JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

FROM THE DESK OF CIO CHARLES RINEHART, CFA, CAIA

2023 SECOND QUARTER

Summer is always a fun time of year, but the folks at our Cincinnati offices have had a few extra reasons to celebrate recently. From FC Cincinnati's rise from worst to first in the MLS, to the Reds' climb to the top of their division, to a visit from Taylor Swift, the Queen City has been full of unusual reasons to celebrate. Fortunately, the market has joined the party, and the S&P 500 is up over 20% from the lows it set last October. All in all, I'd say the year so far has been off to a surprisingly pleasant start.

Why surprising? Well, setting aside the history of Cincinnati sports for a minute, the 2023 economic environment has hardly been a walk in the park. We've seen the Leading Economic Index continue to fall. The current reading, -7.9%, is a level which has preceded or coincided with recession, without fail, going back at least 30 years. The Federal Reserve has continued its war against inflation, pushing monetary policy to its most restrictive level since August of 2007, with expectations for continued hikes this year. We've seen continued geopolitical conflict, politicians playing chicken with the debt ceiling, and experienced the failures of banks with total assets of more than a half a trillion dollars.

In the face of these headwinds, year-to-date the aggregate bond index is up 2.1% and the S&P 500 has returned a surprisingly strong 16.9%. While bonds have a history of providing stable returns during economic slowdowns, there's a seeming disconnect between the sluggish economy and the booming equity market. What's the explanation? Well, it turns out the headline result only tells half the story. The positive stock market returns experienced this year have been highly concentrated in a handful of large technology, communication, and consumer discretionary stocks. The most notable contributors have been Apple, Microsoft, Nvidia, Alphabet, Amazon, Meta, and Tesla. For the sake of brevity, and in homage to Steve McQueen, some have taken to calling these stocks the Magnificent Seven.

On the off chance a reference to a film released in 1960 is a bit on the obscure side, "The Magnificent Seven" is a classic Western that tells the story of a small village beset by ruthless bandits. Desperate for help, the villagers seek the assistance of seven skilled gunfighters. These men, each with their unique talents and backgrounds, come together to protect the village from the marauding outlaws.

The market's Magnificent Seven have done much the same to protect the S&P from this year's general economic malaise. The Magnificent Seven stocks were up over 50% through May, while the remainder of the S&P 500 returned a negative 0.5%. While the rally started to broaden in June, the contribution of the Magnificent Seven lifted the S&P return from a negative total return all the way to positive double digits for the first five months of the year.

It's not unusual to have a handful of stocks outperform the broader market. In fact, you could look at any random six-month period and find seven companies that have significantly outpaced their peers. What is unusual about this year is how large these firms are. The Magnificent Seven are currently seven of the eight largest companies in the S&P 500. In total they represent more than 26% of the index.

FEATURING

TOTAL RETURNS

	2Q 2023	2023
S&P 500	8.7%	16.9%
Dow Jones Industrial Average	4.0%	4.9%
NASDAQ	15.4%	39.4%
Russell 2000	5.2%	8.1%
MSCI EAFE (International)	3.0%	11.7%
Bloomberg U.S. Aggregate Bond Index	-0.8%	2.1%

WEALTH MANAGEMENT
FAMILY OFFICE SERVICES
TRUST COMPANY
ASSET MANAGEMENT

What's the theme that ties them together? Apart from their size, it's their exposure to the other big market-moving story of the year: Artificial Intelligence. The release of OpenAI's Chat GPT has ignited a new spirit of optimism among investors surrounding the possibilities for the new technology's potential to spark transformative changes in the economy. It's an environment that is easy to compare to the internet technology fervor of the late nineties.

That's a parallel that will fill students of market history with both excitement and skepticism. Now, as in the nineties, investors are expecting these market-leading companies to garner huge economic profits from their innovations. You can see this in the change in the earnings multiples the market is willing to pay for these companies. The price-to-earnings ratio for the Magnificent Seven has expanded by 45% this year.* This means that the vast majority of the gains have come from heightened expectations vs. actual business improvements.

Great expectations can signal great opportunities, but they can also signal big risks. The Magnificent Seven are terrific businesses in attractive industries and their futures are likely bright. It is our job as fiduciaries, however, to remember that success is not just about buying good companies but buying companies well. That means keeping an eye out for market exuberance and maintaining proper diversification. In other words, it is important to weigh the seemingly bright future of these firms against the potential impact of the economic environment and the sobering effects that higher interest rates have had on broader asset prices.

