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Market Commentary, Fourth Quarter 2021

January 11th, 2022

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Market Commentary – 2021 Review – 2022 Preview

The change of calendar to 2022 once again provides an opportunity to pause a bit and evaluate the last year and ponder what the new year might bring.

A year-ago many were questioning whether the stock market could become “fatigued” in 2021 after recovering spectacularly from the depths of a COVID induced decline in March 2020. Any such concern was proven unfounded. The widely followed S&P 500 Index provided a total return of 28.7% in 2021 after recognizing large gains of 18.4% and 31.5% in 2020 and 2019, respectively. Combining those 3 years results in an annualized 3-year compound average return of 26.1%. Is that a record? Not quite, but it has been over 20 years since the index achieved greater returns. In fact, between 1995 and 1999 the index exceeded that level in each 3 of those consecutive 3-year periods.

As a reminder, markets can go down as well as up over extended periods of time. 1999 is remembered as the end of the .com internet bubble. Beginning then in 1999 and through 2003, the S&P 500 total return turned negative in each 3 of those consecutive 3-year periods. And once again, in the three 3-year periods between 2006 and 2010, with the Financial Crisis of 2008 as a catalyst, returns were also negative.

Should the above concern us that following strong market returns we might again experience a prolonged period of negative returns? While Phillips Financial will never predict market direction or short-term outcomes, we do recognize that markets fluctuate. And as history has shown, returns will moderate over more extended periods of time. We will experience periods of low or even negative returns. It serves us well to remember that investing is best when viewed in the longer term.

The strong 2021 performance of the S&P 500 also occurred in US market indexes reflecting mid and small capitalization stocks. Returns outside of the United States were not as robust. While international developed market returns were still quite respectable at over 11%, emerging markets experienced a negative total return of 2.5%. In some emerging markets COVID vaccination levels lag developed market counterparts. And some large Chinese stocks suffered significant decreases during the year. However, during 2020 emerging market total returns were in excess of 18%.

PHILLIPS FINANCIAL

6920 Pointe Inverness Way, Suite 230 | Fort Wayne, IN 46804

P: (260) 420-7732 | T: (888) 420-7732 | F: (260) 420-5553 | www.1Phillips.com

The S&P 500 index has long been the most relevant index to use as a barometer of the overall US stock market. The 500 stocks in the index represent the largest of public companies measured by market capitalization. The relative impact of those companies on overall market performance is substantial. For perspective, the S&P 1500 Composite index includes all securities included in the S&P 500 index plus those reflected in the S&P 400 Mid-Cap index and the S&P 600 Small-Cap index. The aggregate total market cap of the S&P 1500 securities was over $46 Trillion at December 31,2021 with the S&P 500 constituting over $42 Trillion, or 91%.

Another important characteristic of the S&P 500 index is the relative impact of just a few very large "mega" stocks. Apple with just under $3 Trillion of market cap represented 6.9% of the index and when combined with the other 9 largest stocks, represented 29.3% of the index. Both the S&P 400 and S&P 600 indexes are much more balanced in terms of market cap, with the largest security in each contributing just 0.8% and 0.7% respectively. It is noteworthy that the market capitalization of just Apple alone is greater than the total market cap represented by all the stocks in either the S&P 400 or S&P 600!

We capture the performance of the overall stock market through positions held in S&P 500 based funds. However, for two reasons we seek to modify those results through overweighting exposure to both the S&P 400 and S&P 600 indexes. One reason is to enhance returns over the long term. The other reason is to diversify away from concentration risk.

With respect to enhancing returns, while mid and smaller cap stocks have underperformed the larger caps over the last 10 years, over time horizons longer than 15 years investors, have been rewarded for investing in these smaller stocks. Diversifying away from concentration risk is also why we see merit over the long term with mid and small capitalization stocks.

We mentioned above the periods of 1999-2003 and 2006-2010 where the S&P 500 three-year annualized returns were consistently negative. During those periods, mid and small capitalization stocks (as reflected in the S&P 400 and S&P 600) measurably outperformed the larger S&P 500 and were frequently even in positive territory.

To recap, we continue to see the benefit of maintaining portfolios that utilize funds that are index oriented and capture all components of the market capitalization spectrum. In our judgement, a tilt towards mid-size and small companies helps with diversification, especially now that one or two large companies can dominate the returns (positively or negatively) of the S&P 500.

