

SC Capital Advisors Investor Insights



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3rd Quarter 2023

2023 3rd Quarter in Review & Outlook

"The key to making money in stocks is not to get scared out of them." —Peter Lynch

Markets give back some gains

Hawkish commentary by the U.S. Federal Reserve board resulted in a partial retracement of year-to-date gains for stocks during the third quarter and net year-to-date losses for bonds (below) as investors perceive that the Fed may hold short term rates higher for longer. Higher energy prices, rising interest rates, the United Auto Workers strike, and renewed concerns over a government shutdown also fueled asset price declines. Mid- and small-cap stocks and REITs lead the declines in equity prices.

Asset Class Returns 2023 (09-30-2023)

	US Large	US Mid	US Small	REITs	Intl Large	Intl Small	Em Mkts	Bonds
Q1	7.5%	3.8%	2.7%	1.6%	8.5%	4.9%	4.0%	3.0%
Q2	8.6%	4.9%	5.2%	2.4%	3.0%	0.6%	0.9%	-0.8%
Q3	-3.2%	-4.2%	-5.1%	-8.6%	-4.1%	-3.5%	-2.9%	-3.2%
2023	13.0%	4.3%	2.5%	-4.9%	7.1%	1.8%	1.8%	-1.2%

Indexes: US Large, Russell 1000; US Mid, S&P MidCap 400; US Small, Russell 2000; REITs, DJ US Real Estate; Intl Large, MSCI EAFE; US Small, MSCI EAFE Small Cap; EM, MSCI Emerging Markets; S&P GSCI TR; Bonds, Bloomberg US Agg Bond. Source: Morningstar.

This year's rally in the broader U.S. stock market has been unusually concentrated with the so-called Magnificent 7 technology-oriented stocks accounting for 69% of year-to-date returns. According to global investment management firm VanEck, the expanding dominance of the "Magnificent Seven" mega-cap technology stocks has raised eyebrows in financial circles, leading to growing concerns about concentration risk in the U.S. equity market. These behemoths, which include Apple, Amazon, Microsoft, Google, Nvidia, Tesla, and Meta have seen their market values soar, making them pivotal players in the stock market's performance. Today, the Magnificent Seven make up over 25% of the S&P 500 Index.

While their spectacular rise underscores the transformative power and profitability of technology in today's digital age, it also poses a potential risk, according to VanEck. If any of these companies were to falter, the ripple effect on the broader market could be significant. Diversification is a cornerstone of risk management in investing, and the increasing reliance on a handful of stocks for market returns challenges this foundational principle.

Protecting against concentration risk

We continue to be impressed with the performance and methodology of the Morningstar Wide Moat Focus index (the Moat Index). Our largest equity Exchange Traded Fund (ETF) holding, the VanEck Morningstar Wide Moat ETF (MOAT), tracks this actively managed index that uses Morningstar’s proprietary quality and valuation screening factors and an equal-weight methodology that protects against concentration risk. We also use similar screening factors in building and managing our Core Equity portfolio segment for our larger portfolios.

U.S. EQUITY MARKET VALUATION OVERVIEW

Magnificent 7 Responsible for 69% of Market Gains

- Stock market rally has been unusually concentrated this year. Magnificent 7 account for 69% of the total market return YTD.

Magnificent 7 Responsible for 69% of Market Gains

Name/Ticker	Index Weighting (%)	YTD Return (%)	YTD Contribution to Index Return (%)
Apple AAPL	6.18	35.10	1.85
Nvidia NVDA	1.98	184.83	1.82
Microsoft MSFT	5.50	33.09	1.60
Alphabet GOOGL	3.11	47.63	1.28
Amazon.com AMZN	2.51	53.71	1.09
Meta Platforms META	1.29	148.53	1.09
Tesla TSLA	1.38	98.90	0.89

Source: Morningstar. Data as of Sept. 25, 2023. For Illustrative Purposes Only.