This narrow market leadership is unlikely to last forever. If the second half of this year repeats the first, The Magnificent Seven will represent over a third of the S&P 500. Apple, which recently surpassed a market capitalization of $3 trillion, would have to grow enough to justify a valuation worth more than the annual GDP of any single country on earth except China or the United States. To benefit from this trend in a way that is disproportionate to the index, investors would have to put upwards of 40% of their assets in just a handful of companies.

If history teaches us anything, it's that we would be wise to avoid that level of concentration in portfolios. From energy producers in 1980, to Japanese conglomerates in 1990, to tech stocks in 2000, to emerging markets commodity producers in 2010, every decade provides a new example of why it is unwise to put all of one's eggs in one basket – no matter how shiny, or artificially intelligent, the container.

As for the future, our crystal ball remains as cloudy as ever. If economic trends continue, we may be in for a bumpy road and the valuations for the Magnificent Seven could fall under pressure. Bonds, for their part, look to be particularly attractive in that scenario, given the increases we've seen in interest rates. Conversely, if the economy improves, more stocks are likely to participate in the rally. Either way the playbook here at Johnson will remain the same: a diversified portfolio of high-quality stocks and bonds is the most resilient and reliable path to long-term success.

Thank you as always for your trust and confidence. I wish you a surprisingly pleasant third quarter. Until next time, I'll finish with a quote from the star of our show. Hey, Chat GPT, what is the single most important principle for successful investing?

"The single most important principle for successful investing is diversification." -Chat GPT 6/29/2023.

**This calculation excludes Amazon, which had negative earnings last year and, therefore, has an incalculable price-to-earnings ratio for 2022. It is expected to be profitable once again in 2023 and trades at 62x next-twelve-month earnings vs. the market at 19x.*

Chief Investment Officer, Charles Rinehart, CFA, CAIA, leads our dedicated team of research analysts and portfolio managers as they manage our investment strategies to deliver financial peace of mind to our clients.

HOLDING CONCENTRATED POSITIONS

THE MATH AND MINDSET OF HOLDING CONCENTRATED POSITIONS

As is always the case in the early days of a new calendar year, predictions on stock market performance entering 2023 were pervasive and dominated financial media. In January 2023, the optimism/pessimism dispersion of predictions was especially wide as bulls were making the case for a strong rebound from the declines in 2022 while bears were pointing to the dark clouds of recession. At the midpoint of 2023, clearly the bulls' positive predictions are in the driver seat (so far), given the strong rebound in the S&P 500 and the historically strong uptrend in Nasdaq. But looking "under the hood" of the indices, driving this strength is disproportionately high contributions from a few stocks which include Apple, Microsoft, Nvidia, Meta (formerly Facebook), Alphabet, just to name a few. In fact, the top 10 stocks in the S&P 500 as of June 30th, 2023, now comprise almost 32% of the S&P 500 index's value, a multi-decade high.

Owners of these individual stocks (and not only in the index), have certainly benefited from the great runs of these strong companies this year. However, we believe it's especially important for investors to take a closer look to evaluate the risk of holding too high of a concentration in just a few individual stocks. This is where psychology comes in: after such a strong run, the natural bias is to hold these names with the expectation that the recent success will persist into the future. That may or may not be true and is impossible to call. Adding to this aversion to sell is the tax burden to diversify, if held in a taxable account.

If history is our guide, we think it's prudent to consider reducing portfolios overexposure to just a few names—the equivalent to the old saying "having all your eggs in one basket." As always, we believe history and data help inform our decisions as to the most prudent way forward, which is especially important with the investment portfolio being the critical linchpin to the broader retirement and wealth planning strategy.

THE MATH ON INDIVIDUAL STOCK PERFORMANCE

It's important to first understand the historic risks associated with owning heavily concentrated positions, which, by some measures, becomes a concern when these holdings exceed around 5% of total net worth. In short, these risks are often underappreciated. In a recent study from Bernstein Research on the Russell 3000 from 1986 to 2022, the median stock underperformed the broader index of 3,000 stocks by more than 5% annually. About two-thirds of relative returns of individual stocks in the index underperformed, and 37% were actually negative in absolute terms. In fact, 39% of all stocks during this period suffered what's considered a "catastrophic loss" of 50% of more and never recovered to their prior high. So, clearly a substantial portion of individual stocks have a high occurrence of underperforming the index and risk even substantial declines.

Some may argue "that's only the bad companies" and "it doesn't apply to the great companies," but, again, history would argue otherwise. According to Dimensional Fund Advisors, since 1972, once a company grows to become one of the top 10 holdings in the S&P 500, they underperform the index going forward.

THE PSYCHOLOGY OF HOLDING CONCENTRATED POSITIONS

Now that we've covered the empirical left-brain angle, we must cover the -- equally important -- subjective, right brain considerations, which, more often than not, override all the data-driven rationale.

