

Financial Insight Quarterly

Your Source for Financial Well-Being



Blaise Benoist, AIF®
Benoist Wealth Strategies, Inc.
Managing Partner, BWS
Branch Manager, RJFS
390 N. Orange Avenue
Suite 2300
Orlando, FL 32801
407-900-2185
blaise.benoist@benoistws.com
www.benoistws.com



38%

Shelter's contribution to the 12-month, 6.5% increase in consumer prices (through December 2022).

Source: Bureau of Labor Statistics, 2023

How Changing Shelter Costs Influence Inflation

Fast-rising U.S. shelter costs — consisting of tenants' rent and owners' equivalent rent — were the top driver of inflation in 2022, but this may be a trend that has already shifted. Shelter costs account for nearly one-third of the value of the consumer price index (CPI), making them the largest component by far. New rents and home prices both softened in the second half of 2022, but because of the way shelter costs are measured, it could take nearly a year for those changes to be reflected in the CPI.

12-month change in shelter costs (CPI-U)



Source: Bureau of Labor Statistics, 2023 (data through Dec. 2022); *The Wall Street Journal*, December 6, 2022

Municipal Bonds: A Tax-Advantaged Way to Put Capital to Work

Municipal bonds are issued by public entities such as state and local governments, health systems, universities, and school districts to help finance the building and maintenance of infrastructure projects such as roads, airports, water systems, and facilities. Despite the higher borrowing costs that resulted from the Federal Reserve's inflation-fighting interest-rate hikes, municipalities issued \$308 billion in debt in 2022 to fund capital projects, after selling more than \$321 billion in 2021.¹

At present, many municipalities are in solid financial shape, due to an influx of pandemic stimulus funds and increased income and property tax revenues. Over the longer term, a federal infrastructure bill passed in 2021 is expected to provide additional money for capital projects and help boost municipal credit quality.²

This means that investors might be able to tap into the higher yields being offered on muni bonds without taking on greater risk. The yield on the Bloomberg Muni Benchmark 30Y Index, a common benchmark, rose to 3.6% at the end of 2022, after starting the year at just 1.5%.³

Municipal bonds issued for new projects, in billions



Source: Refinitiv, 2023

Accounting for Taxes

The interest paid by municipal bonds is generally exempt from federal income tax, as well as from state and local taxes if the investor lives in the state where the bond was issued. For this reason, muni bonds and tax-exempt funds have long been a mainstay in the portfolios of income-focused investors who want to manage their tax burdens.

The taxable equivalent yield is the pre-tax yield that a taxable bond must offer for its yield to be equal to that of a tax-exempt muni bond. Tax-free yields are often more valuable to investors in higher tax brackets, and they have become especially appealing in high-cost

states now that the federal deduction for state and local taxes is limited to \$10,000 a year.

For example, a 5% tax-free yield is equivalent to a taxable yield of about 7.9% for an investor in the 37% bracket and 6.6% for an investor in the 24% tax bracket. Exemption from state income taxes would increase the equivalent yield.

Investors should keep in mind that capital gains taxes could still be triggered if tax-exempt bonds or fund shares are sold for a profit. Also, tax-exempt interest is included in determining whether a portion of any Social Security benefit received is taxable. Some muni bond interest could be subject to the alternative minimum tax.

Reviewing the Risks

Because government entities have the power to raise taxes and fees as needed to pay the interest, muni bonds generally carry lower risk than corporate bonds. From 1970 through 2021, the 5-year default rate for U.S. municipal bonds was 0.08%, compared with 6.8% for global corporates.⁴

Regional economies and the financial strength of issuers can vary widely, so municipal issues are rated for credit risk, as are other bonds. A credit rating ranging from AAA down to BBB (or Baa) is considered "investment grade"; lower-rated or "high yield" bonds carry greater risk.

As interest rates rise, bond prices fall, and vice versa. When redeemed, bonds may be worth more or less than their original cost. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. The return and principal value of bonds and mutual fund shares fluctuate with changes in interest rates and other market conditions, which can adversely affect investment performance.

The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in any index. Past performance is no guarantee of future results. Actual results will vary.

Mutual funds and ETFs are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

1) Refinitiv, 2023

2) *The Wall Street Journal*, November 15, 2021

3) Bloomberg.com, November 30, 2022

4) Moody's Investors Service, April 21, 2022

Diversifying with Market Caps

The U.S. stock market struggled in 2022, with the S&P 500 index ending the year down more 19.4%.¹ The S&P 500, which includes stocks of large U.S. companies, is generally considered representative of the U.S. stock market as a whole, and it is a good benchmark for broad market performance. But there are thousands of smaller companies, and many of those held onto their stock value better during the market conditions of 2022.

The S&P MidCap 400, which includes midsize companies, ended the year down 14.5%, while the S&P SmallCap 600, which includes smaller companies, was down 17.4%.² Although these were losses, it was the first year since 2016 that midsize and small companies outperformed large companies (in this case, by having smaller losses). While large companies have registered the highest average annual returns over the last decade, midsize and small companies have been stronger over longer periods (see chart).

Extending Your Reach

As these trends demonstrate, companies of different sizes tend to perform differently in response to market conditions. This suggests that holding stocks in companies of varied sizes could help diversify the stock portion of your portfolio and allow you to pursue a broader range of growth opportunities. Diversification is a method to help manage risk; it does not guarantee a profit or protect against investment loss.

