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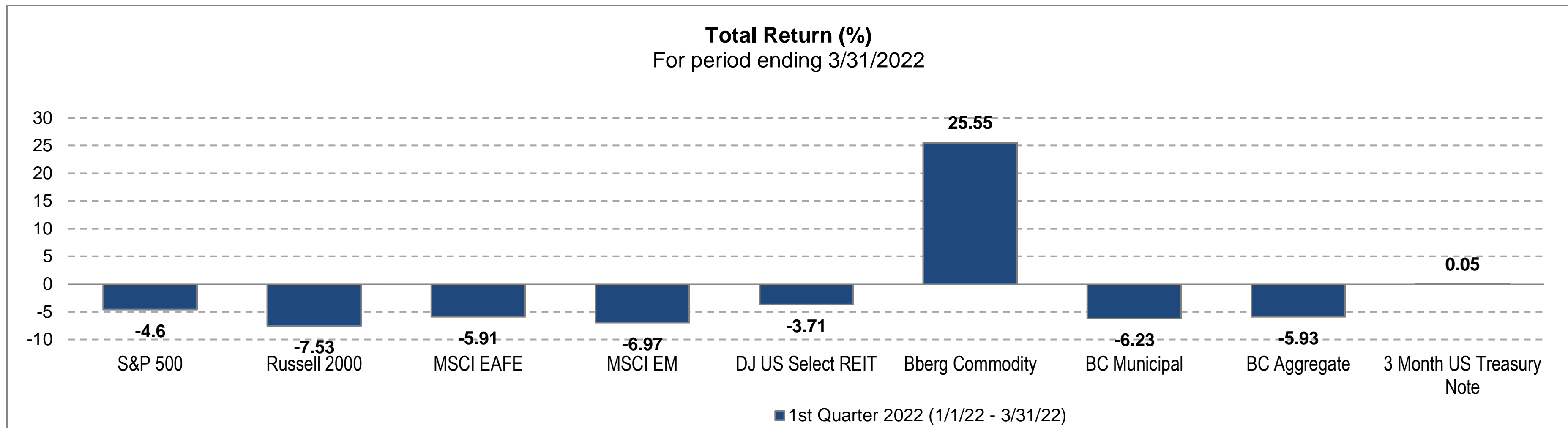
Wealth Management

Revenge of the Volatility

Schneider Downs Wealth Management Advisors, LP
Q1 2022 Market Commentary

Big Thinking. Personal Focus.



The first quarter of 2022 reminded investors, market participants, and commentators that volatility in capital markets is still a very real part of investing. One could be forgiven if they counted themselves among the investors that were lulled to sleep over the preceding 21 months leading into 2022. During that 21-month stretch, capital markets marched higher and higher despite global economies enduring multiple COVID-related shutdowns. Stocks and bonds appreciated in unison, and investors were not confronted with much in the way of market/price swings, as the seven quarters following the March 2020 lows were mostly blissful. The complacency that permeated throughout markets started me thinking about how The Godfather[1] could provide an interesting analogy to the current state of capital markets in the form of Virgil Sollozzo.

Sollozzo was a mobster's mobster; however, he makes a tragic error in calculation and (spoiler alert) attempts to have the head of the Corleone family, Vito, removed so as to have a more enthusiastic supporter of his (Sollozzo) endeavors running the Corleone family. Not only does this attempt fail; Sollozzo's true motives becomes known to the Corleone family. Eventually, Sollozzo tries to broker a truce, but he instead meets his own demise in Louie's Restaurant in the Bronx at the hands of Michael Corleone. Much like Sollozzo was ultimately not able to outrun his deeds, capital markets ultimately have to face the repercussions of an unprecedented monetary and fiscal experiment conducted during COVID. The unprecedented policies of the U.S. Federal Reserve, combined with several rounds of fiscal stimulus checks,[2] created a permission structure for excessive risk taking and speculation by market participants. While this elixir (low interest rates, bond purchases, and stimulus checks) spurred a stunning rally off the March 23, 2020 COVID lows, the elixir's efficacy began to dwindle toward the end of 2021.

The elixir reached its nadir in the first quarter with the NASDAQ and Russell 2000 falling into bear market territory (decline of 20% from its high)[3], the previously unstoppable S&P 500 declining 13%[4], and high-quality bonds having their worst quarter in 40 years.[5] The first quarter of 2022

[1] Two of my colleagues believe that The Godfather is an awful movie. I have checked with human resources and there is nothing I can do to remedy the situation
[2] Also unprecedented in both number of rounds and total value of stimulus payments to U.S. citizens and U.S. corporations (PPP)
[3] https://www.schwabassetmanagement.com/content/no-quarter-consistency
[4] https://www.schwabassetmanagement.com/content/no-quarter-consistency
[5] https://www.wsj.com/articles/bond-market-suffers-worst-quarter-in-decades-11648737087

brought us positive correlation between stocks and bonds (to the downside!), rising interest rates/bond yields, the first land invasion in Europe since the 1940s, and a radical spike in energy prices that put added pressure on inflation that was already stickier and more persistent than forecasted. The first three months of the year were truly the revenge of volatility (that we managed much better than Sollozzo, so far). Most markets were resilient in the face of the volatility, rallying off their intra-quarter lows, but the blissful days of 2021 are firmly in the rearview mirror.

