TAA - If not now then when?

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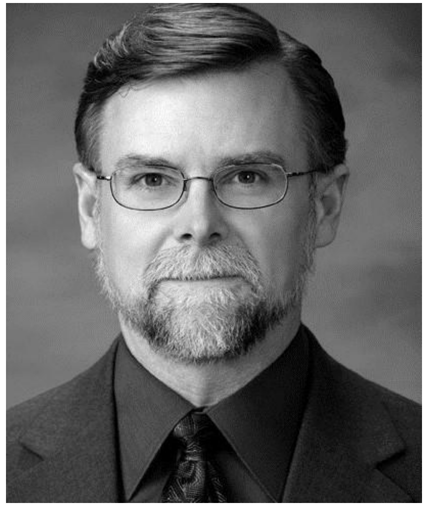

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"The sillier the market's behavior, the greater the opportunity for the businesslike investor"

Warren Buffett

TAA - If not now then when?

or . . . What are the forces that will determine market-direction over the next several years

The way back is closed, only the path forward remains open

- It's a trite phrase to say *"change is the natural order of things,"* sounds too much like an excuse

- Worse yet, it serves to mask the different types of change - and how the best approach for dealing with one type of change is the worst for another

- Different types of change are distinguished by two attributes:
  - Speed or pace
  - Smoothness or direction

Example slow/fast - Telecommunications

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SLOW

FAST

Example slow/fast - Automobiles

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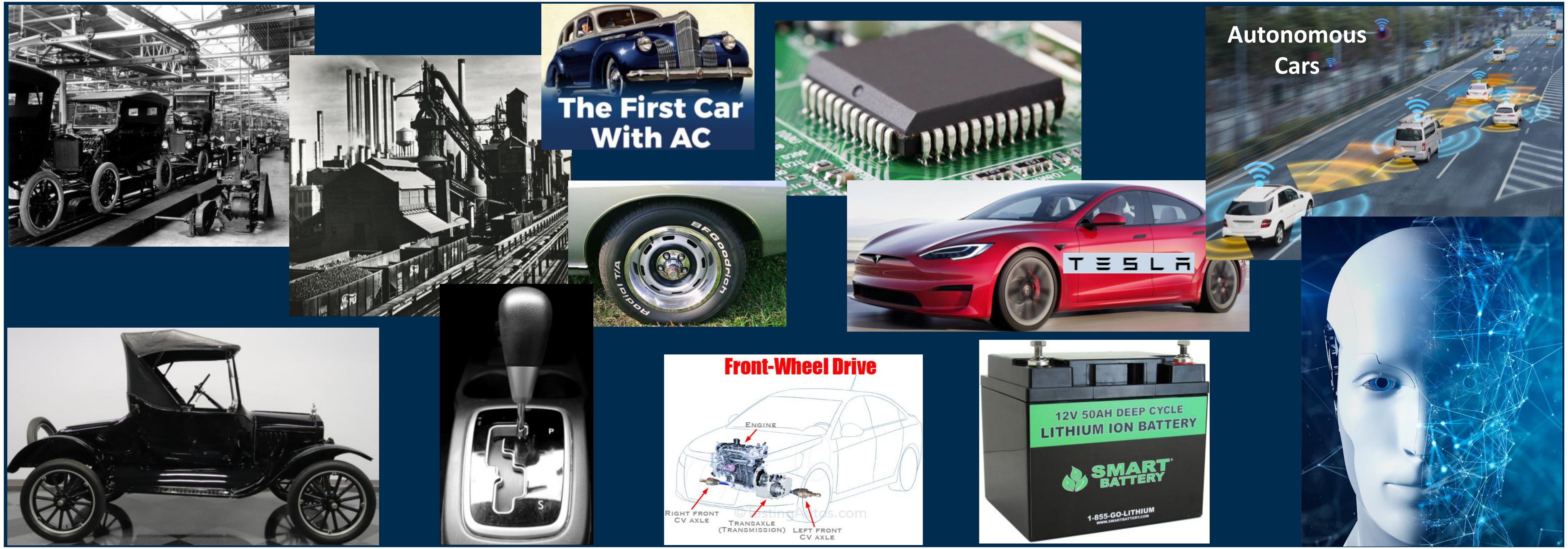

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Example - directional change - 1914 . . .

