Alley Company Quarterly Letter
Fully Invested!

July 12, 2023

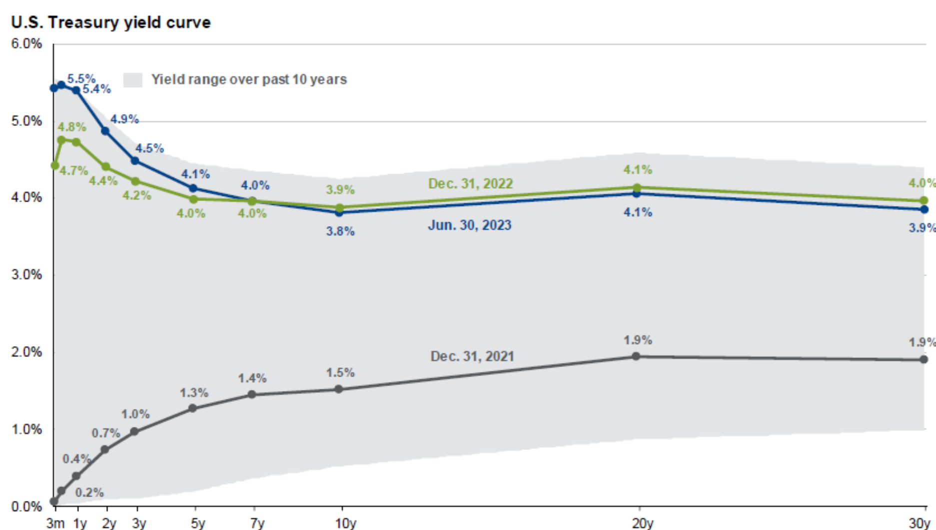
Almost ten years ago, in our Quarterly Letter* entitled Engage! (Q4 2013), we commented on how it seemed like the average investor was allowing near-term market concerns to prevent them from being "fully engaged" with their appropriate portfolio allocation between the "Big 2" asset classes – stocks and bonds.

At the time, worries around a government shutdown and tapering of the Fed's Quantitative Easing (QE) program caused investors to tilt towards bonds over stocks (measured by mutual fund flow data) and park a cumulative $2.7 trillion in money market funds earning next to nothing.

Today, the concerns are different – geopolitical tensions; inflation and rising interest rates; and economic recession fears – but investors are arguably lacking engagement again judging by the fact that money market fund assets have spiked to an *all-time record of $5.7 trillion.* [1] Successful long-term investors should remain fully invested according to their strategic asset allocation targets – the heavier allocation to cash-like securities likely means that investors are under allocated to the Big 2.

The good news for fixed income investors is that yields across the maturity spectrum (e.g., the "yield curve") have shifted *higher* over the past 18 months (see Exhibit 1 below).

Exhibit 1: Higher Starting Yields



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management. Data as of June 30, 2023.