Turning now to another topic in the news these days, inflation emerged as a factor in 2021. Two asset classes, Real Estate and Commodities, are commonly viewed as sensitive to inflation. Predictably, as inflation returned in 2021, returns for both were positively impacted. Both those asset classes experienced negative returns in 2020 when inflation was much subdued. And over the longer term both asset classes have underperformed relative to most others during the long period of low inflation dating back to over 15 years or more.

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Beyond real estate and commodities, inflation can impact fixed income returns. During the last 15 years when inflation remained at historically low levels, total returns on fixed income investments benefited as interest rates also moved lower and remained so. During 2021 we generally experienced negative returns on fixed income investments as both inflation and interest rates increased. With inflation concerns now in the headlines, bonds may not appear to be a great investment, particularly if the Federal Reserve increases interest rates to help mitigate inflationary trends. But let's not get too eager to sell our bond positions or stop adding to bonds if our target allocation indicates the need to rebalance to this important asset class.

Over time equities have been shown to provide an effective hedge against inflation. The role of bonds in a diversified portfolio is to provide cushion against volatility in the stock market (especially in the short term) and to provide ongoing income. Even during inflationary times, these are important reasons to maintain a target allocation to bonds. We do not recommend attempting to time the market to take into consideration inflation. If you have a diversified portfolio, with an appropriate allocation to stocks and bonds, you are probably achieving a reasonable inflation hedge.

As we point out every year, January is a time we hear various predictions of future long-term economic and financial market performance. As a rule, we should not rely on them to impact either our short or long-term investment decisions. However, it is worth noting that these sources are generally predicting lower, but still positive, long term returns for both stocks and fixed income investments.

At Phillips Financial, we believe an important role in our relationship with you is to help manage expectations with respect to future returns. Considering the very strong stock market performance in 2021, as we move into 2022 and beyond, that principle seems more important than ever. If you have any questions or concerns about your investment portfolio and the impacts of inflation or asset allocation, as always, your Phillips Financial advisor is available to discuss your situation with you.

Index	% Last Quarter Return 10/1/21 - 12/31/21	% Year-to-Date Return 1/1/21 - 12/31/21	% Cumulative 1 Year Avg. 1/1/21 - 12/31/21	% Cumulative 3 Year Avg. 1/1/19 - 12/31/21	% Cumulative 5 Year Avg. 1/1/17 - 12/31/21	% Cumulative 10 Year Avg. 1/1/12 - 12/31/21	% Cumulative 15 Year Avg. 1/1/07 - 12/31/21
Bloomberg Barclays US Aggregate Bond Index	0.01%	-1.54%	-1.54%	4.79%	**3.57%**	2.90%	4.09%
S&P 500 Index	11.03%	28.71%	28.71%	**26.07%**	**18.47%**	**16.55%**	**10.66%**
S&P 500 Value Index	8.31%	24.90%	24.90%	18.65%	11.90%	13.29%	7.59%
S&P Mid Cap 400 Index	8.00%	24.76%	24.76%	21.41%	13.09%	14.20%	10.45%
S&P Small Cap 600 Index	5.64%	26.82%	26.82%	20.11%	12.42%	14.50%	10.15%
S&P Small Cap 600 Value Index	4.47%	30.95%	30.95%	18.69%	10.25%	13.52%	8.86%
MSCI EAFE Index	2.69%	11.26%	11.26%	13.54%	9.55%	8.03%	3.60%
MSCI Emerging Markets Index	-1.31%	**-2.54%**	**-2.54%**	10.94%	9.87%	5.49%	4.45%
Wilshire REIT Index	**17.14%**	**46.18%**	**46.18%**	19.19%	10.92%	11.47%	6.80%
Bloomberg Commodity Index	**-1.56%**	27.11%	27.11%	9.86%	3.66%	**-2.85%**	**-2.59%**

Source: Standard & Poor's, Bloomberg, Morgan Stanley Capital International, Wilshire Associates, & Morningstar.
Green = best performing asset class
Red = worst performing asset class

Index returns are for illustrative purposes only, and do not reflect any management fees, transaction costs or expenses. The performance of an unmanaged index is not indicative of the performance of any particular investment. It is not possible to invest directly in any index. Past performance is no guarantee of future results.