The Moat Index was not resistant to market troubles, finishing down 5.44% in September, while the S&P 500 Index declined 4.77%. However, year-to-date the Moat Index continues to lead the S&P 500 by over 300 basis points, according to Morningstar. Smaller-cap companies also saw a modest decline during the month, yet the Morningstar US Small-Mid Cap Moat Focus Index (the “SMID Moat Index”) weathered the storm better than both the small- and mid-cap broad benchmark indexes. We have been adding a new ETF recently that tracks this index into portfolios.

The Moat Index saw its technology exposure increase to the largest overweight in quite some time at the end of 2022, following the drastic declines in valuations for the sector that year, according to VanEck. Now, with the incredible rally that many of these companies experienced in the first half of the year, their valuations have become less attractive. During the September review, the Moat Index continued its shift away from growth stocks, which began in June 2023, to more of a blend/value posture.

The technology sector saw the largest reduction in exposure, signaling growth as an overvalued segment of the U.S. market, according to VanEck. Tech stocks are now the largest underweight in the Moat Index, about 12% relative to the S&P 500 Index. This technology sector void was filled by companies from more value-oriented sectors such as industrials, financials, and consumer staples.

Morningstar Quality & Price Factor Benchmarks

Total Returns through 9-30-23

Name	YTD	Annualized								
		1 Month	3 Month	6 Month	12 Month	3 Yr	5 Year	10 Year	15 Year	Since Inception
Morningstar Wide Moat Focus Index	17.16	-5.44	-4.84	2.93	28.61	13.58	12.23	12.89	13.63	14.47
Morningstar Narrow Moat Index	10.86	-3.02	-1.92	2.79	16.65	10.35	9.88	11.87	-	11.05
S&P 500	13.07	-4.77	-3.27	5.18	21.62	10.15	9.92	11.91	11.28	10.71
Russell 2000 (Small Cap stocks)	2.54	-5.89	-5.13	-0.19	8.93	7.16	2.40	6.65	8.13	10.71

Data source: Morningstar

Past performance is no assurance of future results.

Valuations of the Moat Index are significantly more attractive than a market cap-weighted broad market index like the S&P 500. According to VanEck, the weighted average price-to-fair value of the Moat Index fell from 0.81 to 0.77

following the September rebalance, signaling a 23% discount to Morningstar’s fair value estimate. This is in contrast to the S&P 500 Index, which featured a weighted average price-to-fair value ratio of 0.96 as of the same date.

We own a number of the Magnificent 7 with a low cost basis in non-qualified accounts. These tax constraints prevent us from rebalancing in the same manner that the Moat Index and the ETF that tracks it. However, we have trimmed positions to control risk yet keep capital gains consequences to a minimum.

September blues for stocks

Apparently, the biggest headwind for stocks during the quarter was that it contained the month of September. Below, Blackrock collected nearly 98 years of monthly returns dating back to 1926. The only month that has averaged a negative return is September. A lot of people would probably guess that October would be the worst month given some of the historical down drafts of that month such as the Crash of ’87. But, no, it is September which also has the lowest percentage of up months dating back to 1926. Of course, only a speculator would attempt to avoid losses by going to cash prior to September. And that would be a 50-50 proposition. The proper mentality is to use the occasion to add quality names at more reasonable prices.

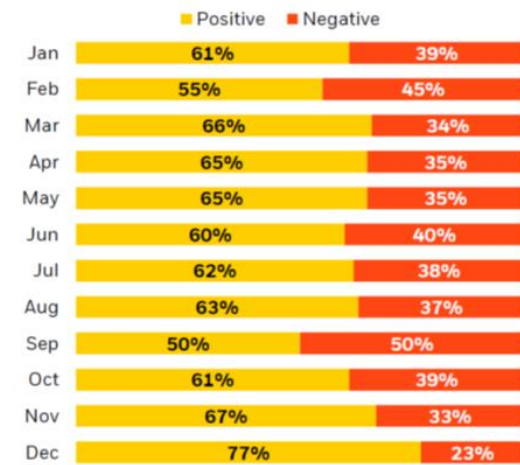
SEPTEMBER IS A TOUGH MONTH FOR STOCKS

September historically the worst month for stocks

Avg stock market return by month
(since 1926)



Positive/Negative returns for stocks by month



Source: Morningstar as of 8/31/23. U.S. stocks are represented by the S&P 500 Index from 3/4/57 to 8/31/73 and the IASBBI U.S. Eq Stock Tr USD Index from 1/1/26 to 3/4/57, unmanaged indexes that are generally considered representative of the U.S. stock market during each given time period. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You can not invest directly in the index.

