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THE TEMPO VANTAGE

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Will Congress Never Learn?

(And a brief history of bank regulations)

The first quarter of 2023 started on a very positive note. The market was strong, with the S&P 500 up 8.8% through February 2. It seemed we might avoid a recession.

Then something unexpected happened.

Mid-sized banks started to fail. The market then did what it does best when something unexpected occurs: overreact.

In just a few days the financial sector dropped 20% and took the rest of the market down with it (S&P 500 down 5%).

What happened?

It all started nearly 100 years ago (cue *It's Only a Paper Moon*).

A major contributing factor to the Great Depression was banks taking too much risk. In essence, low-risk, secure deposits should not be mixed with higher risk investments.

To separate banks from risky investments, the Government passed the Banking Act of 1933, also known as the Glass-Steagall Act.

But banks were hungry to make more money. Right from the start people tried to tear down Glass-Steagall, starting with Glass himself in 1935!

Despite this, for the next 60 years the Act worked well. The market had ups and down, but these were caused by things (gold, oil, inflation) other than banks.

But the lobbying efforts persisted, and Glass-Steagall was systematically weakened. First in the 1980s under Reagan and then again in 1999 with the Financial Services Modernization Act (aka the Gramm-Leach-Bliley Act) under Clinton.

Within ten years the banks were in trouble again, this time with the housing/mortgage crisis (aka the Great Recession) of 2008.

A major contributing factor to the Great Recession was banks taking too much risk. Sound familiar?

In the wake of the Great Recession, the Government passed the Dodd-Frank Wall

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Steet Reform and Consumer Protection Act with essentially the same goal as Glass-Steagall. Separate conservative banking from risky Wall Street.

This time it only took ten years to undo.

In 2018 Donald Trump signed the Economic Growth, Regulatory Relief and Consumer Protection Act. This act effectively exempted dozens of second tier banks (such as Silicon Valley Bank and Signature Bank) from the Dodd-Frank Act.

And here we are. Only five years later and another banking crisis.

I don't blame the banks for asking (not entirely). Their job is to make more money for the bank and its shareholders (and if executive bonuses are higher as a result, well, so be it.).

I blame politicians swayed by corporate money (lobbying and political contributions).

Notice this is not a Republican or a Democratic problem. It is a weak politician problem with no understanding of history. Will they never learn?

With all the bad news you might think that the first quarter was a disaster for investors. Not so.

For the quarter the S&P 500 was up 7.5%, Small caps rose 2.7% and international stocks, 8.5%. Outliers on the upside were technology (+17%) and electric grid (+12%). Negative-side outliers include financial (-6%) and healthcare (-2%).

After losing 15% from 2021 to 2022, bonds turned in a good performance in the first quarter of 2023, gaining 3% (BarCap Agg). Most bond categories were close to this figure.

Where to from here?

The worst of the banking crisis is likely over. Larger banks have come to the rescue with takeovers or large deposits to help shore up failing banks.

Don't for a second think these large banks were being altruistic. They either smelled a bargain or wanted to deflect blame on their industry. Probably both.

Biden is now pledging to restrengthen banking regulations. I hope he is successful. Unfortunately, our Congress is so fractured it is hard to imagine them passing anything.

Moving forward, what concerns me more than banks is the impending battle for the debt limit. While I expect some volatile times ahead, in the end calmer minds will prevail.

Before I move on to Tempo performance, I want to address the elephant in the room (did you know there was an elephant in the room?): If bank stocks were falling so much and we have a position in a financial fund, why didn't I do anything (i.e., sell it!)?

Excellent question!

The drop in banking and financial stocks was quick and sharp. Financial funds such as the ones we own were down 20% in just a matter of days.

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We didn't (and don't) have much direct exposure to Silicon Valley Bank and Signature Bank. These two stocks were less than 2% of the financial funds we own. Since our financial fund represents a 2.5% allocation within Lifestyle portfolios, that means that 0.05% of your Lifestyle portfolio was exposed to these stocks.

While individual stocks can go to zero, industries and mutual funds do not. If the market overreacted on the downside, as it usually does with unexpected events, then I don't want to be a seller at the low.

Which brings me to the larger point. Most days there are no trades in your accounts. Dynamic Growth and Dynamic Income trade every quarter, and Diversified Income and Lifestyle are not on any set trading schedule. Some quarters there is trading, but many there is not.

Just as it was an active decision not to sell our financial fund at the bottom, it is an active decision not to trade Lifestyle or Diversified Income for the sake of trading. These are longer term strategies where we are trying to maximize the risk-reward trade-off over a market cycle (3-5 years), not a few days.

Now on to performance.

Tempo Financial Advisors' 1st Quarter Investment Performance

Moderate and Aggressive **Tempo Lifestyle** accounts were in line with benchmarks for the first quarter of 2023 as well as for the year ending 3/31/23. Returns ranged from +4% to +5% for the first quarter and between -4% and -6% for the year.

Interestingly, Tempo conservative clients trailed the benchmark in the first quarter by about 0.5%, but are ahead of the benchmark for the year by the same amount.

How can this be?

On the US equity side, we have strategic allocations in sectors that outperformed (technology, electric grid) and sectors that underperformed (financial, healthcare). These balanced each other and we were left with market-matching performance relative to equities.

With few exceptions, our bond holdings were also relatively close to the benchmark.

That leaves us with alternatives. I define alternatives as anything that does not correlate to stocks or bonds, but has a risk profile closer to bonds.

Alternatives allowed us to outperform in Lifestyle in 2022 as our basket of alternatives (flat to slightly positive) easily outperformed bonds (-13%).

The reverse was true in the first quarter of 2023. Alternatives were flat to up slightly, while bonds were up 3%.

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The more conservative a Lifestyle account is, the higher the percentage of alternatives (and bonds) in the portfolio. As a result, conservative accounts were the only ones to underperform in first quarter while outperforming for the year ending 3/31/23.

The **Tempo Dynamic Income and Diversified Income** programs struggled a bit in the first quarter with returns of +1.5% and +0.5%, respectively, which underperformed the Agg (+3%) as well as short-term bonds (+1.7%).

The story is parallel to conservative Lifestyle accounts. The alternatives in our income strategies both held us back in the first quarter while helping us longer term. For the year ending 3/31/23, both Dynamic Income and Diversified Income were down about 1%, compared to the Agg, which was down 5%.

Tempo Dynamic Growth, which did well for the first nine months of 2022, has now struggled for the second quarter in a row. Returns were fractionally positive (+0.2%) compared to the benchmark return of +4%.

Coming off a rough and volatile 2022 in the equity markets, Dynamic Growth accounts were positioned for the worst. Equity allocations at 40% (our lowest allowed) and the rest split between bonds and alternatives.

Not only did the worst not happen, but returns were attractive. A perfect recipe for underperformance.

That is how Dynamic Growth is positioned today as well. If the market does well, Dynamic Growth will likely underperform. If, on the other hand, the market struggles, Dynamic Growth will likely outperform.

The low correlations in Dynamic Growth (i.e. it can be up in a down market and vice versa) can be tough to take in an up market if all you have is Dynamic Growth. But Dynamic Growth is a nice conservative addition to a portfolio with riskier assets elsewhere.

Reminder

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Dan

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