Definitions and Disclosures:

Bloomberg Barclays Aggregate Bond Index. An index managed by Bloomberg to track the general performance of the domestic taxable investment grade bond market.
S&P 500 Index. An index that measures the large-capitalization sector including roughly 500 leading companies representing over 80% of the largest market capitalization in the U.S. equity markets. It is a capitalization-weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation.
S&P 500 Value Index. Contains those securities from the S&P 500 Index with lower-than-average sales and growth rates and that generally reflect lower price-to-earnings and price-to-book ratios.
S&P MidCap 400 Index. An index that measures the mid-capitalization sector including roughly 400 leading companies representing about 7% of the U.S. equity market. It is a capitalization weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation.
S&P SmallCap 600 Index. An index that measures the small-capitalization sector including roughly 600 leading companies representing about 3% of the U.S. equity market. It is a capitalization-weighted index from a range of securities chosen by Standard & Poor's for liquidity and industry group representation.
S&P SmallCap 600 Value Index. Contains those securities from the S&P SmallCap 600 Index with lower-than-average sales and earnings growth rates and that generally reflect lower price-to-earnings and price-to-book ratios.
MSCI EAFE Index. An index developed by Morgan Stanley Capital International Inc. as an equity benchmark for performance of publicly traded securities in developed international markets.
MSCI Emerging Markets Index. An index developed by Morgan Stanley Capital international Inc. as an equity benchmark for performance of publicly traded securities in emerging markets.
Wilshire REIT Index. An index developed by Wilshire Associates to track the general performance of Real Estate Investment Trusts (REITs) traded on domestic equity markets.
Bloomberg Commodity Index. An index managed by Bloomberg to provide a diversified, economically rational and liquid benchmark for commodities as an asset class. The index is currently composed of the prices of 22 exchange traded futures contracts on physical commodities.

Focus on Phillips: BJ Batt

BJ Batt joined Phillips Financial in 2014. Since joining the group he has worked with many medium to large-size organizations, assisting them in streamlining their back-office operations with particular focus on benefit administration

BJ grew up in Fort Wayne and earned a Bachelor of Science Degree from Taylor University in 2006. "I originally went to school to be a pastor but found myself looking for a job after college and chose to try my hand at sales," said BJ. "Pastoral Science is actually a great education for sales: you learn to speak well in public and one-on-one, and to take content that may be considered 'boring' and apply it to real life,"

His first job out of college was with ADP, working with businesses to streamline the administration of benefits for their employees. "At ADP I was unable to truly partner with clients," explained BJ, "So I began looking for a more appealing fit…one that would allow me to work on complex problems with lots of different clients, as a trusted partner not a salesperson."

"I met Chad Burch, who was head of Phillips' benefits group at the time, because he was on ADT's call list of advisors to reach out to. We bonded over our experiences in church leadership, which grew into a conversation about how he was looking for someone to join him and help grow Phillips' benefits business."

"We've had really good growth in the time since I joined. There have been a lot of positive changes and the services offered have expanded. We've really carved a niche in the self-insured world -- like a boutique self-insured advisory firm. Recently, I have taken over Chad's role in guiding the group."

BJ's team works with over 100 businesses and organizations in the Fort Wayne area and elsewhere. The members of the group provide their expertise in various areas, guided by their mission to "help employers and their employees thrive."

Asked about his favorite part of his job, BJ replied, "Partnering with employers. When an employer sees me as a trusted member of their team – not just a sales guy trying to get my way – it is very gratifying. I want them to know that I am sincerely invested in their best interests. I really enjoy connecting a problem to the right solution. I don't claim to personally know all the solutions, but I can connect them to the person who will. Our group's expertise and efforts become a really valuable asset to the organizations with which we work."

"I heard this quote a lot in college, but it applies just as well to my current work philosophy: 'A person convinced against their will is of the same opinion still.' Meaning, not to convince someone begrudgingly but to help them get there on their own."

Outside of work, BJ's energy is devoted to time with his family and continuing his commitment to his faith. BJ and his wife, Tiffany, have been together for 18 years. She is co-owner of Growing Up Goods, an online and pop-up children's clothing boutique. "We have two kids, Callahan who is six and Harper who is four. We are a pretty active family, so we keep busy with bike riding, golfing, golf lessons for the kids, and Callahan's soccer. The kids are very into animals and vacationing," BJ said. "I'm not sure what they think they need to take a vacation *from* at this point in their lives, but they are adamant they need regular vacations."

BJ is also an active member at Pine Hills Church where he is an elder, works with the senior high youth group, and speaks regularly.

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Phillips Financial Website