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3/31/24 Focal Point: Diversification Mitigates Uncertainty

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The current market environment is characterized by two fears. The first is caution based on the array of worrying economic, political, and geopolitical headlines in the news. The second is the fear of missing out, driving markets to concentrate in a small group of stocks that have been outperforming.

A major theme for 2023 was that S&P 500 returns were highly concentrated in just a few large stocks, which is evident by comparing the S&P 500 (which is capitalization weighted) to the Equal Weight S&P 500 (with the same members, but each has an equal 0.2% contribution). Looking at rolling 6-month returns in the chart to the left, the gap had surpassed 10% on 6/30/23 for only the third time since 1992. In the subsequent 6-month period, Q3 and Q4 of 2023, it narrowed to just 2%. But in Q1'24, with the S&P up 11% versus the Equal Weight up 7%, the 6-month rolling gap is back up to 3% (although it's down from 5% as of the end of February after a good March for Equal Weight). While less concentrated than their recent peak, markets remain top heavy.

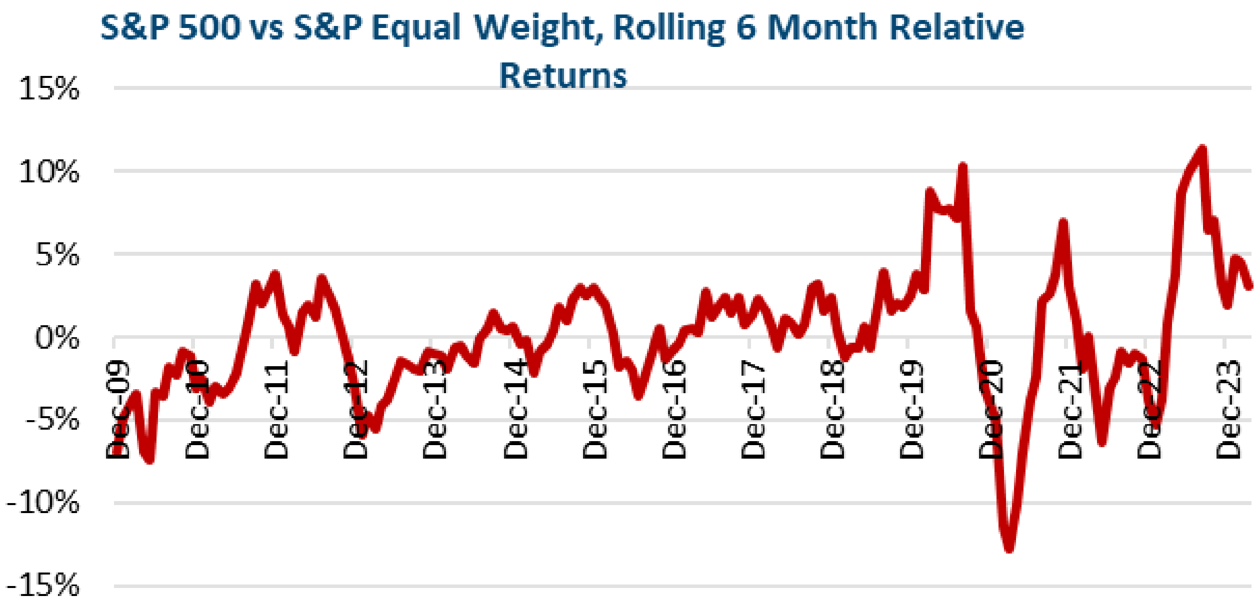

Chart 1

Chart 2 shows the earnings yield on the S&P 500, the yield on the 10yr Treasury, and the difference between the two, known as the Equity Premium. A higher Equity Premium means stock investors are getting more compensation relative to bonds. From 2002 to 2007, prior to the Fed's QE interventions, a 1-3% Equity Premium was common. This suggests the current Equity Premium of 0.55% is low and makes stocks sensitive to interest rate changes.

