Avantia

March 4, 2021

Quarterly Market Review

In this Issue:

A Note on Ukraine:

War is an ugly and inhumane behavior. Even when justified, it is brutal and scars both the victors and the conquered. With the Russian invasion of Ukraine and the underhanded nature with which it was attempted, Avantia expresses its heartfelt sorrow to the massive loss and displacement currently occurring in Ukraine and to the Ukrainian people. We wish this conflict to be over soon and for peace to return to the region as soon as possible.

However, as a family office our primary role for our clients is to help guide investment portfolios through times of stress in financial markets. As with any displacement, it is important to consider the risks and opportunities presented and we are actively pursuing those opportunities and managing those risks. Russia and Ukraine are a very small part of the global AUM and global GDP. Given the generally unfavorable nature of the region to investors, our asset managers have been under-weight to these countries even before 2014. That said, the spillover effect in commodities, and into other emerging economies and that of developed Europe are impactful and we see them as favorable entry points as we will discuss later in this article.

Market Summary:

Despite the human tragedy currently occurring in Ukraine, we remain bullish on risk assets in 2022 and expect returns to be higher among equities and real assets than in bonds. We further expect volatility and certain aspects of inflation to remain elevated and to have an outsized emotional impact to clients that are not used to the long run average volatility of risk assets, especially on the tails of 2021 where returns were considerably higher than the long run average. This, however, presents opportunities for investors.

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Markets

Asset Class Views:

The most important characteristic of an investor is the patience to stay invested for the long term as shorter term and secular trends unfold. This is even more important today in this period of high inflation, volatility, and geopolitical turmoil.

Figure 1(Sources: J.P. Morgan, Vanguard, Bank of New York Mellon, Russell)

Opportunity Set		Detail	Outlook	Conviction
Major Asset Classes		Public Equity	↑	
		Real Assets	↗	
		Fixed Income - Inflation Protected	↗	
		Fixed Income - Nominal	↘	
Factors		Value	↑	
		Small Cap	↗	
		Term	↓	
		Credit	↗	
Preference by Asset Class	Public Equity	U.S.	↗	
		International	↑	
		Emerging Markets	↗	
	Fixed Income	U.S. Treasuries	↘	
		Municipal - High Quality	→	
		Municipal - Credit	→	
		Corporate - High Quality	→	
		Corporate - Credit	→	
		Cash - USD	↘	
	Real Assets	Real Estate	↗	
		Master Limited Partnerships	↑	
		Gold	↑	
		Bitcoin	→	

Equities:

Many investors are concerned that the US equity market has grown expensive and are asking if they should sell their equities. However, they don't know where they would go. Inflation is likely to erode cash, rising rates are a drag on fixed income returns, and global equities seem too risky. To some degree comments on high valuations, inflation, and volatility are true, but we make the case below that equities are a core holding in an account and there remain pockets of value and opportunity. Specifically, the US equity market is modestly expensive with a P/E Ratio of 21.1 compared to the 25-year average of 16.8. However, if an investor had taken P/E ratio as their cue to leave equities back in 1996 after Alan Greenspan's "Irrational Exuberance" speech and sought to reenter the equity markets when prices returned to 1996 levels, the investor would still be in cash today missing the 106% move in the S&P500 from 741 in December 1996 to 4,766 in December 2021. While US Equities are somewhat expensive on a historic basis, there are indeed pockets of opportunity within the asset class. Most notably, we continue to believe in value stocks over growth stocks (see figure 3) and small cap stocks over large cap stocks. In figure 3 below we see that small value stocks are currently priced at 93.5% of their 20-year average P/E ratio whereas large growth stocks are priced at 165.1% of their 20-year average.