Yields get real

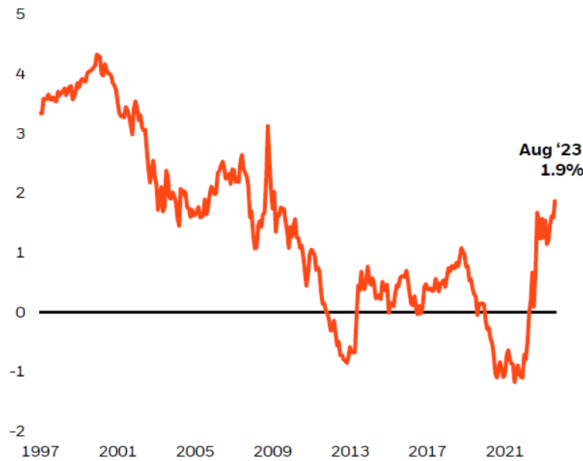
Prior to the start of this current central bank tightening cycle, a major theme in the investment industry was the “death of the 60/40 portfolio.” This meant that a traditional conservative allocation of 60% stocks and 40% bonds would not provide adequate required returns for long term investors due to low and even negative real, or after inflation, yields on bonds. In the chart below from Blackrock, as of August 2023, the rise in bond yields has resulted in the highest real yield for bonds since the financial crisis of 2008-09. Real yields on core bonds hit 1.9% and have even improved a bit more since then.

INFLATION ADJUSTED RETURNS

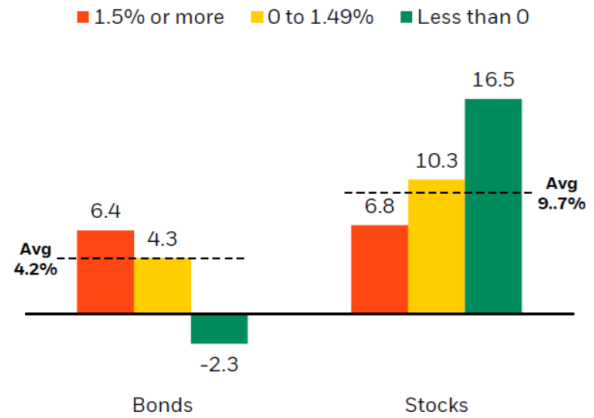
Inflation adjusted (real yield) for bonds

10-year real yields on bonds

(yield minus expected inflation, since January 1997)



12 month returns after real yield levels on bonds



Source: Morningstar, Federal Reserve, Bureau of Labor Statistics as of 8/31/23. U.S. stocks are represented by the S&P 500 TR Index and U.S. bonds are represented by the Bloomberg U.S. Agg Bond TR Index. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You can not invest directly in the index.

Higher yields do provide competition for stocks. In the right half of the chart above, Blackrock looks at returns of both stocks and bonds 12 months after periods in which real bond yields were high (>1.5%), medium (0-1.49%), and negative. With real yields currently greater than 1.5%, this certainly bodes well for bonds and perhaps less so for stocks. However, a real yield of 2% on bonds is still less than half of the long-term average “risk premium” for stocks, which is 5-5.5% more than the 10-year Treasury bond over a 30-year time horizon, according to Investopedia.com. High current real yields certainly do not warrant a dramatic shift from stocks to bonds. It just means that perhaps talk of the “death of the 60/40 portfolio” can be put on the back burner for now.

