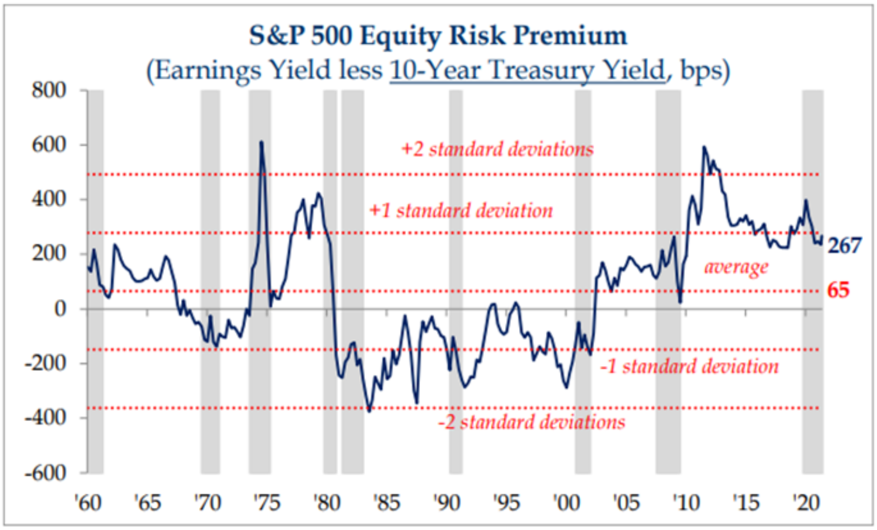
The Best & Worst of Times

In looking back at the economic landscape of the last eighteen months, we are reminded of Charles Dicken's opening lines from a "Tale of Two Cities" – *it was the best of times, it was the worst of times*. On one hand, we find ourselves in one of the fastest economic and market recoveries in recent memory. Supported by ample liquidity, accommodative monetary and fiscal policies, strong earnings, and expanding margins, equity markets have continued to set new highs -- even as Covid variants and supply chain disruptions have hindered important parts of the economy from reaching their pre-pandemic levels.

Treasury and fixed income markets have told a similarly confounding narrative: yields have for the most part range-traded, even as mounting evidence suggests that inflation will not be as transitory as the Fed would like the market to believe. Lower risk-free rates have served to further support equity prices, since both equity risk premiums and equity yields can fall when rates stay lower for longer. All in all, while the last eighteen months have presented one of the most economically, socially, and psychologically challenging times in history, they have also presented a generational opportunity for wealth creation not seen since the post WWII era. The best and worst of times indeed.



Source: Strategas

The Thinking Man's Approach

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- Discipline: staying the course with a long-term, value-oriented mindset, and not getting caught up in investment fads and excessively speculative themes
- Tax efficiency: exchange funds allow investors to diversify concentrated portfolios without having to realize taxable sales. Variable prepaid forward contracts allow investors to receive payment for their shares without finalizing the transaction, such that capital gains can be deferred to a later date
- Portfolio protection: buying protective puts and/or writing covered calls allow investors to insure portfolios from systemic and idiosyncratic risks
- Leverage: augments returns, and provides liquidity without triggering taxable events. Sizing portfolio leverage should take a "look-through" approach which factors in existing portfolio company leverage. Sizing should be conservative enough to guard against downside scenarios