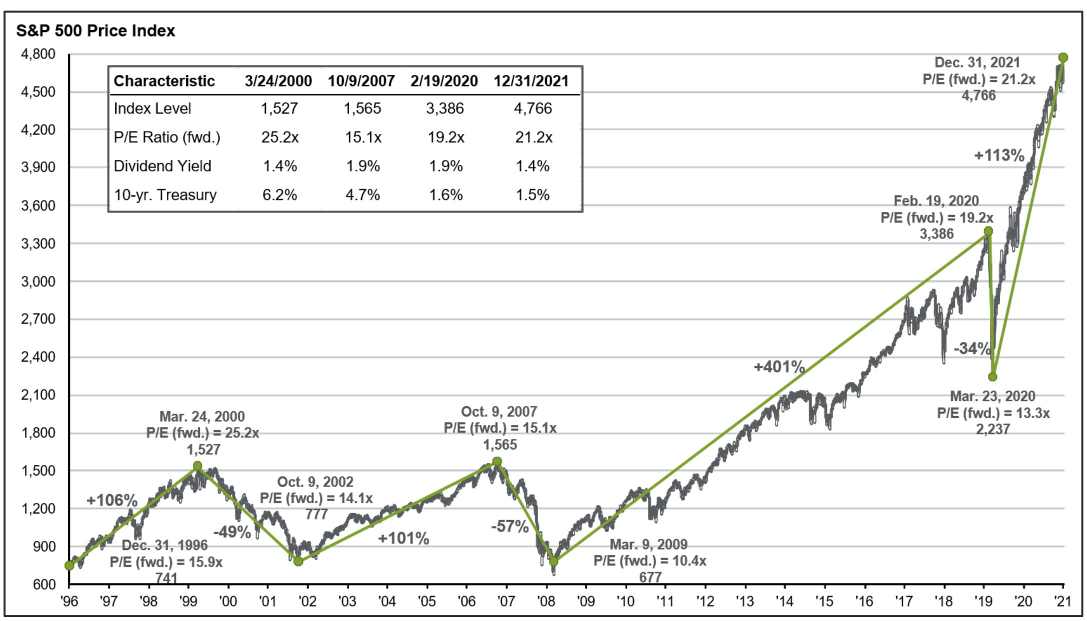


Figure 2 (Source: JPM Guide to the Markets)

Figure 3 (Source: JPM Guide to the Markets)

10-year annualized

	Value	Blend	Growth
Large	13.0%	16.6%	19.8%
Mid	13.4%	14.9%	16.6%
Small	12.0%	13.2%	14.1%

2021

	Value	Blend	Growth
Large	25.2%	28.7%	27.6%
Mid	28.3%	22.6%	12.7%
Small	28.3%	14.8%	2.8%

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	15.8 / 13.7	21.2 / 15.5	30.6 / 18.5
Mid	15.7 / 14.5	19.4 / 16.4	33.7 / 20.4
Small	15.9 / 17.0	23.4 / 21.4	43.3 / 35.5

Since market peak (February 2020)

	Value	Blend	Growth
Large	27.1%	45.0%	61.7%
Mid	32.4%	38.3%	42.9%
Small	37.1%	35.6%	31.7%

Since market low (March 2020)

	Value	Blend	Growth
Large	105.5%	119.0%	136.0%
Mid	134.1%	131.5%	122.2%
Small	141.1%	128.5%	114.1%

	Value	Blend	Growth
Large	115.0%	135.3%	165.1%
Mid	108.2%	118.2%	165.1%
Small	93.5%	109.1%	121.9%

Within the equity allocation, we expect active management to have a tailwind in 2022 relative to 2021, however we feel this is most strongly the case in the non-US portion of portfolios. While Non-US equities typically trade at a lower P/E multiple than US equities, at this point that differential is near a 2.5 standard deviation to the "attractive" side of the equation. In other words, non-US equities are less expensive than US equities and by a very wide margin. We expect international equities to outperform both US and Emerging markets and for this to be largely driven by increased earnings as those economies open and multiple expansion as the supply chain continues to move more quickly. We expect emerging market indices to be held back by their natural "overweight" to growth style companies.

Figure 4 (Source: JPM Guide to the Markets)

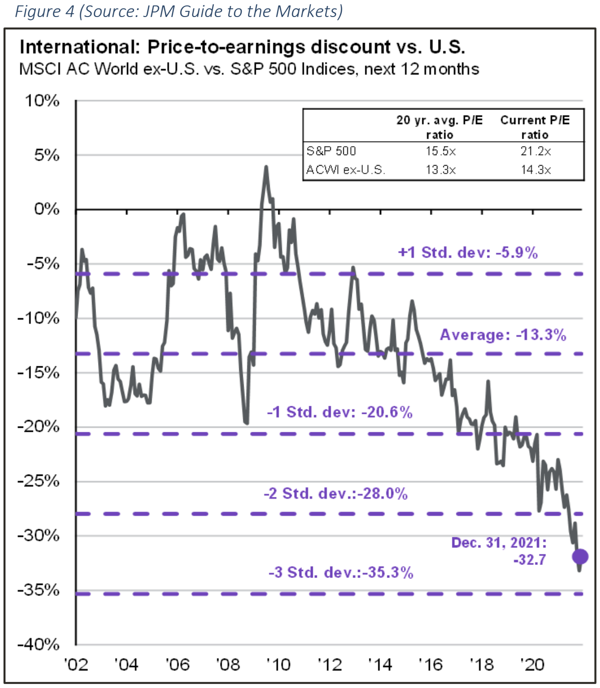


Figure 5 (Source: JPM Guide to the Markets)