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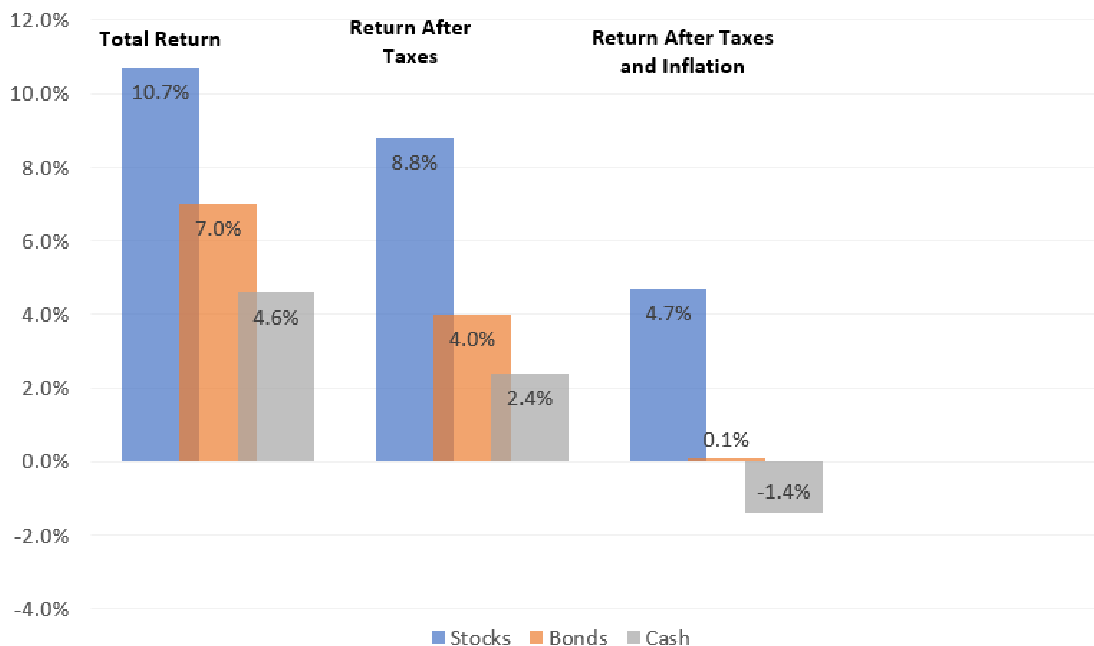
The exhibit depicts Treasury yields midway through 2023 (blue line) relative to where they were at the end of 2022 (green line) and the end of 2021 (dark line). The gray shaded area represents the 10-year range for yields. Importantly, higher starting yields provide investors with a better opportunity for future *nominal* returns.

Particularly striking is the rise in yields at the very front end of the yield curve and this largely explains the recent interest in money market funds and short-term bonds. While competitive yields for *savers* are arguably long overdue, *investors* need to be mindful that short-term interest rates are influenced by the actions of the Federal Reserve and thus current yields could be "here today, gone tomorrow" when the Fed begins to reverse its recent rate hiking campaign. Additionally, both *opportunity cost* and *long-term purchasing power* are significant factors to consider when parking assets in cash-like investments.

Exhibit 2 below shows a study of long-term returns conducted by the Schwab Center for Financial Research. While stocks are clearly the most productive asset class relative to taxes and inflation over time, we know it is still appropriate for many investors to maintain an allocation to bonds in cases where time horizons are shorter and/or risk tolerance is lower.

Exhibit 2: Long-Term Purchasing Power Analysis of Stocks, Bonds, and Cash



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc. Indices representing each asset class are the S&P 500® Index (stocks), Ibbotson Intermediate U.S. Government Bond Index (bonds), and Ibbotson U.S. 30-day Treasury bills (cash investments). Historical marginal tax rates and inflation rates were used to adjust "Return After Taxes" and "Return After Taxes and Inflation." Chart results assume a 51-year holding period, dividend payments were taxed annually at the highest marginal tax rates, and capital gains were calculated at the end of the period at the long-term capital gains rate (20% as of 2020). Return data is annualized.

The superior return for stocks over time emanates from taking on the risk of being an equity owner in productive businesses. We have commented frequently in our Quarterly Letters** on the importance of innovation in the American economy and how it can drive growth and productivity. The recent development of artificial intelligence (AI) is another example that is currently unfolding. Used appropriately, AI has the potential to drive productivity, economic growth, and corporate earnings.

For long-term investors, it's prudent to be "fully invested" in one's custom strategic asset allocation program. Fixed income securities have higher starting yields relative to the recent past and equity ownership is expected to benefit from future innovation and astute management teams running global businesses.

For clients with new money, it is important to understand that the year-to-date gains in the stock market have been driven largely by just a few index constituents which means that the broad market could very well have some catching up to do. In any case, we often take a "dollar-cost averaging" approach to putting funds to work in custom portfolios. This helps negate the all-too-common urge of the average investor to "wait for a better time" to get fully invested in their asset allocation program.

*We have published Quarterly Letters four times a year since 1998. These essays, which can be found on our website, are intended to maintain an appropriate long-term focus on investing rather than getting caught up in near-term news events and market noise.

**Our Q3 2017 Quarterly Letter entitled Secret Sauce commented on the importance of innovation in American business, including its positive impact on economic growth.

[1] Board of Governors of the Federal Reserve System

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