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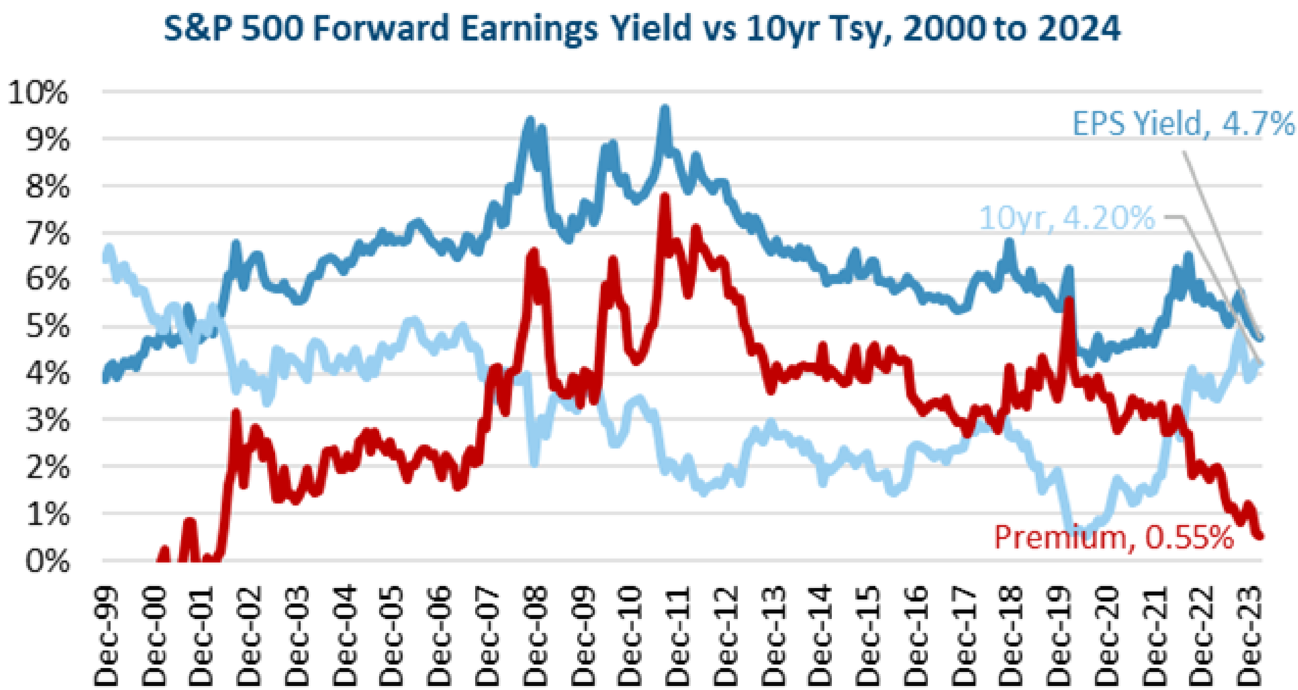

Chart 2

Extending this view beyond just the S&P 500 shows that other markets have seen their Equity Premiums decline as well but are not yet as extreme as the S&P 500. The chart to the left adds the Earnings Premiums for the Russell 2000 (small cap US), MSCI EAFE (developed international), and MSCI EM (emerging markets). While these other indices are at post 2009 lows, they are just reaching their pre-2009 levels, unlike the S&P 500 which has already passed below that point. This is yet another example of how, expanding outside of a narrow group of large US stocks, there are other areas of appeal.

