & ETFs present the best downside capture ratio of 70.7 which is due to a heavier weighting in commodities and energy stocks.
- Accounts that invest in the Rising Dividend Stock Strategy present second best downside capture ratio of 72.4 which is fairly close and a testament to the benefits, in our view, of investing in these types of companies.
- Accounts that are "Exceptions" have the least desirable Downside Capture Ratio but even then, they have declined only 77% as much as the weighted market indexes. Accounts in the "Exceptions" group often have concentrated stock positions, low cost basis positions (i.e. very large unrealized capital gains), or some other variable that prevents us from managing them like the Rising Dividend Stock Strategy or the Mutual Fund/ETF Strategy.

Some client accounts are performing better, others worse, and past performance is no indication of future returns, but we have included every client account regardless of size or strategy. We aim to impart that our strategies are managing risk and volatility during exceptionally uncertain and volatile market conditions, and that, on average, our strategies are outperforming the stock and bond markets on a weighted basis.

Closing Comments

For many years clients have understandably been focused on returns, "how much am I making", or "how much are my accounts growing". We measure Risk Tolerance and Investment Objective through direct questions, but we are keeping a keen eye on other, equally important measures like Risk Need and Risk Composure because they matter in markets like these even if clients may not know it.

This stock market sell-off is a tough one, but this bond market sell-off is much, much worse on a historical basis. In our view, the best client outcomes and planning results come not from trying to beat the market during good years, but by

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trying as much as possible to avoid account drops during bad years. It is easier, in our view, to achieve consistent account performance when client accounts don't have to dig out of or recover from deep troughs.

This may be a long, bumpy road until inflation is sorted out and the Federal Rate hikes are complete. We may or may not enter a recession. What we do know is that client investment plans and portfolio strategies are built for this. I read and conduct research voraciously and try to stay flexible, adapt to conditions as they change, and be humble to markets that can be at once powerful and unforgiving. Clients should hopefully understand and appreciate why we say that the best outcomes come from building a plan, sticking to a plan, and never, ever making investment decisions based on emotion.

Questions & comments are welcome.

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Sources & Disclosures

[1] Reuters, New York Times, TD Ameritrade, Wall Street Journal, Factset
[2] Mike Tyson, pre-fight interview, 1996.
[2] Investopedia, Morningstar.
[4] Fiserve, UAT (FA Directed Private Investment Management trading platform), as of 10/15/2022 market close.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.
Investing in stocks involves risk and their returns and risk levels can vary depending on prevailing market and economic conditions.
While stocks generally have the potential for greater return than government bonds, they involve a higher degree of risk. Government bonds, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. government if held to maturity. Although government bonds are considered free from credit risk, they are subject to interest rate risk. Bond prices rise as yields fall.
Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.
Generally, CDs may not be withdrawn prior to maturity. CDs are FDIC insured up to $250,000 per depositor per insured depository institution for each account ownership category. CDs may be issued by out of state institutions.
Investment strategy and potential market action are based on data as of this newsletter and subject to change at our discretion, at any time. This is not a solicitation to buy or sell any security. These changes are the result of continuous research and management that is part of the service you receive along with your PIM portfolio. Your results may vary based on your risk tolerance, tax considerations, income requirements, and liquidity needs. Past performance is not indicative or predictive of future returns.
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