CLEARPOINT

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THE OUTCOME IS INCOME – EVOLVING PORTFOLIO CONSTRUCTION

BY BRIAN T. WUNDERLE, CFA, MANAGING DIRECTOR AND JOHN P. LENEHAN, ASSOCIATE - CLEARSTEAD

Income always has been, and always will be, the great equalizer for investors. After a 15-year hiatus, income-oriented strategies can once again make a meaningful contribution to overall portfolio returns. In the first quarter of 2020, the expected return was 6.4% on stocks and 1.3% on core fixed income. A "60/40" portfolio—one that is invested 60% in stocks and 40% in bonds—was projected to return 4.4%.[1] Three years later, the projected return is 7.2% on stocks and 4.7% on core fixed income. A 60/40 portfolio is projected to return 6.5%.[2]

CURRENT MARKET ENVIRONMENT

Following the 2008 global financial crisis, interest rates were pushed at or below zero by global central banks to help stimulate economic growth. This brought about the phrase There Is No Alternative ("TINA"), where investors were pushed to take additional risk to generate returns. More than a decade later, global central banks have been aggressively increasing interest rates to combat inflation following the pandemic. The Federal Open Market Committee boosted rates seven times in 2022, causing the Bloomberg U.S. Aggregate index to register the worst performance on record, down 13%.[3] The Federal Reserve tightening helped

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Research and Investment Management, Reporting and Operations, Private Client and Administration teams.

Lauren Simonski joined Clearstead as a Staff Accountant. Lauren has a bachelors and MBA from Heidelberg University. She was previously employed as an Accounts Specialist at NOshok Inc.

Tricia Cindric joined Clearstead as a Sr. Client Service Associate. Tricia has deep experience in the wealth management industry. She was most recently employed at Hightower Advisors as a Client Service Manager.

Tom Kotick joined Clearstead as a Director of Trust and Estates. Tom is a graduate of Ohio University and holds his CPA and CFP. Prior to joining Clearstead, Tom was a Principal and Senior Financial Advisor at Signal Tree Financial Partners and has previous experience at BDO as Tax Managing Director and Head of Ohio Private Client Services.

Steve Drum joined Clearstead as an Associate Portfolio Manager. Steve has a Bachelor of Business Administration in Finance from Cleveland State University. He was previously employed at Prosperity

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moderate inflation, but also has prompted investors to expect a challenging growth environment moving forward.

While increasing short-term interest rates put pressure on fixed income prices and expected economic growth, it has helped restore some balance between asset classes when evaluating risk and return expectations. The sharp rise in real or inflation-adjusted yields means that fixed income assets today are already offering the most attractive income potential that we have seen in more than a decade. In this era of slower growth, moderating inflation, and increasing yields, we believe investors should realize a higher proportion of their return objectives from income-oriented investments.

WHY INCOME MATTERS

Historically, investors were able to rely on an income-oriented approach, rather than a total-return approach, given yields were sufficient to meet most or all an investor's spending needs. After the Global Financial Crisis, historically low interest rates made that impossible as investors had to focus more on capital appreciation to achieve their objectives. However, for the first time in recent memory, bond yields are high enough that income-seeking retirees can use them to help support a 4% withdrawal rate from their portfolios.

There are several compelling reasons why investors should focus more on income to achieve total return objectives in today's market environment rather than capital appreciation:

1. **Portfolio Diversification:** Relying on capital appreciation alone can lead to an over-concentration in a particular asset class or sector, which can increase risk. Fixed income has historically served as a portfolio ballast, helping support returns during periods of economic stress and equity market selloffs. Over the last 46 years, investors have never encountered a three-year span of losses in both equity and fixed income markets.[3]

2. **Volatility Mitigation:** Growth investments, such as equities, can fluctuate wildly in response to market events and cause investors to make detrimental buy or sell decisions at inopportune times. Certain income-producing assets provide a steady stream of cash flow that helps mitigate volatility, may increase downside protection, and could lead to better investor outcomes.

3. **Retirement Planning:** For investors approaching or in retirement, income is often a critical consideration. Generating a steady stream of income from investments can help to supplement other sources of retirement income, such as Social Security or a pension. In many cases, income-generating assets can be more tax-efficient than capital gains. For example, dividends from qualified dividend-paying stocks may be subject to lower tax rates than capital gains from selling stocks.

4. **Efficient Portfolios:** Dating back to the Global Financial Crisis, historically low rates meant that investors were not able to count on bonds to make much of

Advisors as an Operations Team Associate and has previous experience at UBS Financial Services.