In all three broad regional areas of equities, we expect value to somewhat outperform growth and for this to be more the case in the back half of the year. The value style price to earnings ratio is the most in favor it has been since 2001. (See figure 5)

Fixed Income:

In 2021, Municipal fixed income was a relative bright spot given the risk of increased taxes and the potential for increased benefit to taxable investors in the municipal market. We expect that to continue in 2022 and into 2023 as well. In a rising rate environment, short duration fixed income tends to outperform longer duration given the difference in the price sensitivity to a change in interest rates. With the markets currently expecting north of 6 rate hikes this year (see figure 6), we expect rates to grind higher throughout the year and for this to be further supported with the Fed's plans to taper its bond purchasing programs at an increasing rate. We are overweight credit and underweight duration despite spreads being tight. There are pockets of value to be had, specifically within ultrashort duration and levered loans.

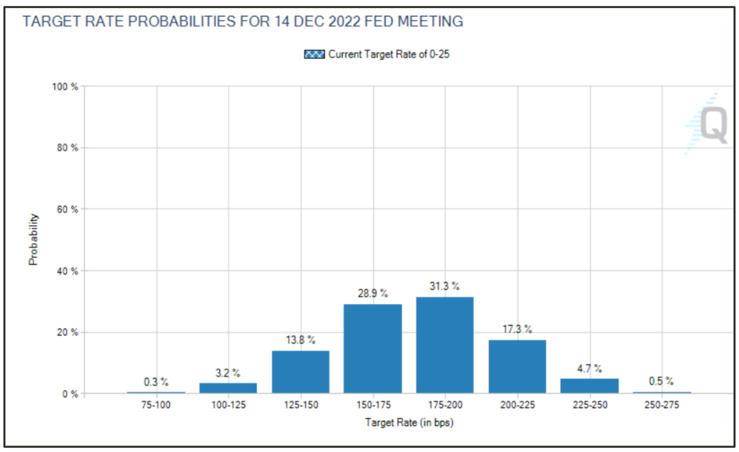


Figure 7 (source: CME - www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html)