1914-1921
- Creation of the Federal Reserve
- Global pandemic (The Spanish Flu)
- Great Depression of 1920
- World War I

- Depended on other nations for capital
- Largely an agricultural economy
- Developing superior manufacturing techniques allowing it to grow its exports

- Shifted to a provider of capital to other nations
- Era of the roaring 1920s
- Optimism, rapid growth, and purchase of cars

Example - directional change - 1929 . . .

1929-1945
- Great Depression of 1929
- World War II
- Eight-year drought - The Dust Bowl

- Large and rapidly growing economy
- Relatively separate from the rest of the world, endeavoring to remain apart and uninvolved

- Leader of the Free World
- Major provider of capital to other nations
- Nation builder

What life teaches us about dealing with change most effectively

- We’ve learned that when managing through change defined by speed or pace . . .
- It’s best to just keep doing what’s worked so well in the past
- Maybe we tweak our approach at the edges to account for recent developments.

What life teaches us about dealing with directional-change

- In contrast, when managing through change defined by a directional shift, breaking instead of bending, or just a simple discontinuity . . .
- The worst possible approach is the one described on the prior slide
- Continuing to do what worked so well in the past almost assures that we'll faceplant
- The best approach when facing a change of direction is to forget everything we think that we know and start with a clean sheet of paper

What does this have to do with investments?

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- Occasionally (and thankfully not very often), investments experience a directional change or breakage instead of bending
  - Success during these periods requires that we set aside what worked so well in the past . . .
  - And seek an approach that best harmonizes with the inherent new realities
- Individuals often have a hard time making these shifts if they've become emotionally attached to what worked so well in the past
  - Similarly, organizations often have a hard time making such shifts if they have monetary incentives tied to solutions from the past
  - Such individuals and institutions inevitably faceplant - and by so doing, create opportunity for the rest of us

What life teaches us about dealing with directional-change

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PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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The way back is closed, only the path forward remains open

There are different types of change

It's a trite phrase to say *"change is the natural order of things,"* sounds too much like an excuse.

Worse yet, it serves to mask the different types of change - and how the best approach for dealing with one type of change is the worst for another.

Different types of change are distinguished by two attributes:

- Speed or pace
- Smoothness or direction

Speed or pace

Speed or pace is either fast or slow. Most of the time, change proceeds slowly. Telecommunications provides a ready example.

SLOW → ← FAST

For fifty years, telecommunications developed at a slow but steady pace. But then, with the development of integrated circuits (silicon chips), the Internet, lithium batteries, and the World Wide Web, the pace of change moved from slow to fast.

Automobiles and personal travel provide a second example.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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SLOW → ← FAST

Once again, for fifty years, automobiles developed at a slow but steady pace. But then, with the development of integrated circuits (silicon chips), lithium batteries, ultra-lightweight composite construction materials, and artificial intelligence, the pace of change moved from slow to fast.

Smoothness or direction

A different type of change is related to smoothness and/or direction. Often the distinction is seen most clearly when our system either bends or breaks. The early 1900s provide an excellent example.

1914-1921
- Creation of the Federal Reserve
- Global pandemic (The Spanish Flu)
- Great Depression of 1920
- World War I

- Depended on other nations for capital
- Largely an agricultural economy
- Developing superior manufacturing techniques allowing it to grow its exports

- Shifted to a provider of capital to other nations
- Era of the roaring 1920s
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The pressures resulting from the global pandemic, world war, and economic depression during the years 1914-1921 helped change the direction of the US economy and the priorities of American society. While the creation of The Federal Reserve System in 1914 helped facilitate that directional change. A more recent example unfolded during the mid-1900s.