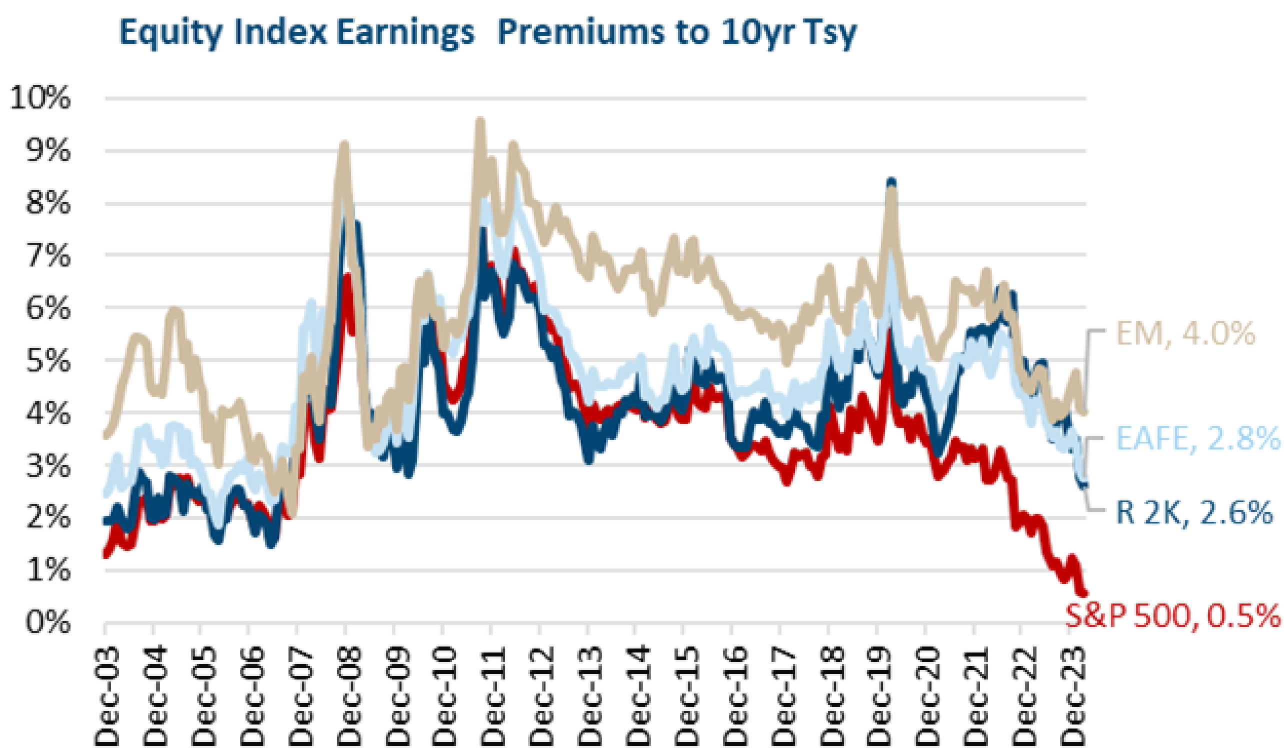

Chart 3

The post 2009 period was dominated by low interest rates and Large Cap US stocks. Now, after a period of interest rates returning to a normal range and other parts of the equity markets showing relative appeal, the benefits of diversification are returning. Yet after a period of Large Cap outperformance centered on a narrow group of stocks, the temptation for investors is to hide in that narrow group, especially in a period of uncertain headlines. But periods of uncertainty are when diversification can be most beneficial. When investors face a wide range of risks and potential outcomes, diversification remains one of the best tools. Of course, a key component of this is that certain parts of the portfolio can benefit in certain market environments, but may lag in others. A softening of the economy could weigh on Equities, but a decline in rates would boost Fixed Income. If high valuations are challenged by rising interest rates, the segments of the Equity market with wider Earnings Premiums could benefit. This is how *Diversification Mitigates Uncertainty*.

benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your Grimes account holdings correspond directly to any comparative indices or categories. **Please Also Note**: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your Grimes accounts; and, (3) a description of each comparative benchmark/index is available upon request.

The information contained herein is based upon sources believed to be true and accurate. Sources include: *Factset Research Systems Inc.,* Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Board of Governors of Federal Reserve System, Fred: Federal Reserve Bank of St. Louis Economic Research, U.S. Department of the Treasury

-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.