Acknowledge Recency Bias: This is the strong inclination of investors to project forward what has recently occurred in the past. As noted by the data detailed earlier, this is a dangerous mindset, and, as objective wealth advisors to our clients, one we feel obligated to call out and emphasize as a potential blind spot in our clients' portfolio strategy.

Accept the Implied Tax Liability: If held in a taxable account, the value of large and overly concentrated positions with low costs basis (and large unrealized capital gains) are a mirage. Why? Because the reality of the situation is there is an implied liability in the form of a deferred tax capital gains liability, which investors should acknowledge and subtract from the value of the portfolio. The liability can be as high as 23.8% (top long term capital gain rate with the net investment income surtax), and sometimes it's easier to just factor in this liability to Uncle Sam as deferred debt on the family balance sheet. The alternative is to hold these assets and take on the risk with the intention of passing the investments to heirs at death. This has substantial tax advantages because heirs would receive a "step up" in basis, which means their new cost basis would be priced as of the date of death and could be a presumably higher value than the original cost basis. If the heirs were to sell the shares shortly after the "step up" (i.e., within weeks or days), there could be minimal tax liability, which is a substantial tax advantage if the decedent was willing to take on the risk during their lifetime.

Consider the Asymmetric Impact: Finally, we believe it's useful to walk through a mindset exercise and consider one's lifestyle in two scenarios. For example, let's say a family has $5 million in investible assets with $3 million concentrated in one low basis stock. If that single holding were to decline 50% (not unrealistic), wouldn't a $1.5 million decline in net worth (from $5 million to $3.5 million) radically change how a retiree or soon-to-retire person plans their spending? More than likely, yes. Conversely, would a 50% increase of that stock (to $4.5 million) and a net worth increase from $5 million to $6.5 million radically change one's lifestyle and spending to the upside? In our experience, most of the time, the answer is no. Other than having to worry even more about overexposure to a single company, which in this case would comprise 70% of investible assets in the upside scenario, this may not create a radical change in lifestyle.

STRATEGIES TO MANAGE THESE POSITIONS

So, what to do? What are some strategies to balance the impacts of a disastrous drop in the portfolio versus the tax liability? There are several tactics to employ, and they do not have to be executed in isolation. In fact, we think a well-thought-out mix of several of the following strategies might be the best path to address this thorny issue.

Systematic Selling Plan: If the concentrated position is in a taxable account and has large unrealized gains, a systematic and intelligent navigation of the tax brackets across multiple tax years would be prudent. This would require an in-depth tax analysis and should be executed with the partnership of a CPA or tax advisor. The goal is to spread out these taxable gains over multiple tax years to limit the damage to cash outflows (for the tax liability), while potentially keeping the capital gains tax rate below the maximum 23.8%.

Charitable Strategies: If a family is already charitably inclined, low basis concentrated positions in taxable accounts are a great candidate to employ to fund meaningful causes. Again, we suggest working with a knowledgeable tax advisor. Every one of these tactics could comprise an entire article by themselves, but below is a brief overview of each:

Donor Advised Fund: A dedicated charity account can receive low basis stock; the donor gets a tax deduction on the gross amount (subject to AGI limitations) and the donor advised fund can sell the shares without capital gains tax. This is a great tool but is irrevocable. Once the donation is made, it can't be pulled back.

Donate Charitable Remainder Trusts (CRT): Funds can be donated to a CRT in exchange for annual taxable payments (fixed or variable) to the donor. The income tax deduction equals the value of the assets transferred less the present value of the expected CRT payments. There are many complexities with this strategy, and we believe this shouldn't be executed without a trusted advisor.

(article continued)

Gift to Family or Friends: Low basis shares can be gifted directly to friends or family. There is no tax deduction for the donor, and this isn't taxable to the recipient, but the recipient does "inherit" the low costs basis, which effectively transfers the implied tax liability. The annual limit to gift in 2023 is $17,000 from one person to another. Anything above that requires the donor to file a gift tax return to reduce the lifetime estate tax exclusion for the donor.

Options Strategies: Protective Puts; Covered Calls, Collars: The various options strategies are beyond the scope of this article, and there are many advantages and disadvantages to consider. But, in short, protective puts can be purchase to "lock in" a selling price to protect a downside move while selling covered calls can add extra income to the portfolio but limits the upside to the shares. A collar strategy employees a combination of puts and calls, which effectively limits the upside and the downside on the shares. All these options strategies require continual maintenance (as options expire), costs to purchase the options, and liquidity considerations with respect to the underlying shares.