Jacob Stefko joined Clearstead as an Associate Performance Analyst. Jacob has his Master of Finance from Case Western Reserve University, specializing in Financial Big Data Analytics. He has interned at Sotera Health and Cloud Fire Capital.

Mysha Bryan joined Clearstead as an Associate Corporate Development. Mysha has a MBA from Duke University. She has past experience as a Mergers & Acquisitions Analyst with Elevate Women's Health and as an Investment Banking Analyst at KeyBanc Capital Markets.

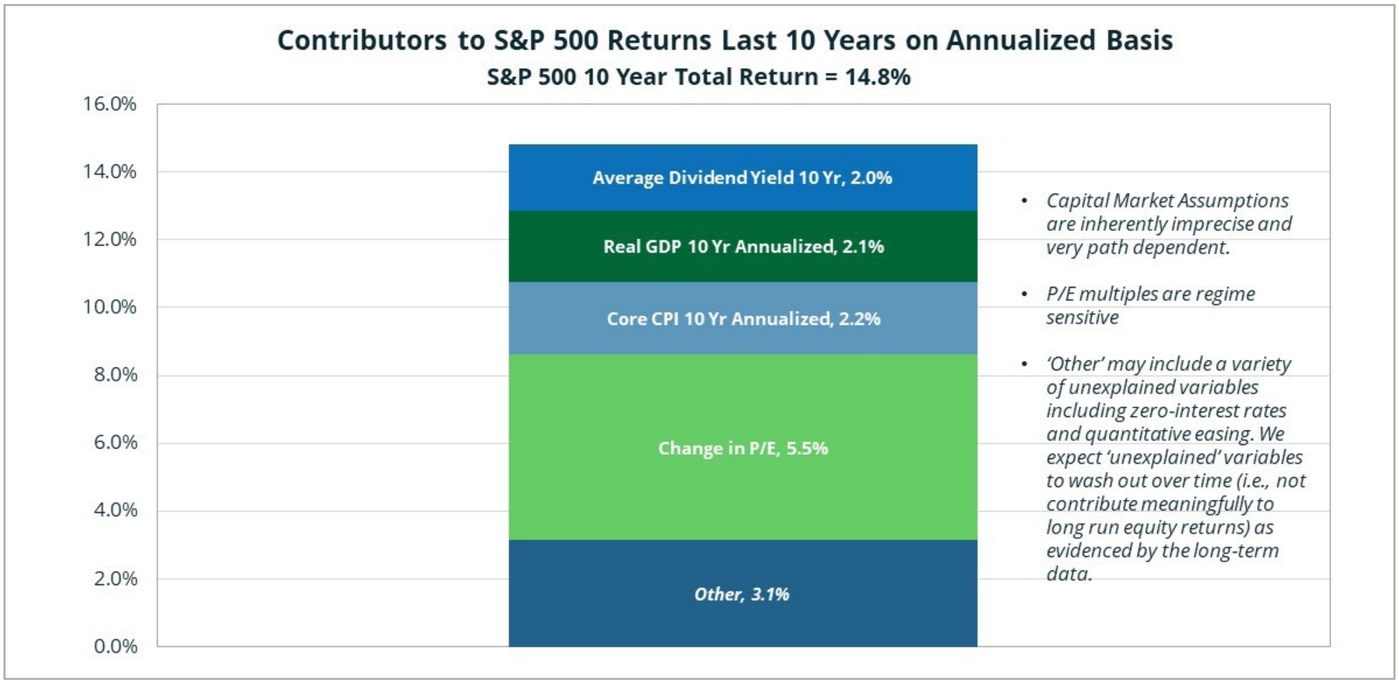
These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

a contribution to a portfolio's total return. But with bonds offering higher potential income today, investors may be able to take less risk with their equity investments and still meet their return expectations.

While capital appreciation remains an important component of total return, income-generating assets can provide diversification, consistent income, and downside protection which leads to more efficient portfolios. Incorporating these assets thoughtfully into a portfolio could drive better investment outcomes.

Over the past decade, income has taken the backseat while capital gains drove equity market returns. As shown in the chart below, change in Price-to-Earnings has been the largest contributor to the S&P 500 overall returns. The past decade of S&P 500 returns has been driven by multiple expansion. Given our current interest rate environment, the chance of the next decade of returns being driven by multiple expansion is low. It is our expectation that income, not capital appreciation, will drive a larger portion of the total portfolio return over the next decade.

DECOMPOSITION OF RETURNS (2011-2021)



Source: Clearstead, Bloomberg LP, Total returns of S&P 500 from 30-June-2011 to 30-June-2021 decomposed by primary return drivers: Annualized Real GDP, Annualized Core CPI, Average Dividend Yield, Change in Price-to-Earnings ratio over the ten- year period, and residuals or "unexplained".