For more on how we are positioning our portfolios, please contact your investment advisor or:
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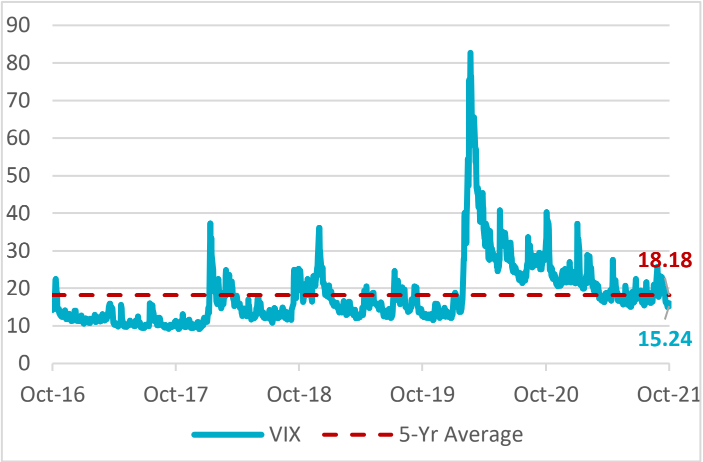
And yet we would be remiss if we didn't also acknowledge that the general mood in markets has more recently deteriorated. It has been almost a year since we last saw a meaningful or sustained correction in any major equity market (other than China), while smaller corrections on the order of 2%-3% have been broadly interpreted as buying opportunities. The last couple of months have also seen mounting concerns around ambitious infrastructure and social safety net spending, and the tax increases that will accompany them. Add to that mounting geopolitical and economic tensions in China, and the whole host of social changes which may or may not be covertly affecting how people think and behave, and you end up with a market that, at the margin, only stands to be disappointed.

Even the ongoing experiment in modern monetary theory, is still just that: an experiment. Can a country, economically powerful as it may be, really print as much money as it likes without adverse long-term economic effects? Can a country's debt and deficits really grow forever, in as much as a country remains productive? Are we in for smooth sailing, an eventual clean exit from the pandemic, and a fresh decade of prosperity, or will something in the end have to give?



Source: Factset

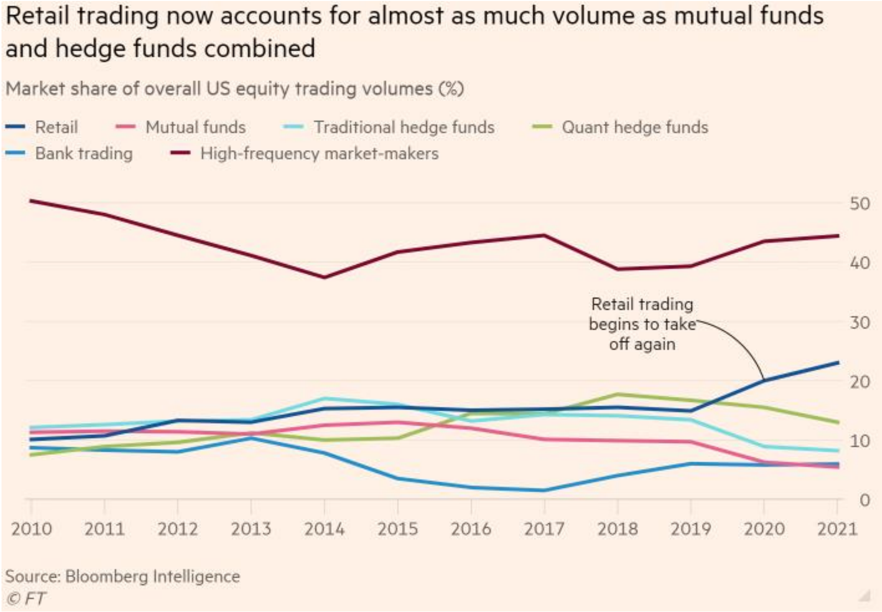
Though we do not have all the answers, what we can say is that real returns across asset classes, in our opinion, will most likely come down over the next decade. The threat of lower returns combined with the prospect of new sources of uncertainty has prompted us to ask ourselves the following question: *what is within our control, and what is outside of our control*? In this edition of our Thinking Man series, we will explore a handful of tools and philosophies which we believe are in our control, and that we can deploy to the benefit of our portfolios across various market environments.

