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**2022 Fourth Quarter Review**

Greetings Clients:

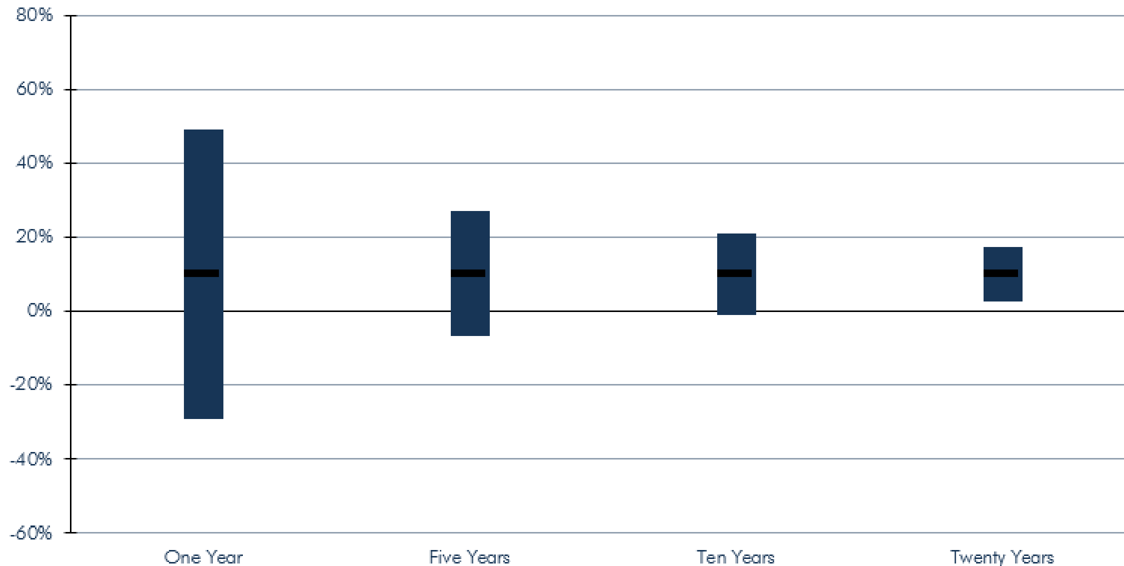
This past quarter's letter is a whopper…apologies; we have a lot on our minds. Here is the executive summary:

1. 2022 was a down year
2. Inflation will drive the markets' short-term performance
3. The long-term annual target of 8% remains unchanged
4. We are cautiously optimistic that our recent outperformance might just be the tip of the iceberg

U.S. stocks declined 18% in 2022, world stocks were down 18%, and bonds declined 13%, as represented by the S&P 500 Index, the MSCI All Country World Index, and the Bloomberg Barclays Aggregate Bond Index.

We preferred the previous year's numbers: U.S. stocks appreciated 29%, world stocks were up 19%, and bonds were only down 2% in 2021.

And yet these calendar year returns are noise; the important thing is that, even after last year, U.S. stocks have averaged 10.2% growth per year since 1926 and a portfolio mix of 70% stocks/30% bonds has averaged 9.0%. We know that volatility decreases over longer holding periods:




We know that if we pay attention to your cash needs, we will achieve your goals.

Predictably, the longer that our clients have been with us, the higher their returns. All growth clients who joined us before 2021 have positive returns; if you joined us more recently, we are aware of how unpleasant it is to see negative numbers at the beginning of our relationship, and we thank you for your confidence and patience; it will be rewarded.

We find the current economic situation intellectually fascinating, and the divergence in investment performance tantalizing.

Inflation remains the single most important factor driving market performance. Can the Federal Reserve push down inflation without launching a recessionary spiral? Maybe. Friday's jobs report showed slowing but still comfortably positive growth; there couldn't have been any better news for the Fed. Our economy is behaving in unprecedented ways after its near-complete pandemic shutdown and restart. Especially the housing, automobile and labor markets. Economists are hoping that labor shortages will compel employers to retain workers, avoid a spiraling loss of momentum (Sahm's Rule), and achieve the desired soft landing.

While fascinating to pore over current economic data and consider past events, achieving your financial goals does not require us to determine when the next economic contraction will occur or predict how long it will last. Which

is why our focus is on 1) making sure that our growth target is attainable; and 2) achieving it with the least amount of gut-wrenching volatility. We believe starting with the entire universe of investments and then making measured adjustments remains the best way to do this.