PORTFOLIO IMPLEMENTATION

Asset classes that offer higher income yields include:

1. **Public and Private Fixed Income:** These include bonds and bond funds, which pay a fixed rate of interest over a specified period. Although fixed-income markets had their challenges last year, the silver lining is that the current yield environment has created improved prospects for future fixed income returns. Attractive yields can be found across the fixed income sector, and some of the best value is short-term, higher-quality investments, which we believe should hold up well even if the overall economy weakens.

2. **Dividend-paying Stocks:** These are stocks that pay regular dividends to shareholders, typically quarterly or annually. Traditional dividend strategies tend to be more defensive, outperforming when economies slow. That is because

companies able to pay high and consistent dividends are often more mature, with relatively stable business models and stronger balance sheets, which can help them navigate periods of market stress.

3. **Private Real Estate:** Investing in private equity real estate involves the acquisition, financing, and ownership (either direct or indirect) of property or properties via an investment fund. Private Real Estate funds generally require a capital commitment that is drawn over time as suitable investments are made. Private real estate could help improve portfolio diversification, provides above average and stable income, and inflation protection qualities. Clearstead prefers private real estate over listed REITs, because REITs are publicly traded and subject to broad stock market volatility.

4. **Public or Private Infrastructure:** These are investments that are a form of "real assets," which contain physical assets such as bridges, roads, highways, or energy. This is a more defensive asset class, generally having lower volatility of earnings and higher yields than broader equities.

It is important to note that these asset classes are not mutually exclusive, and many investments can offer both income and capital appreciation potential. As outlined above, investors have numerous options to enhance the income producing characteristics of their portfolios, but must consider their individual goals, risk tolerance, and investment time horizon when selecting investments.

CONCLUSION

The role of income within client portfolios has changed. While we still expect some volatility in the near term, investors can capture yields that have not been this high in years. As interest rates stabilize and there is more clarity on monetary policy, fixed income returns should benefit. Income will play a more meaningful role because the opportunity for capital gains has diminished for both equity and fixed income. Today, income-oriented investing can have a meaningful impact on overall portfolio returns and will be a necessity for achieving clients' financial goals.

Clearstead is actively working with clients to increase the dividend and yield income components of their portfolios. Examples include increasing exposure to corporate lending strategies that feature high, floating-rate yields, or working to ensure that portions of U.S. equity exposure are oriented to dividend-paying stocks. When capital gains are harder to achieve, dividend-paying stocks provide a way for investors to get paid through potentially rocky markets. Equally, we continue to advocate for exposure to real-assets—private if possible, or public if not—that have high-dividend yields, the explicit ability to pass along rising inflationary dynamics to investors, and feature stable, recession-resilient cash-flows.

Ultimately, Clearstead believes in the core tenants of diversified, balanced investment strategy and remaining disciplined through periods of elevated volatility. While balanced portfolios struggled in the calendar year 2022, as both equities and bonds suffered negative returns, now is an opportune time to reassess investment strategy. The benefits of equities drive long-term returns through capital appreciation, but the current economic environment may favor a larger component of returns from income. Until we are confident the Federal Reserve has reached its terminal rate, we believe portfolios that focus more on income characteristics will aid in helping clients achieve their investment objectives.

Source:

(1) Based on Clearstead Investment Office's 2020 Capital Market Assumptions (Russell 1000 / Bloomberg U.S. Aggregate).
(2) Based on Clearstead Investment Office's 2023 Capital Market Assumptions (Russell 1000 / Bloomberg U.S. Aggregate).
(3) Bloomberg.

MARKET BENCHMARK RETURNS

April 30, 2023		1M	3M	12M	YTD
US Large Cap	S&P 500	1.6%	2.7%	2.7%	9.2%
US Small Cap	Russell 2000	-1.8%	-8.1%	-3.6%	0.9%
Developed Intl	MSCI EAFE	2.8%	3.2%	8.4%	11.5%
Emerging Intl	MSCI Em Mkt	-1.1%	-4.7%	-6.5%	2.8%
Real Estate	NAREIT	0.3%	-7.7%	-16.1%	1.8%
Core Fixed	BarCap Agg	0.6%	0.5%	-0.4%	3.6%
Short Fixed	BarCap 1-3Yr	0.3%	1.0%	1.1%	1.9%
Long Fixed	BarCap LT G/C	0.7%	-0.1%	-3.9%	6.5%
Corp Debt	BarCap Corp	0.8%	0.4%	0.7%	4.3%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.