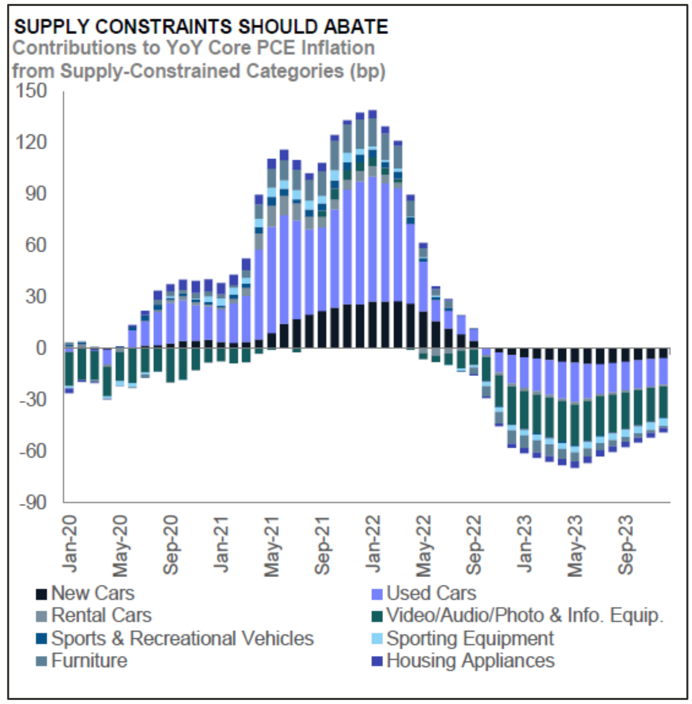
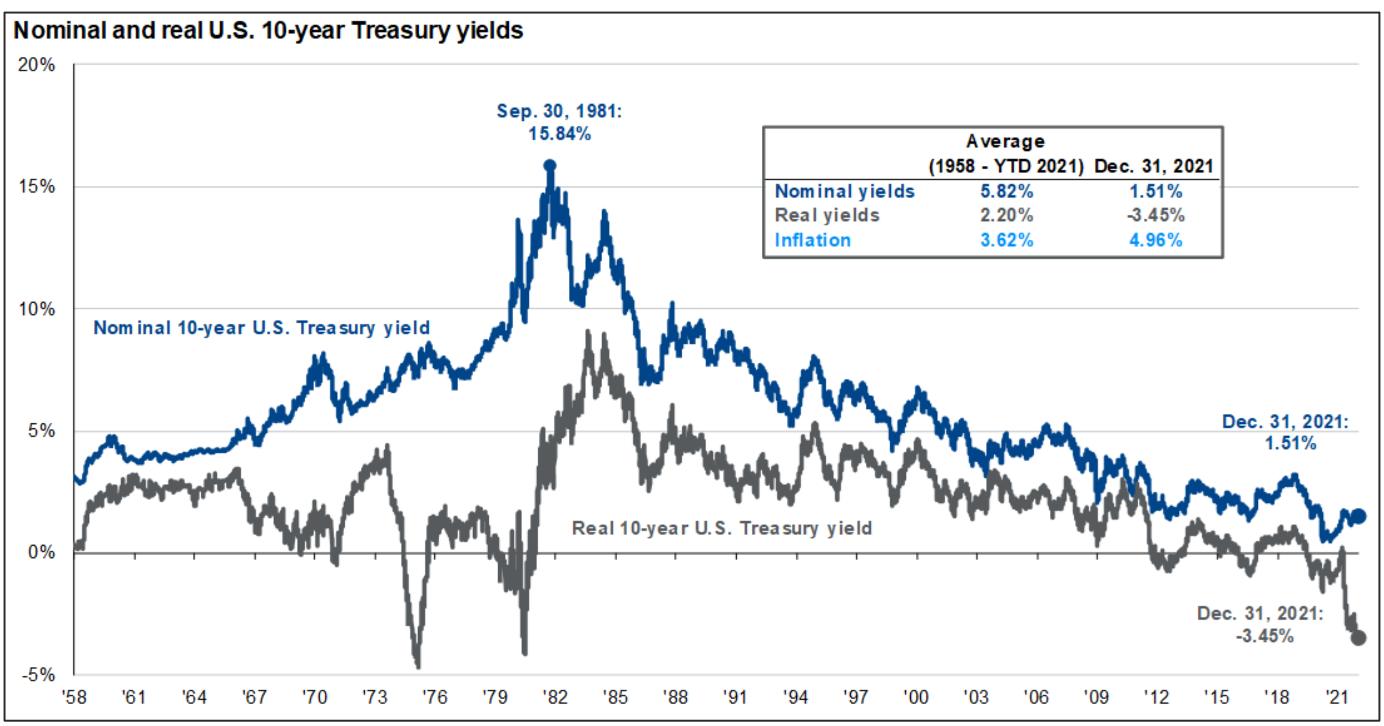


Figure 6 (Source: Goldman Sachs Asset Management)

Inflation remains elevated and ought to stay elevated through the first half of 2022 and slowly move toward the Fed's target of 2% by the end of the year. According to Goldman Sachs Research, the supply chain accounts for roughly 70-80% of the inflation we are seeing. Further, supply constraints should lessen in the second half of 2022. (See figure 6)



	Average (1958 - YTD 2021)	Dec. 31, 2021
Nominal yields	5.82%	1.51%
Real yields	2.20%	-3.45%
Inflation	3.62%	4.96%

Figure 8 (Source: J.P. Morgan Asset Management)

Planning

Asset Location: Is There a Free Lunch in Finance?

Imagine you could make one "free" change in your financial structure that could meaningfully add to your total return over the course of the next twenty years. Would you make that change? One such change is referred as "Asset Location" and it is defined as the location of assets in a client's financial structure to take advantage of the structural tax differences of the investments available. Regardless of the answer to this question, most investors do not understand asset location, its definition, or its power. In 2010, David Blanchett and Paul Kaplan of Morningstar researched the impact of five financial planning strategies and measured the potential benefits to an investor. In the study, updated in 2013 and linked below, they found approximately 22.6% more retirement income was possible through strategic financial planning.