Control Factor #1: Discipline

First and foremost is the ability to maintain a long-term investment mindset, and to systematically reflect that mindset in our investment decisions. The last year has seen the rise of meme stock trading, the creation of any variety of cryptocurrencies with no basis for value other than the promotional skills of their proponents, the inflating and bursting of the SPAC (special purpose acquisition company) bubble, and the "gamification" of stock trading via platforms like Robinhood.[1] The result has been 1) an increase in the popularity of the idea that a company's stock price does not ever actually have to reflect reality,

[1] Gamification is a term used to refer to the application of typical elements of game playing (e.g. point scoring, competition with others) to other areas of activity, typically as an online marketing technique to encourage engagement with a product or service.

and 2) an attitude which tends to give full faith and credit to the most far-fetched of management or Street forecasts. If there was ever a time in history to point to what investing isn't, it is right now.



To be sure, for as long as there has been fundamental investing, there has also been speculation. But it does seem as if more recently a greater share of what were historically disciplined, long-term investors have experienced a fair bit of FOMO, or "fear of missing out." No doubt that some of this speculative recklessness is the result of the amount of liquidity that is sloshing around in the system, combined with the rise of an army of retail traders. Without batting an eyelash, valuations can double or triple in a matter of months, not only because people are willing to believe that growth will eventually come, but simply because they have more money with which to place their bets.

We are of quite another mindset. More liquidity should have no bearing on the discipline with which capital is allocated. We cannot but reaffirm the view that, in the long-term, equity prices are not only a voting mechanism that depends solely on opinion. There is, and there will always have to be, *some* anchoring to the competitive / economic reality in which companies operate. A company cannot be a great company simply because a bunch of people believe it is. At some point companies have to actually *be* great companies. Our job is to find and invest in them before others realize it, such that the price we pay is less than value we will eventually get. This level of discipline in our investment philosophy might make it more difficult to realize gains from speculative optimism in the short-term, but it also protects us from moments when a hard reality meets an overextended expectation. We will always prefer to avoid the possibility of permanent losses, to blinding ourselves in the pursuit of large, but fleeting gains. To this end, our focus will always be on finding the highest quality companies with an ever-present eye on valuation, operational capabilities, and competitive advantages.

Consistent with this long-term mindset, we would also include the philosophy of "staying invested" as part of being disciplined, specifically with respect to the whole spectrum of private and public risk assets. It is very easy to mistake discipline for being conservative in one's investment approach. As an example, we might imagine the investor who sees equity valuations as being too lofty and decides to shift portfolio allocations to "safe" assets like public fixed income, thinking that they have outsmarted the market for having tactically allocated away from "expensive assets." We believe that in the current investing environment this is exactly the wrong approach, principally because it is only risk assets that are likely to outperform inflation over the next decade. To be sure, we continue to believe in the Fed's "transitory" rhetoric, but we do believe that over the next decade or so, inflation is likely to average 50-100bps above the Fed's average target of 2.0%. At the same time, hyper-supportive monetary policy has created asset inflation across most, if not all assets, effectively pulling future returns in to the present. For these reasons, we believe that in order to be a "disciplined investor" today, one needs to have the strength to be risk-on, confident that the technological and innovation growth engine that is the American economy will prosper in the long-term, regardless of shorter-term policy / social obstacles.

Control Factor #2: Tax Efficiency

This category of controllable portfolio measures is concerned with maximizing the tax efficiency of a portfolio's investment gains, without the incremental risks of taking on leverage. The two most popular structures for doing so are: exchange funds and prepaid forward contracts.

a. <u>Exchange/Swap Funds:</u> the basic structure of an exchange fund allows an investor to swap highly appreciated stock positions for an equal value of units of a fund that holds a basket of different stocks. Additionally, most exchange funds must invest 20% of their gross assets in qualifying assets like real property, which tend to be less correlated with equities. Though swapping into an exchange fund does not generate liquidity, exchange funds do allow investors to diversify their holdings without triggering a taxable event. This can be particularly useful in portfolios where one, or a handful of investments have generated outsized returns, and therefore represent a disproportionately large percentage of portfolio value.

   Typically, an exchange fund remains opens to new transfers of stock until it reaches some target size. After the fund reaches its target size, it closes for seven years. After seven years, an investor has the option to redeem their units, subsequently receiving a pro rata share of some or all of the stocks in the fund's portfolio. Most exchange fund managers offer monthly, quarterly, and sometimes even daily liquidity once the seven year term has expired, while redemptions before the seven-year period typically trigger fees of approximately 2% of net asset value (NAV).