Back into your "Catastrophic Number": For some with relatively modest spending needs, this might be the most practical solution for many approaching or in retirement. In short, this means doing the math on the total liquid net worth needed to reasonably fund living expenses for the rest of your life. This is your Catastrophic Number. Once we know that, one could sell down the concentrated position in an amount to the level of the Catastrophic Number to ensure a confident retirement. Of course, this requires paying the associated tax bill. Anything above the Catastrophic Number can then be maintained with the concentrated holdings, but, this time, with the confidence that even if the concentrated holding went to $0, retirement isn't at risk. The only thing at risk after executing this strategy is the assets that were earmarked for family inheritance and/or charities–effectively transferring the risk to those parties after death.

BOTTOM LINE

Concentrated positions are a great problem to have because it usually means extremely strong growth, but there are many factors to consider when managing this situation prudently. Handling these situations is a case study of how the integration of investment management, tax planning, estate planning, and cash flow is critical. But that's just math. The mindset is equally important because, without the psychological impetus to actually proceed with executing the recommended tactics, the math means nothing at all.

NEW SHAREHOLDERS

For more than 20 years, Johnson Investment Counsel has been 100% emploee-owned. This independence allows our employees to focus on serving our clients without any pressure from external shareholders. We are pleased to announce and congratulate seven new shareholders of the firm: Senior Research Analyst Bryan Andress, Senior Portfolio Manager Sandy Himmelsbach, Portfolio Manager Ryan Martin, Senior Portfolio Manager Laura Mattern, Senior Portfolio Manager Max Monk, Senior Portfolio Manager Justin Rowden, and Senior Portfolio Manager Michael Timm.

Bryan Andress, CFA
Johnson Asset Management
Senior Research Analyst
Principal

Sandy Himmelsbach CFP®, ChSNC®
Johnson Investment Counsel
Senior Portfolio Manager
Principal

Ryan Martin, CFA
Johnson Asset Management
Portfolio Manager
Principal

Laura Mattern CFA, CFP®
Johnson Investment Counsel
Senior Portfolio Manager
Principal

Maxwell Monk, CFA
Johnson Investment Counsel
Senior Portfolio Manager
Principal

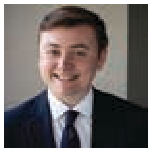
Justin Rowden, CFP®
Johnson Investment Counsel
Senior Portfolio Manager
Principal

Michael Timm, CFA, CFP®
Johnson Investment Counsel
Senior Portfolio Manager
Principal

PROMOTIONS AND DESIGNATIONS

We are committed to continuing education to provide personal development for our employees and better service to our clients. We are pleased to announce that these individuals have been promoted or have earned a new designation. Congratulations to Joe White, CFA, CFP® who has been recently promoted to Portfolio Manager. Congratulations to Human Resource Coordinator Danielle DePew, SHRM-CP®, who has earned her Society for Human Resources Management Certified Professional certification, Credit Analyst Alex Wirt CFA, CFP®, who has earned the Chartered Financial Analyst® (CFA®) designation and Portfolio Manager Assistants Donald Ennis, CFP® and Max Klett, CFP®, who have both earned the CERTIFIED FINANCIAL PLANNER™ designations.

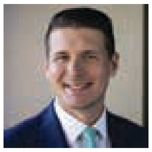
DePew



Ennis

Klett

White



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ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $17 billion in assets for clients in 49 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-only, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

- WEALTH MANAGEMENT
- FAMILY OFFICE SERVICES
- TRUST COMPANY
- ASSET MANAGEMENT

LOCATIONS

CINCINNATI - KENWOOD
CINCINNATI - WEST
CLEVELAND - AKRON
COLUMBUS
DAYTON
METRO DETROIT

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

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NEW HIRES

- **Cooper Crawford**
  Portfolio Manager Assistant
- **Gretchen DeVries**
  Client Support Assistant
- **Linda Higgins**
  Receptionist
- **Ryan Hogan**
  Equity Research Associate
- **Michael Prebles**
  Portfolio Manager Assistant
- **Bryant Robinson**
  Operations Trading Associate
- **Logan Wiedmann**
  Gift Fund & Operations Associate

Crawford

DeVries

Higgins

Hogan

Prebles

Robinson

Wiedmann

2023 TOP WORKPLACE

Johnson Investment Counsel has been selected as a Top Workplace by the Cincinnati Enquirer for the tenth year in a row. The award is based solely upon employee feedback and evaluates criteria such as opportunities for career development, workplace culture, compensation, and overall job satisfaction.

We are honored to receive this award and proud of our employees and their commitment to provide exemplary service to our clients.

TOP WORK PLACES 2023

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10 CONSECUTIVE YEARS