For the purposes of our example, let's make a few simplifying assumptions. In this, our investor has two accounts, an IRA account with $1,000,000 of cash and an individual taxable account with $9,000,000 of cash. Their financial advisor has determined that the optimal asset allocation is to be 50% stocks and 50% bonds. The investor is in the highest marginal tax brackets. We will assume 0% turnover and no re-balancing in the portfolio for the twenty-year time horizon. We will further assume that returns are linear and that stocks will return 8%, Taxable bonds 5%, and Municipal bonds 3.75% every year for the next twenty years. From a tax perspective, there will be no capital gains tax due on the bonds and the stocks will fully recognize their long-term capital gain at the end of the period. The scenarios below show the effect that Asset Location has on a portfolio. In each of these situations, we change the asset location, but not the value.

In the base case titled Scenario 1, both the IRA account and the taxable account have the same mix of stocks and bonds. This results in a total after-tax wealth of $28,447,842 given the assumptions from above.

Scenario 1:

Taxable Account	
Target Allocation:	
Equities	50%
Muni Bonds	50%
Taxable Bonds	0%
Start of Period Post Tax Value:	
Equities	$4,500,000
Muni Bonds	$4,500,000
Taxable Bonds	$0
End of Period Post Tax Value:	
Equities	$17,053,422
Muni Bonds	$9,396,684
Taxable Bonds	$0

IRA Account	
Target Allocation:	
Equities	50%
Muni Bonds	50%
Taxable Bonds	0%
Start of Period Post Tax Value:	
Equities	$500,000
Muni Bonds	$500,000
Taxable Bonds	$0
End of Period Post Tax Value:	
Equities	$1,379,643
Muni Bonds	$618,093
Taxable Bonds	$0

End of Period Total Allocation	
Equities	$18,433,065
Fixed Income	$10,014,777
Total After-Tax Wealth:	**$28,447,842**

While the return is appealing, we know this solution is far from optimal. The first asset location item to consider is a shift in the allocation of stocks and bonds between the accounts given the inherent tax differences of the accounts and assets. In Scenario 2, we consider the impact of changing the IRA allocation to 100% bonds and adjusting the taxable account allowing the total allocation to remain 50/50 stocks to bonds.

Scenario 2:

End of Period Allocation	
Equities	$18,948,247
Fixed Income	$9,588,794
Total After-Tax Wealth:	**$28,537,041**

Taxable Account	
Allocation:	
Equities	56%
Muni Bonds	44%
Taxable Bonds	0%
Start of Period Post Tax Value:	
Equities	$5,000,000
Muni Bonds	$4,000,000
Taxable Bonds	$0
End of Period Post Tax Value:	
Equities	$18,948,247
Muni Bonds	$8,352,608
Taxable Bonds	$0

IRA Account	
Allocation:	
Equities	0%
Muni Bonds	100%
Taxable Bonds	0%
Start of Period Post Tax Value:	
Equities	$0
Muni Bonds	$1,000,000
Taxable Bonds	$0
End of Period Post Tax Value:	
Equities	$0
Muni Bonds	$1,236,186
Taxable Bonds	$0

By making just one change in the location of the assets and no change to the returns, we see $89,198 added to the total after-tax wealth value. This money was generated by simply locating existing assets in accounts that offer the most advantageous outcome. However, with Municipal bonds now in the tax deferred IRA account, which is not subject to annual income taxes, there is still further room for improvement. Municipal bonds add value to our High-Net-worth clients due to their tax-advantageous structure allowing the income generated to often be exempt from income taxes. Since Municipals will be unable to add significant value to an IRA, we can seek higher-performing taxable bonds to leverage the tax-deferred nature of the account. In scenario 3, we replace the Municipal Bonds in the IRA account with higher-performing taxable bonds.