Here is a table from the Morningstar database to highlight some of the recent adjustments that we have made and a few of the opportunities that we see:

| Name | Ticker | % Total Return 3 Month | Total Return 2022 | % Total Return 5 Year | % Total Return 10 Year |
|---|---|---|---|---|---|
| Coinbase Global Inc Ordinary Shares - Cl... | COIN | -55.00 | -85.98 | --- | --- |
| Vanguard S&P 500 Growth ETF | VOOG | -3.14 | -29.48 | 9.47 | 13.15 |
| T. Rowe Price Emerging Markets Stock | PRMSX | 12.22 | -23.36 | -2.77 | 2.00 |
| iShares Core S&P 500 ETF | IVV | 4.46 | -18.16 | 9.16 | 12.37 |
| SPDR® Portfolio Developed Wld ex-US E... | SPDW | 16.62 | -16.01 | 1.69 | 4.73 |
| Dodge & Cox International Stock I | DODFX | 15.97 | -6.78 | 1.33 | 5.06 |
| Vanguard Dividend Growth Inv | VDIGX | 10.81 | -4.88 | 11.56 | 12.80 |

This table shows seven possible investments. They are ranked by the *Total Return 2022* column from worst to least bad. I will reference the investment symbol ("Ticker") for ease of identification. For fun we start with cryptocurrency exchange company Coinbase (COIN), which lost 85% of its value last year. We don't recommend investing in a single company. If you were a complete believer in technology companies, you could invest in the Vanguard S&P 500 growth index fund (VOOG), which declined 29.48% last year. Growth has outperformed value for years, but not last year. We have been worried for some time that our portfolios had too much growth, so we do not own this fund. Next, the emerging markets stock fund (PRMSX) was our worst performer last year. As the dollar strengthened, globalization unraveled, and money flowed as far away from Russia as possible, we concluded that emerging markets will not be attractive for the foreseeable future and we reduced our target allocation. However, we thought it very likely that investors would recognize that emerging markets were oversold, so we declined to liquidate existing holdings. And we were right: the emerging markets fund has bounced back 12.22% in the last 3 months.

The highlighted holding is an S&P 500 index fund (IVV – there are several to choose from). This is effectively the default investment: we frequently ask ourselves: do our clients need to pay us or anyone else for investment management, or could they just put all of their stock allocation into this single fund? And honestly, if a person had the fortitude to stay invested and not capitulate when markets fall, one could do a lot worse that just owning a

broad index of large US companies: like Coinbase for example, that would have been a lot worse. We believe we will outperform simple indexes, and more importantly for most clients, working with a professional will ensure that they avoid the really big portfolio killers like serial losses from buying high and selling low, excessively priced and extraneous insurance products, and years of uninvested cash balances and other manifestations of negligence.

One of Ridley Cove's strongest beliefs is that international investments are an attractive portfolio choice. Big companies based in the US and other countries are generally selling to the same customers around the world; there will be regional differences which will provide some diversification, and the biggest impact on the performance differential between US and non-US stocks will be the exchange rate between countries. If the dollar appreciates against the euro, for example, it will buy more shares of an international company when we invest, but if the dollar keeps appreciating, those shares will convert back into fewer dollars when we redeem. And the opposite is true: if the dollar depreciates, we will not be able to buy as many shares of foreign companies, but we will be able to redeem for more dollars. In general, rebalancing regularly to maintain allocation targets results in buying low and selling high. This is a beautiful process that happens automatically and does not require you or your advisor to make a successful prediction (but one must be disciplined). Fluctuating exchange rates turbocharge this built-in mechanism.

Chief Allocation Strategist Steve Bobo did a beautiful analysis of international investing a few years ago. Looking at the previous 45 five-year rolling return periods for which we have reliable performance data on the most widely accepted international stock index, US companies outperformed international companies 24 of the 45 periods. That is almost evenly split. So we remain patient and keep investing in our international companies until the exchange rate shifts.

And we have had to be very patient: it has been 12 periods since the international index has outperformed the S&P 500. Looking at the last two columns in the table above, you can see that the 10-year annualized return for the S&P 500 was 12.37% vs. 4.73% for the international index. And last year the international index broke the S&P 500's winning streak: the S&P 500 did over 2% worse than the international index. Furthermore, in the last three months, the international index has recovered 16.62% versus 4.46% for the S&P 500. Not coincidentally, the dollar has weakened and buys about 10% fewer euros now that it did at the end of September.

And we are seeing even more stark outperformance by our value and quality investments: last year, our Dodge & Cox international value fund (DODFX) was down only 6.78% and our Vanguard Dividend Growth fund (VDIGX) was down only 4.88% versus an 18.16% decline from the S&P 500 fund (IVV).

We think it is possible that we are experiencing the beginning of a reversionary moment that could lead to significant outperformance in your portfolios. Then again, inflation could decline faster than expected, US growth stocks could resume their supremacy over value and international stocks, and Amazon and Salesforce could reverse last week's announced job cuts. We will continue to be patient and willingly giving up some of the gains, knowing that your financial goals are secure and that we will eventually profit.

As always, I will end on my appeal for updates on your spending needs. Our 30% allocation to cash and bonds in the growth portfolios is usually more than enough for any unexpected surprises, but don't hesitate to contact me any time to talk this through.

Please contact me if you have any questions about your investments, our strategy, or your financial goals. Our money is invested right alongside yours.

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