   On a practical note, though exchange funds are good tools for tax-efficient portfolio diversification, over the last several years, the demand for exchange funds has far outpaced the capacity availability of open exchange funds, particularly for popular stocks like Apple and Amazon. Currently the primary providers of exchange funds are Eaton Vance (the largest), Goldman Sachs, and Morgan Stanley.

b. <u>Variable Prepaid Forward Contracts:</u> a variable prepaid forward contract allows an investor to sell stock (usually to a broker-dealer) for between 75-90% of the current value of a stock. Though the investor receives cash up front, the forward contract allows the investor to defer having to pay capital gains taxes, mainly because, under the contract, the sale is not officially finalized until a later date. The primary condition required for the structure is that the future sale involve a *variable* amount of proceeds. As an example, an investor enters a prepaid forward contract to sell stock, receiving $100 as an advance (on securities with a current market value of $110). Later, the investor must deliver the stock according to a variable formula, or an equivalent value in cash. If the investor physically delivers stock on settlement, they will recognize a gain or a loss based on the difference between $100 and the basis in the stock delivered. Alternatively, if the investor delivers cash, the gain or loss is based on the difference between $100 and the payment made to settle the contract.

Control Factor #3: Protection

In this category of controllable portfolio measures we will discuss hedging portfolios through protective puts and /or by writing covered calls. Below we will discuss some of the key considerations for doing so.

a. Protective puts: as a reminder, the buyer of a put contract has the right but not the obligation to sell 100 shares of an underlying security at the strike price if the price of the underlying security is below the strike price at expiry. The key determinants of a put's utility as a hedge is determined by three primary factors: expiry (the term of the protection), strike (what % change in price is protected), and most importantly, volatility (how expensive the protection is, holding all else equal). Like most insurance contracts, the basic dynamic of buying protective puts is to sacrifice a small percentage of the portfolio's value (the put premium) in order to protect against losses of a much greater magnitude.

   The key consideration for investors to make in choosing and sizing protective put(s) will depend on the scope of protection that is desired. If an investor wants to take a more targeted view on possible drawdowns, then rather than buy a put outright (which covers all downside scenarios) and investor can buy an at-the money put and simultaneously sell an out-of-the money put (i.e. a put spread). Doing so would only cover losses up to a certain point, say 10%, but it is also a cheaper alternative, since the sale of the lower-leg put offsets the cost of buying the upper-leg.

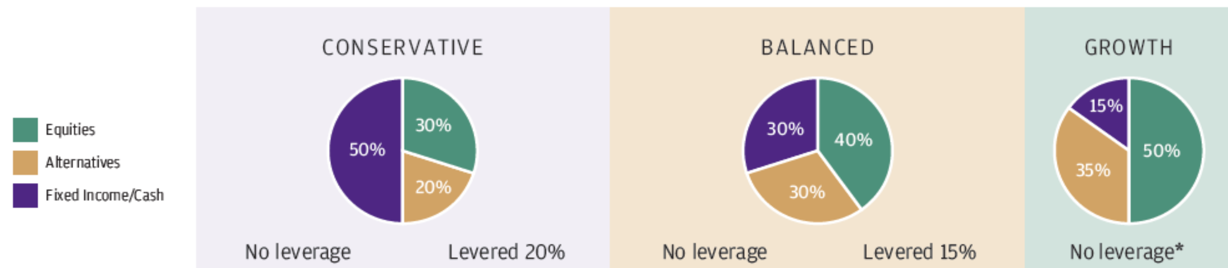
b. Covered calls: the second, albeit less "protective," way of hedging a portfolio is to write at-the-money calls on existing equity positions. The basic idea of a covered call writing strategy is to monetize the volatility in a stock by exchanging all of the potential future upside present in owning a stock outright, for a call premium collected in the present. That premium can be interpreted in one of two ways: as a coupon with an imputed annual return, or as a protective measure which serves as an offset to drawdowns in the underlying position. As an example, if an investor buys a security at $100, and simultaneously sells a call with a one month expiry and a call premium of $5, then that premium can be seen as a 5% return, or as reducing the positions breakeven price to $95. It is in this sense that a covered call is less protective, since in our example it would only serve to protect against the first 5% of losses.