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)

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The pressures resulting from the 1929 Depression. The environmental disaster of the eight-year drought, and WWII fundamentally changed the direction of the US economy and meaningfully altered the preferences of American society. The change that unfolded during these years was more akin to the breaking of a bone and its subsequent resetting.

Best method for dealing with change

Life provides valuable lessons. We've learned that when managing through change defined by speed or pace, it's best to just keep doing what's worked so well in the past. Maybe we tweak our approach at the edges to account for recent developments. But we stick with what has proven itself out through the test of time. OK, maybe when the speed of change ramps up from slow to fast we have to be a bit more nimble, and perhaps tweak the edges a bit more aggressively, but that's about it.

In contrast, when managing through change defined by a directional shift, breaking instead of bending, or just a simple discontinuity, the worst possible approach is the one described above. Continuing to do what worked so well in the past almost assures that we'll faceplant.

The best approach when facing a change of direction is to forget everything, we think that we know and start with a clean sheet of paper. Such an approach requires that we ask: "What's the game, rules, players, field, and their relative strengths and weaknesses?" By asking this question, we're admitting that we can't predict the future, but we can narrow it down to a small number of possible outcomes and assign probabilities to each.

How does this relate to investments?

Investment is no different. We experience remarkably long periods of smooth, flexible, unidirectional change, mostly slow, but sometimes fast. Success, during such periods, is best accomplished by continuing to do what worked so well in the past. At the edges, we seek to lower costs, improve tax efficiency, and make tiny adjustments for recent new developments.

But . . . occasionally (and thankfully not very often), investments experience a directional change or breakage instead of bending. Success during these periods requires that we set aside what worked so well in the past and seek an approach that best harmonizes with the inherent new realities. Individuals often have a hard time making these shifts if they've become emotionally attached to what worked so well in the past. Similarly, organizations often have a hard time making such shifts if they have monetary incentives tied to solutions from the past. Such individuals and institutions inevitably faceplant - and by so doing, create opportunity for the rest of us.

Interest rates and bonds

Interest rates fell from 16% to ½% over the 40 years just ended. 2020 may have ushered in a change of profound dimensions, whereby interest rates now rise for the next 40 years. Why does this matter? When interest rates rise, bond prices fall. Do you

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or . . . What are the forces that will determine market-direction over the next several years

What comes next?

- It's not about pace, it's about direction

- It is our belief that the menu of investment opportunities and risks is changing
  - This development is not related to the pace of change, but instead concerns the direction of change
  - We view this to be a pretty big deal

- We don't have a crystal ball, no one does
  - We can't identify the winners and losers in advance
  - Nor can we determine future market turning points, market-timers always fail

- But we can say quite a bit about the drivers that will determine the future paths taken by investment markets and national economies over the next so many years

Why do we say over "so many years"?

- Why do we say over "so many years"?

- Do we mean over the short-run or over the long-run?
  - Actually, neither
  - Instead, it is our understanding that this directional change for investment opportunities/risks will continue for whatever number of years (short or long) until the driving factors are adequately reflected

Nine drivers of directional-change

- Renewable energy
- Haves versus the have-nots
- China
- Velocity of money
- Interest rates
- Valuations
- Zombies
- Environment and demographics
- Creative destruction

Renewable energy

- The production/generation of electricity is shifting from fossil fuels to renewable energy sources

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- The production/generation of electricity is shifting from fossil fuels to renewable energy sources

- Creates new jobs
- Destroys existing jobs
- Advantages and disadvantages certain geographies
- Makes existing reserves and infrastructure worthless
- Consumes critical commodities
- Consumes capital
- Environmental impact