In closing, we are deeply saddened by the recent terrorist attacks in Israel and the tragic loss of innocent lives. It is a painful reminder of the senseless violence that affects people of all backgrounds and beliefs. Our thoughts are with the victims and their families during this difficult time. May those affected find strength and support in the face of this adversity, and may we all work toward a future where such acts of violence become a distant memory.

Please let us know if you have any questions. We look forward to talking with you soon.

—Dana L. Crosby, CFA, CFP®

ETF Returns

For the period ending 9-30-2023

Name	Ticker	YTD	1 Month	3 Months	12 Months	3 Year	5 Year	10 Year
U.S. Large Cap								
iShares Russell 1000	IWB	12.80	-4.79	-3.21	20.84	9.37	9.47	11.47
iShares Edge MSCI USA Momentum Factor	MTUM	-3.03	-4.82	-2.87	8.50	-0.49	4.66	11.40
iShares Edge MSCI USA Quality Factor	QUAL	16.80	-5.06	-1.90	28.58	9.84	9.54	11.83
PowerShares S&P 500 Low Volatility ETF	SPLV	-6.34	-3.78	-5.80	4.07	5.19	5.73	8.91
Vanguard High Dividend Yield ETF	VYM	-2.34	-3.35	-1.88	12.40	11.86	6.85	9.41
VanEck Vectors Morningstar Wide Moat	MOAT	16.84	-5.44	-4.95	28.00	13.01	11.69	12.32
U.S. Mid Cap								
SPDR® S&P MidCap 400 ETF	MDY	4.09	-5.26	-4.33	15.18	11.82	5.84	8.66
PowerShares S&P MidCap Low Volatil ETF	XMLV	-6.27	-3.81	-4.39	4.80	7.63	2.39	8.4
PowerShares DWA Momentum ETF	PDP	8.73	-5.21	-4.95	14.70	0.50	5.54	8.90
PowerShares High Yld Eq Div Achiev™ ETF	PEY	-4.20	-6.85	0.97	7.94	14.86	5.81	9.89
U.S Small Cap								
iShares Russell 2000	IWM	2.50	-5.85	-5.17	8.86	7.02	2.29	6.61
PowerShares S&P SmallCap Low Volatil ETF	XSLV	-10.10	-4.15	-0.49	-0.70	8.12	-1.96	5.73
REITs								
iShares US Real Estate	IYR	-5.13	-7.37	-8.66	-1.04	1.94	2.33	5.53
International Large Cap								
iShares MSCI EAFE	EFA	6.94	-3.65	-4.94	25.82	5.72	3.21	3.74
iShares Edge MSCI Intl Momentum Factor	IMTM	3.48	-3.58	-5.18	20.11	0.69	3.42	-
PowerShares DWA Developed Mkts Mom ETF	PIZ	6.11	-5.68	-5.75	20.14	-1.06	2.30	2.98
iShares Edge MSCI Intl Quality Factor	IQLT	5.21	-4.05	-5.59	23.78	4.91	5.04	-
PowerShares S&P Intl Dev Quality ETF	IDHQ	7.26	-3.35	-3.84	25.76	2.26	4.74	5.36
iShares Edge MSCI Min Vol EAFE	EFAV	4.59	-2.86	-3.38	17.55	0.85	0.55	3.67
iShares International Select Dividend	IDV	-1.18	-1.61	-1.61	20.72	7.29	1.48	2.07
International Small Cap								
iShares MSCI EAFE Small-Cap	SCZ	1.69	-4.58	4.26	17.74	0.98	0.70	4.16
WisdomTree International SmallCp Div ETF	DLS	3.08	-3.41	-2.58	17.17	2.90	-0.39	3.07
Emerging Markets								
iShares MSCI Emerging Markets	EEM	0.92	-3.11	-4.07	11.32	-2.92	-0.25	1.39
PowerShares S&P Em Mkts Low Volatil ETF	EELV	0.53	-2.75	-3.12	10.67	7.62	1.90	1.35
PowerShares DWA Emerging Markets Mom	PIE	6.83	-2.85	-0.70	16.27	1.23	3.26	2.12

Data source: Morningstar

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