Scenario 3:

End of Period Allocation	
Equities	$18,948,247
Fixed Income	$9,923,360
Total After-Tax Wealth:	**$28,871,607**

Taxable Account	
Allocation:	
Equities	56%
Muni Bonds	44%
Taxable Bonds	0%
Start of Period Post Tax Value:	
Equities	$5,000,000
Muni Bonds	$4,000,000
Taxable Bonds	$0
End of Period Post Tax Value:	
Equities	$18,948,247
Muni Bonds	$8,352,608
Taxable Bonds	$0

IRA Account	
Allocation:	
Equities	0%
Muni Bonds	0%
Taxable Bonds	100%
Start of Period Post Tax Value:	
Equities	$0
Muni Bonds	$0
Taxable Bonds	$1,000,000
End of Period Post Tax Value:	
Equities	$0
Muni Bonds	$0
Taxable Bonds	$1,570,752

With these final adjustments made, Scenario 3 was able to generate $423,765 over our base case by simply shifting the account level asset allocation and being smart about product selection.

As we stated at the outset, the above situation has been drastically simplified to allow an unfamiliar reader to follow along and grasp the concept. In practice, there are many more variables. For example, clients seldom have just two account types. Other account types include trust, split-interest trusts, donor advised funds, private foundation accounts, Roth IRA accounts, 401ks, defined benefit plans, and the list goes on. Clients will also seldom have only three investment options that are suitable to meet their needs. A more complex solution would include private equity, hedge funds, active management, tax-loss harvesting, inflation protection, and more. Of course, each of these items will interact with the different account types in different ways, so it is important for an advisor to carefully consider these factors and to refine a client's plan over time as the solution will change.

*As with any forward projection, this analysis is only for illustrative purposes and is not to be misunderstood as financial advice. Financial advice is specific to individuals, and we hope to show readers the value of being thoughtful about location of assets in the financial structure.
For further information, please follow the link below.

https://www.morningstar.com/content/dam/marketing/shared/research/foundational/677796-AlphaBetaGamma.pdf

Avantia Lifestyle

Banksy: Exit Through the Gift Shop

In the past 40 years, English graffiti artist, Banksy has become one of the world's most recognizable street artist while managing to remain relatively anonymous. His distinguishable style portrays satire, dark humor, and irony that has captivated the eyes of many, including affluent art investors. Recently, his piece titled "Exit Through the Gift Shop" was listed on Masterworks.io, a group allowing investors to own shares of multimillion dollar paintings. According to Masterworks, this is their third offering by Banksy who holds the title as the most requested artist on the platform. When asked for her thoughts on this acquisition by Masterworks, fine art appraiser and consultant, Kimberly Hereford, PhD commented "It's interesting that Masterworks acquired this piece. A symbiotic coupling as both Masterworks and Banksy, subvert and challenge the long-held traditions of the art market - Masterworks with fractional investing and Banksy's Dadaism anti-art."

Figure 8 (Source: www.screendaily.com)

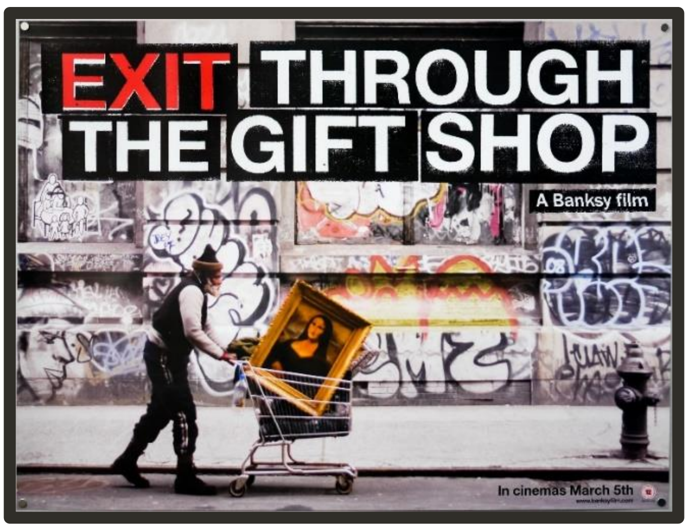


Figure 8 (Source: www.screendaily.com)

Like Banksy's earlier "modified oil paintings," in this 2009 painting the artists "vandalizes" a traditional pastoral landscape with the spray-painted text "Exit Through the Gift Shop." This familiar text is recognizable as the title of the artist's famous 2010 Academy Award-nominated documentary which tells the story of Thierry Guetta, a French immigrant in Los Angeles and his obsession with street art. The film is a collection of videos from Guetta's constant documentation of his every waking moment of his life. From a chance encounter with his cousin, the artist Invader, to his introduction to a host of street artists with a focus on Shepard Fairey and Banksy, Guetta portrays the rise of street art through the lens of his handheld camera.

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