SORFIS
INVESTMENTS

January 5, 2023

2022 Annual Letter

2022 was that rare year when both stocks and bonds declined—and declined significantly. The S&P 500 fell 18.1%, with dividends included, and the more tech-heavy Nasdaq dropped about 32%. The bond market, using the Bloomberg U.S. Aggregate Bond Index as a proxy, declined 13%. The worst previous loss for that index occurred in 1994 when it fell by just 2.9%.

In last year's annual letter, I wrote that "the returns from stocks and bonds during the next 13 years are likely to be much lower than during the last 13 years. With interest rates close to zero and stock valuations near all-time highs at year-end, the odds favor much lower returns going forward." Little did we all know how quickly the tide would change.

The more significant declines in technology stocks followed years of outperformance, especially during those 13 years from 2009 through 2021 for the Nasdaq. Value strategies finally had their day in the sun in 2022. The Vanguard Value ETF, for example, declined by only 2% during the year. And Berkshire Hathaway, run by one of the most famous value investors of all time (Warren Buffett) and the company that is the core holding in our Absolute Return Strategy, had a positive return of 3.3%.

To put 2022 into further perspective, here are a few more statistics[i]:

- The S&P 500's 18.1% decline was its fourth worst yearly drop since 1940.
- With data going back to 1928, there were five years when both the S&P 500 and the 10-Year Treasury Bond had negative returns: 1931, 1941, 1969, 2018, and 2022.
- With data going back to 1928, there was only one year when both the S&P 500 and the 10-Year Treasury Bond had a negative return greater than 10%: 2022.

In our **Diversified Strategy**, where we diversify widely and adjust the asset mix based on a client's life situation and risk tolerance, we mostly experienced moderately negative returns, except for those new clients who joined us at opportune times during the year. We came into the year with a shorter duration on bond portfolios than the aggregate bond indices, and we tended to own one or more value ETFs in client accounts. And so, while we fully acknowledge that you can't spend relative performance, that positioning proved useful in helping the strategy fulfill its aims and do what it's supposed to do in a year like 2022.

For clients in our **Absolute Return Strategy**, if you went all year without opening your brokerage statements and are just now getting around to it, 2022 may have seemed like an uneventful year. Every client account in this strategy achieved a positive return during the year, ranging from approximately +2% to +13%[ii]. The large position in Berkshire Hathaway and the overweight positions in the energy sector were the key holdings that drove performance during the year.

We don't know what the future holds, and it's darned near impossible to predict any given year in the stock market. But we can assess where we've come from—and where we are—to determine potential risks and make sure we're prepared and positioned to handle those risks, should they present themselves.

By most valuation measures, the S&P 500 and most U.S. market indices reached valuation peaks in 2021 and the beginning of 2022 that surpassed the previous high marks reached in 1929 and 2000. The 1929 peak led to a negative return that year, followed by worse years in 1930 and 1931. The 2000 peak led to a negative return that year, followed by worse years in 2001 and 2002. Are 2023 and 2024 destined to be even worse than 2022?

We don't know and don't think anyone does. High valuations as we enter 2023 still leave negative outcomes as a significant risk. But there are other market concerns far different from what happened at the 1929 and 2000 peaks—most notably, government and central bank involvement in trying to avoid bad outcomes. That involvement created vast amounts of capital to support both the economy and the markets from the beginning of the Covid pandemic until this past year when the Fed has (slowly) begun to unwind some of its efforts to support the economy.

Recession is a greater risk than usual. Again, it's not something that can be predicted with any degree of accuracy. But the Fed has done much of what it said it would do during the last several years. It currently seems to be saying that it wants a recession to bring inflation down more quickly, and that it'll keep working to accomplish that unless the economy breaks bad enough that the Fed needs to reverse course. And the lag between the higher inflation and interest rates we've seen and the increased costs depressing corporate profit margins also adds to the recession risk.

That all sounds like a risky environment in which to invest, and maybe it is—at least riskier than normal. But we also must keep in mind that markets tend to bottom before economies. In the Global Financial Crisis of 2007–2009, the U.S. stock market reached its low in early March 2009, even though the recession lasted a few months longer. And one of the all-time great times to invest in the stock market was in the summer of 1932. Suppose you had perfect foresight to know that the Great Depression would last several more years and that World War II was on the other side of that. Would you have been brave enough to invest in stocks in mid-1932? Few probably would have, but from the perspective of great investment returns, that would have been the right thing to do.

In managing portfolios in this unpredictable future, we've restructured how we define our strategies and services. We basically do four things, which are shown in the boxes below:

Diversified Strategy	**Absolute Return Strategy**
Customized Strategies	**Financial & Retirement Planning**

If you're reading this not as a current client but as a potential investor, there is more information on our website about the strategy differences at: sorfis.com/strategies

For some clients, the Diversified Strategy—where we'll adjust the mix of stocks and bonds to your situation, and rebalance over time—is best.

For other clients, the Absolute Return Strategy might be a better fit, with its focus on valuation and likelihood of holding more individual stocks—including some occasional large positions in individual stocks when they are attractive on both absolute and relative valuations, such as our Berkshire Hathaway holding as we enter 2023.

Our contact information is included below for easy reference. As always, feel free to call or email us if you have any questions. And thank you for your support!

All the best,

Joe Koster

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Portfolio performance is shown net of the advisory fees of 0.75–1.00%, the highest fees charged by Sorfis in its strategies during the year. Performance does not reflect the deduction of other fees or expenses, including but not limited to brokerage fees, custodial fees, and fees and expenses charged by mutual funds and other investment companies. The data used to calculate the portfolio performance was obtained from sources deemed reliable and then organized and presented by Sorfis.

The performance calculations have not been audited by any third party. Actual performance of client portfolios may differ materially due to the timing related to additional client deposits or withdrawals and the actual deployment and investment of a client portfolio, the length of time various positions are held, the client's objectives and restrictions, and fees and expenses incurred by any specific individual portfolio.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

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[i] A big thanks to Charlie Bilello for posting these statistics on Twitter (@charliebilello).

[ii] These returns are net of fees, as calculated by our service provider Morningstar, Inc. Please see further performance-related disclosures, above.