Conventional wisdom would argue that the ballast of any portfolio over the last 40 years has been high-quality bonds. This wisdom is conventional because almost every time risky asset volatility reached a fever pitch, high-quality bonds guided portfolios from tempestuous seas into calmer waters. Applying conventional framework to the unprecedented circumstances investors currently face would have led market participants to lean into an asset class, fixed income, that had its largest drawdown in 40 years[6]. High-quality bonds (Barclays U.S. Aggregate) underperformed both U.S. stocks (S&P 500) and International Developed Stocks (MSCI EAFE) during the quarter, adding volatility to the portfolio, not dampening it. The team at SDWMA decided to apply an unconventional framework to combat the end of near-zero interest rates and the beginning of monetary tightening by global central banks as they unwound the policies enacted during COVID. Leaning into real assets (infrastructure, farmland, and timberland) and real estate (multi-family, industrial, office, and grocery-anchored retail), we steadily reduced our exposure to core fixed income over the past 24 months since COVID reared its ugly head. Unlike in 2021 where fixed income was flat to marginally positive, the first quarter of 2022 saw sharp declines across U.S. Treasuries, Investment Grade Corporates, and High Yield/Junk bonds. Just as they did in 2021, our real asset and real estate exposure provided ballast to our portfolios and positive performance in the face of rising inflation and interest rates. As markets brace for the prospect of several additional interest rate hikes by the Federal Reserve over the next twelve months, our strategic income exposure (real assets and real estate) will continue to play an integral role in our portfolios. For those who have not seen my interview with the CIO of Versus Capital, Casey Frazier, please visit our video hub for a more in depth and layered discussion on real assets.

Applying an unconventional framework to fixed income was a tailwind for our portfolios. However, a more traditional approach to equities provided stability in the face of elevated volatility. As discussed in the opening graphs, two of the broad U.S. equity indices (NASDAQ and Russell 2000) briefly entered a bear market and the S&P 500 had a peak to trough decline of -13%[7]. While there were much larger drawdowns in individual stock names, with average drawdown of individual names in the S&P 500 down 19% and down 29% in the NASDAQ, the broader indices showed much more resilience. The three major domestic indexes, as exhibited above, rallied high single digits to low double digits off of their 2022 lows. For those investors who had capital to incrementally purchase, there were opportunities to add on weakness; for those who were fearful or

Major indexes and maximum drawdowns							
	Year-to-date				Past 52 weeks		
Index	YTD return	Index maximum drawdown from YTD high	Average member maximum drawdown from YTD high	Index return from YTD low	Index maximum drawdown from 52w high	Average member maximum drawdown from 52w high	Index return from 52w low
S&P 500	-5%	-13%	-19%	9%	-13%	-25%	13%
NASDAQ	-9%	-21%	-29%	13%	-22%	-46%	13%
Russell 2000	-7%	-15%	-28%	8%	-21%	-44%	8%

[6] It is important to note that a bad day in the stock market is a bad year in the bond market. The worst quarter of performance in the bond market is -6%, there were days during March of 2020 where stocks declined in excess of 6%.

[7] https://www.schwabassetmanagement.com/content/no-quarter-consistency

content with equity exposure, showing fortitude in the face of volatility avoided selling at the lows on the year. As we stated in the opening salvo of this quarterly commentary, volatility is back after lying dormant for most of the past two years. There is nothing special or unique about this volatility other than the fact we just haven't experienced it since the first quarter of 2020.

It is incredibly hard to write about potentially capitalizing on international equities given the current state of affairs in Ukraine. The first land invasion in eastern Europe in the 1940s has displaced millions and cost the lives of several thousand Ukrainian citizens. The atrocities in Bucha, a once beautiful and vibrant suburb of Kiev, will haunt all of us. The investment team continues to believe in the relative attractiveness of international developed and emerging market equities over the intermediate to long term time horizon. We will expand on those under separate cover in another letter/venue. For now, our thoughts and prayers are with the Ukrainian people; may cooler heads prevail so that the rebuilding of the Ukrainian nation can begin.

One of the main themes, if not the main theme, of 2022 is going to be the return of volatility. The volatility is likely to appear in familiar places (stocks) and unfamiliar places (high-quality bonds). While this might be uncomfortable, the volatility is normal given what the market is digesting. Higher inflation is forcing global central banks to raise interest rates, upward pressure on wages and other input costs are creating tension on margins and overall profitability of companies, and war in Ukraine is weighing on valuation and growth prospects internationally. Our approach as advisors remains the same; be the calming force watching over your assets and ensuring the integrity and trajectory of your financial plan remain on course. The investment team is marrying a conventional approach, not overacting to volatility, with an unconventional approach of leaning into real assets and high-quality commercial real estate in the face of steadily rising interest rates and stickier and more persistent inflation. While we do not have a crystal ball to predict where the market is going, what we do know is that investing is a marathon not a sprint. Being consistent in our approach, with your goals, objectives, and your overall financial plan as our lodestar, the SDMWA team is looking forward to continuing to run this race with you in 2022. We hope you and your families are doing well and are getting ready for a restful spring break. Thank you for your continued trust in our team in managing your life's work. We look forward to seeing you in person or on Zoom soon!

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