Hutchinson Financial Advisors, Inc.
5243 Hickory Park Drive, Suite C
Glen Allen, VA 23059

Main: 804.729.6420
Fax: 804.729.6425

HutchinsonAdvisors.com

4th Quarter Market and Economic Update

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"The best bargains are always found in frightening environments." -***Howard Marks***

"In the midst of chaos, there is always opportunity." -***Sun Tzu, 'Art of War'***

Happy New Year! Thankfully, 2022 is over, and none too soon. It was a historic year for financial markets, and when historians write about significant years in financial history, 2022 will certainly be near the top of the list. According to Ned Davis Research (NDR), the S&P 500's 19% decline was its seventh worst since 1926. The Nasdaq did even worse, down 33%. For the last forty years, bonds often stood as a port in the storm in times of equity market turmoil. Not in 2022, as U.S. Treasury bonds fell 29%! Meanwhile, the Bloomberg U.S. Bond Aggregate had its worst performance ever, down 13% in 2022. It was a year with almost no place to hide, which made it the most difficult environment I've encountered in my over thirty-year career. One thing that made 2022 unique when compared to 2008, 2002, and 1987, is that there was no stock market crash. Instead, it was a series of double-digit declines with strong intermittent rallies between the declines.

What went wrong? More than anything, it was inflation that got away from the Fed and other global central banks. That led to one of the fastest rate-hiking campaigns on record. Other things that provided headwinds included the Chinese economy (the globe's second largest) sputtering thanks to that nation's strict Zero-Covid policy; a major war in Eastern Europe that impacted both food and energy markets; higher interest rates in an effort to fight inflation, courtesy of central banks around the world; quantitative tightening, which is designed by central banks to reduce money supply and to tighten financial conditions; and a badly inverted yield curve, which portends economic weakness. Also, the bubble burst on cryptocurrencies and non-fungible tokens (NFTs), which led to a string of bankruptcies and a very high-profile criminal prosecution. Home prices declined as buyers became almost invisible with mortgage rates over 6%. Finally, corporations, and countries, seemed to begin moving toward a more domestic version of supply chains. Have I forgotten something?

Often in my year-end letters, I joke about the folly of forecasting. I'll save you from reading that this year. Instead, I want to touch on investment mistakes. For it is in our mistakes that we can learn valuable lessons and then apply those lessons as we move forward. The reality is that mistakes will always happen in investing. Even the greatest investors in human history, who I quote often in my updates, talk about the mistakes they've made or continue to make every year. One big mistake many investors often make is to focus too much on the short-term. In a memo from November 22, 2022, the great Howard Marks, wrote the following: "***Obviously, no one should attach much significance to returns in one quarter or year. Investment performance is simply one result drawn from the full range of returns that could have materialized, and in the short term, it can be heavily influenced by random***

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events." We've certainly had our fair share of random events in 2022. Also, while we know we should focus on the long-term when investing, it doesn't make it any easier to see the negative numbers on each of our statements, even if it is just a short-term downturn. Regardless, understanding the mistakes we've made can help us to become better investors for the long-term.

As most of you know, we have three investment programs here at HFA. Simply put, the three are growth, balanced, and conservative. I was quite pleased with the relative outperformance of the balanced and conservative portfolios. I wish I could say the same for the growth portfolio, but I cannot. The growth portfolio suffered its worst one-year decline ever. A mistake I made in the growth model was in thinking companies could continue to grow in a slower economy, while also underestimating external factors on those growth companies and how it would impact their respective valuations. For the better part of the last decade, the U.S. and global economies have been stuck in a slow growth mode. Throughout this period, companies that could grow much faster held up best (think of large-cap technology, for example). I expected that our high-quality growth holdings could maintain their growth rates and their stocks would follow. Unfortunately, the sluggish global economy was too much for growth companies to overcome and they declined precipitously. Also, because many of these companies are large and high-quality, they were used as a source of funds by many who were forced to sell something. External factors such as rate hikes and a surging U.S. dollar also hit high quality growth names. An example of something that surprised me is the cybersecurity industry. If there is one industry that has a long pathway for growth, it is cybersecurity. No matter what is happening in the economy, one could reasonably expect sales of cybersecurity companies to continue their strong growth. Yet, our cybersecurity holding, which performed well for years, could not overcome the external factors and the sluggish economy, and its stock fell hard.

Aside from reinforcing the need to focus on long-term investing, other valuable lessons learned include not to underestimate the impact external factors can have on even wonderfully profitable and solid businesses, and to acknowledge that even great companies will see a significant valuation reset as rates increase, especially given the historic speed at which rates rose in 2022. These are lessons we can take with us into 2023 and beyond.

At the top of page 1, I included two quotes (yes, another from Howard Marks), each of which conveys a similar message: it is after large declines in asset prices that we find the best opportunities for future gains. Just like the seeds of every bear market are sown during bull markets, the seeds of every bull market are sown during bear markets. Thus, *it is at the point of maximum pessimism and decline that prospective returns are at their highest*. You may be reading this and wondering if I'm saying the bear market is over. Was the low point in mid-October the end of the bear market? Would it shock you if I said I don't know? The ultimate bear market bottom can only be known for certain with the benefit of hindsight. However, for the first time in quite a while, I am seeing great companies trading at good-to-great prices. In fixed-income, I'm seeing actual rates of return that are meaningful for credit investors. Finally, I'm seeing the speculative excesses being removed from financial markets. This is what excites me as we move forward.

To be certain, there are always risks, and I worry about everything. The mechanics of the market have changed greatly over the past two decades as more money is traded by computer algorithm than ever before, which leads to periods of unprecedented volatility. It's one reason we see such wild swings intraday. Regulatory changes enacted after the 2007-2009 Great Financial Crisis have led to less liquidity in some markets, and that adds to volatility. The rate hikes we've experienced around the globe in 2022 have brought an end to the great monetary

experiment of the past 12-13 years: zero-percent interest rates. How might that impact all asset prices over the next decade or more? Does this shift to a more normalized interest rate policy around the globe mean a change in the secular trend of all financial markets? That is something which we are keeping a keen eye on because it will influence how we value assets. In the end though, investing is about buying assets for the long-term. That's how you grow your wealth over time: buying great assets at good to great prices and holding them until they become overvalued, or something changes with the investment.

I know it is never easy to see any sort of decline in your portfolio, no matter how temporary it may be. I can't stand it either, even if the chance to buy quality businesses at better prices excites me. I said in my 2021 year-end letter that I thought 2022 could be a tough year, and it certainly proved to be. It was much tougher than I imagined it would be. While we can't know for certain until this time next year, I believe that 2023 will prove to be a better year for financial markets than many are predicting. The key is to remain flexible and to avoid having a myopic view of the macro environment and of the assets into which we've invested.

Housekeeping notes: 1) we've had lots of people asking us to help them manage their workplace retirement plan. We're about to launch a fully compliant partnership with a group to allow us to do this very thing. Be on the lookout for more information over the next month or so. 2) Per the Secure Act 2.0, the Required Minimum Distribution Age (RMD) is going from 72 to 73 beginning in 2023. 3) Salary deferral limits for 401k/403b/457 plans have increased for 2023, as have IRA and Roth IRA contribution limits. Please contact us with any questions as it relates to these items.

I hope you and yours are healthy and enjoying a wonderful start to the new year. Please let us know if there is anything we can do for you. We're always here to help. From all of us at HFA, thank you for your trust, confidence, and loyalty. It is a joy and a privilege to work with you and your family.

Best wishes,

Harvey E. Hutchinson IV
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President

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