Control Factor #4: Leverage

There are two reasons for borrowing against the assets in a portfolio: augmenting returns and accessing liquidity without having to realize capital gains (for onshore investors). Before discussing some of the key considerations for employing portfolio leverage, we should first note that historically we have been fairly conservative in using debt to augment portfolio returns simply because we already benefit from the balance sheet leverage on many of our investments. Whether it is a publically traded company or a private equity portfolio company with a more aggressive leverage profile, the result is the same: leverage increases equity returns because 1) debt capital lowers the amount of equity capital required to finance fixed assets and working capital; 2) profit dollars over and above the fixed payments to debtholders accrue to equity holders; and 3) interest payments lower a company's taxable income.

The primary factors to consider when employing portfolio leverage are debt sizing and cost. To that end, the focus of taking on debt should be on assessing the magnitude and probability of possible downside scenarios. This is due to the particularly vindictive nature of levered returns: if the value of a levered portfolio decreases to the point where the lending bank issues a margin call, an investor will have to sell shares at precisely the wrong time; that is, when prices are low and buying opportunities abound.

Sample asset allocations for various types of investors



	Conservative: No leverage	Conservative: Levered 20%	Balanced: No leverage	Balanced: Levered 15%	Growth: No leverage*
Expected equilibrium return**	5.9%	6.4%	7.2%	7.8%	8.1%
Expected volatility	7.0%	8.4%	10.2%	11.7%	12.5%

Less Risk .... More Risk

Source: J.P. Morgan Wealth Management

As with any portfolio decision, it is vital to gain a clear picture of a client's total balance sheet and cash flow position before implementing yield-enhancing measures. In the case of adding leverage we would go even a step further and factor in the balance sheet leverage of public and privately-held portfolio companies. This is principally because more levered companies will tend to have higher betas, which all else equal, should translate to more downside in a broader market correction. With banks willing to lend 50-75% of liquid portfolio values at rates well below other leverage markets there is the easy temptation to want to lever-up as much as possible and extract the full benefit of the carry between lending rates and equity returns. We would suggest a more tempered, "look-through" approach which will likely result in a more moderate levered return but also in a more correction-resilient portfolio. We are firm believers in finding the "sweet-spot" level of leverage: one that is large enough to augment returns when the financial picture is rosy, but one that is also conservative enough to not impair portfolios with forced selling. Though leverage sizing depends on the particulars of the client(s) and their portfolio(s), we believe that an adequate baseline for *conservative* leverage should be between 20-25%.

Conclusion

It goes without saying that a wealth manager's primary function is precisely to manage both the uncertain and the unknowable. Simply put: to price risk in a way that maximizes risk-adjusted returns over the long-term. This involves maintaining an ever-present eye on the macro picture, as well as the competitive and industry forces that lead to certain companies outperforming.

We cannot control the C-suite of the companies we are invested in, and we definitely cannot control what the market's reactions will be to the ever-widening slew of headlines and financial data that gets produced on any given day. What we can do however, is have a disciplined commitment to our investment philosophy, and to opportunistically complement that philosophy with a handful of simple, yet powerful tools. As discussed, these tools include: using tax-efficient liquidity structures, opportunistically hedging portfolios, and employing moderate portfolio leverage. All are important, and all contribute to long-term investment success.

As a final note, we would add that the wealth management relationship is first and foremost a human relationship, where communication and psychology are as important as any amount of sophisticated investment or portfolio analysis. If there is one thing we can control and be proactive about, is maintaining clear and open lines of communication with clients. This includes keeping them informed of market developments and opportunities, but it also includes listening enough to gain a client's full trust, comfort, and confidence.

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