The most convenient and comprehensive way to diversify by size is through mutual funds or exchange-traded funds that track indexes based on *market capitalization*, calculated by multiplying the number of outstanding shares by the price per share. There is no standard classification system, but Standard & Poor's indexes offer a helpful comparison and are used as benchmarks for many funds.³

S&P 500: \$14.6 billion or more

S&P MidCap 400: \$3.7 billion to \$14.6 billion

S&P SmallCap 600: \$850 million to \$3.7 billion

Russell indexes are also commonly used to construct funds based on market capitalization. The Russell 1000 includes large and midsize companies, while the Russell 2000 is a comprehensive small-cap index. Actively managed funds focusing on market capitalization typically include stocks chosen by the fund manager rather than following an index.

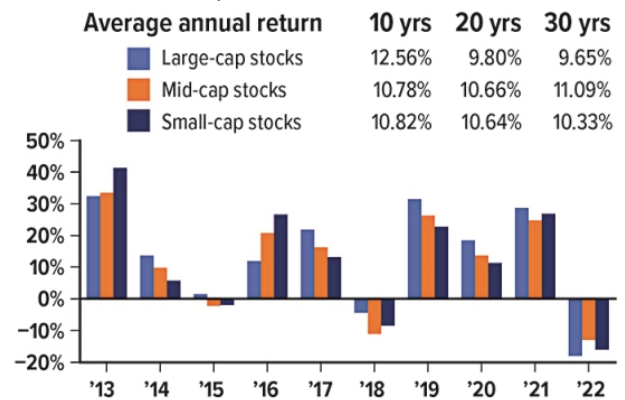
Stability, Growth, and Volatility

Stocks of larger companies, or large caps, are generally considered more stable than the stocks of smaller companies, because their size can help them weather rough economic times — as demonstrated by their strong performance during the pandemic. Large

caps may provide solid long-term returns, but they typically have lower growth potential, because they have already experienced substantial growth. Many large U.S. companies have heavy overseas exposure, which makes them more sensitive to global economic forces, one reason they struggled in 2022.

Performance in Three Sizes

Even with poor performance in 2022, large-cap stocks have provided the highest returns over the last decade. However, mid caps were the leader over the last 20- and 30-year periods, with small caps not far behind.



Source: Refinitiv, 2023, for the period 12/31/2012 to 12/31/2022. Large-cap stocks are represented by the S&P 500 Composite Total Return Index, mid-cap stocks by the S&P 400 MidCap Total Return Index, and small-cap stocks by the S&P 600 SmallCap Total Return Index. Expenses, fees, charges, and taxes are not considered and would reduce the performance shown if they were included. The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Rates of return will vary over time, particularly for long-term investments. Actual results will vary.

Mid caps may have greater growth potential than large caps, and midsize companies might react more nimbly to changes in the business environment. Mid caps are associated with higher risk and volatility than large caps, but are considered more stable than small caps.

Small-cap stocks might offer the highest growth potential of the three classifications, because they have the furthest to grow and are more likely to react quickly to market opportunities. However, they are typically the most risky and volatile class of stocks.

The investment return and principal value of stocks, mutual funds, and ETFs fluctuate with market conditions. Shares, when sold, may be worth more or less than their original cost.

Mutual funds and ETFs are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. You should read the prospectus carefully before investing.

1-3) S&P Dow Jones Indices, 2023

A Mortgage Recast Is an Alternative to Refinancing

If you would like to reduce your monthly mortgage payment without having to refinance, then you may want to explore a mortgage recast. When you recast your mortgage, you put money toward the principal balance of your current home loan. Your mortgage lender then recalculates (reamortizes) your loan based on your new, lower balance, which reduces your monthly payment. Your interest rate and the number of years remaining on your loan stay the same. Here are three scenarios where a mortgage recast might be especially appealing.

- You have extra cash on hand, perhaps from a bonus or an inheritance. It's sitting in a low-yield account.
- You are close to retirement or retired. You want to keep your home but lower your monthly expenses.
- You bought a new home with a smaller down payment than you intended because your old home is still on the market. But once your old home sells, the proceeds can be applied to your new mortgage through a recast.

Refinancing your mortgage may be a better option if your goal is to pay off your loan faster by shortening the term, or if you want to lower your interest rate or obtain cash. But if your objective is simply to lower your monthly payment and save on interest charges, then recasting your mortgage may be appropriate.

Recasting is generally simpler and less expensive than refinancing because you're keeping the same mortgage instead of applying for a new one. It doesn't require an extensive application, a credit check, a new appraisal, or closing costs, though you typically will need to pay a processing fee.

Check with Your Lender

Not all mortgage lenders offer recasts, and some types of loans, including FHA, VA, USDA, and certain jumbo loans are not eligible for recasting. If you do qualify for a recast, your lender will give you more details about the process.

You may be able to recast once you've increased your equity by making extra payments or by paying a lump sum toward your mortgage balance. Minimums vary, but the additional principal required may be as little as \$5,000. Of course, the more you put toward your principal, the lower your future monthly mortgage payment. If you are currently paying principal mortgage insurance (PMI), putting a lump sum toward your mortgage may help erase that, further lowering your monthly payment.

One drawback of a mortgage recast is that it could tie up money you might need later for other purposes. To access your equity in the future, you may need to refinance, take out a home equity loan, or even sell your home.

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