Haves versus the have-nots

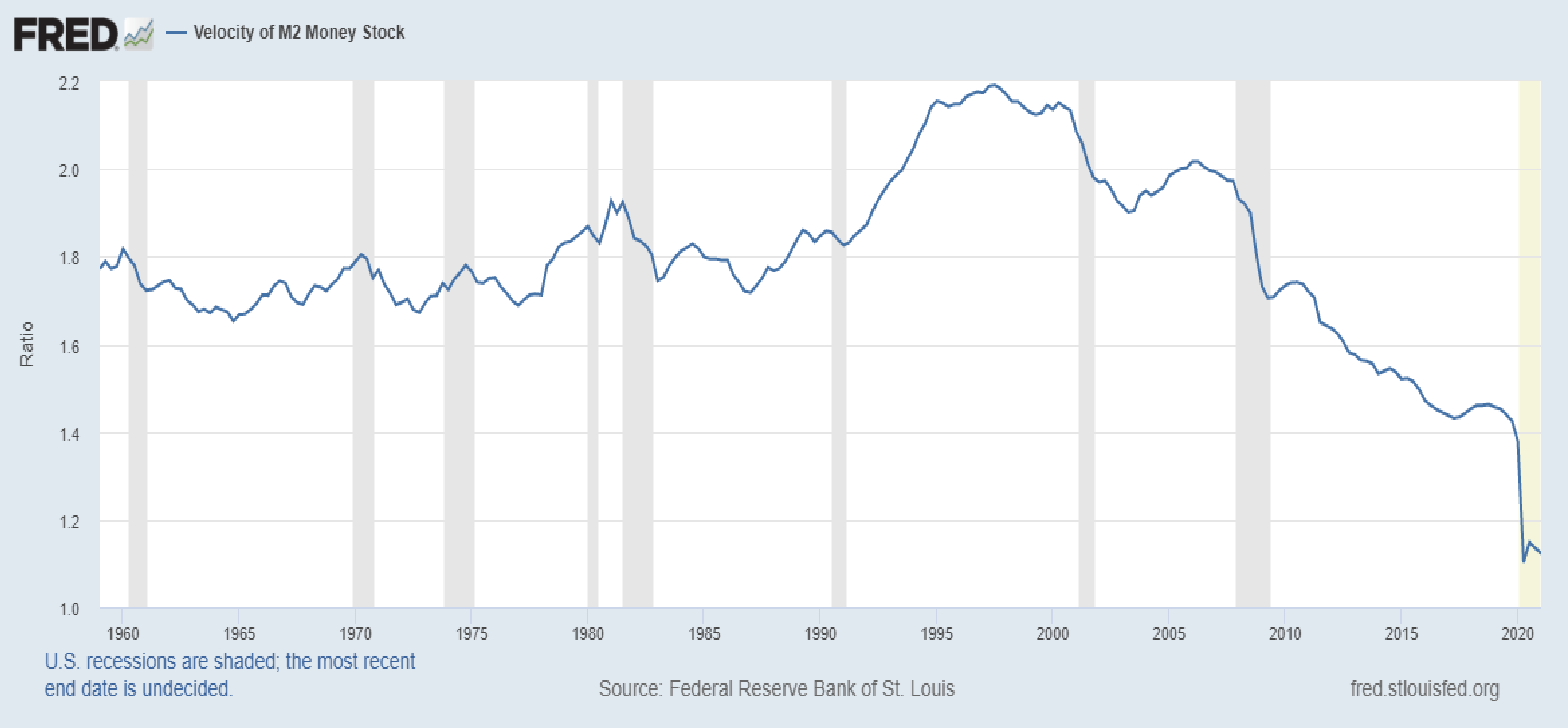
- Gaps between haves and have-nots . . . is not new
- The size and nature of the current gap . . . is not new
- Growth in the existing gap . . . is not new
- What is new
  - Social media and related real time communication
  - Visibility
  - Cognizance and recognition of the gap
  - Putting in your face . . . continuously
  - Constant drum beat on the gap
  - Geographic breadth
- The potential for problematic social disturbance is significant

China

- China and the United States have entered into a multi-decade long cold war

Velocity of money

- The velocity of money has reached an unsustainably low level and will have to rise (significantly)

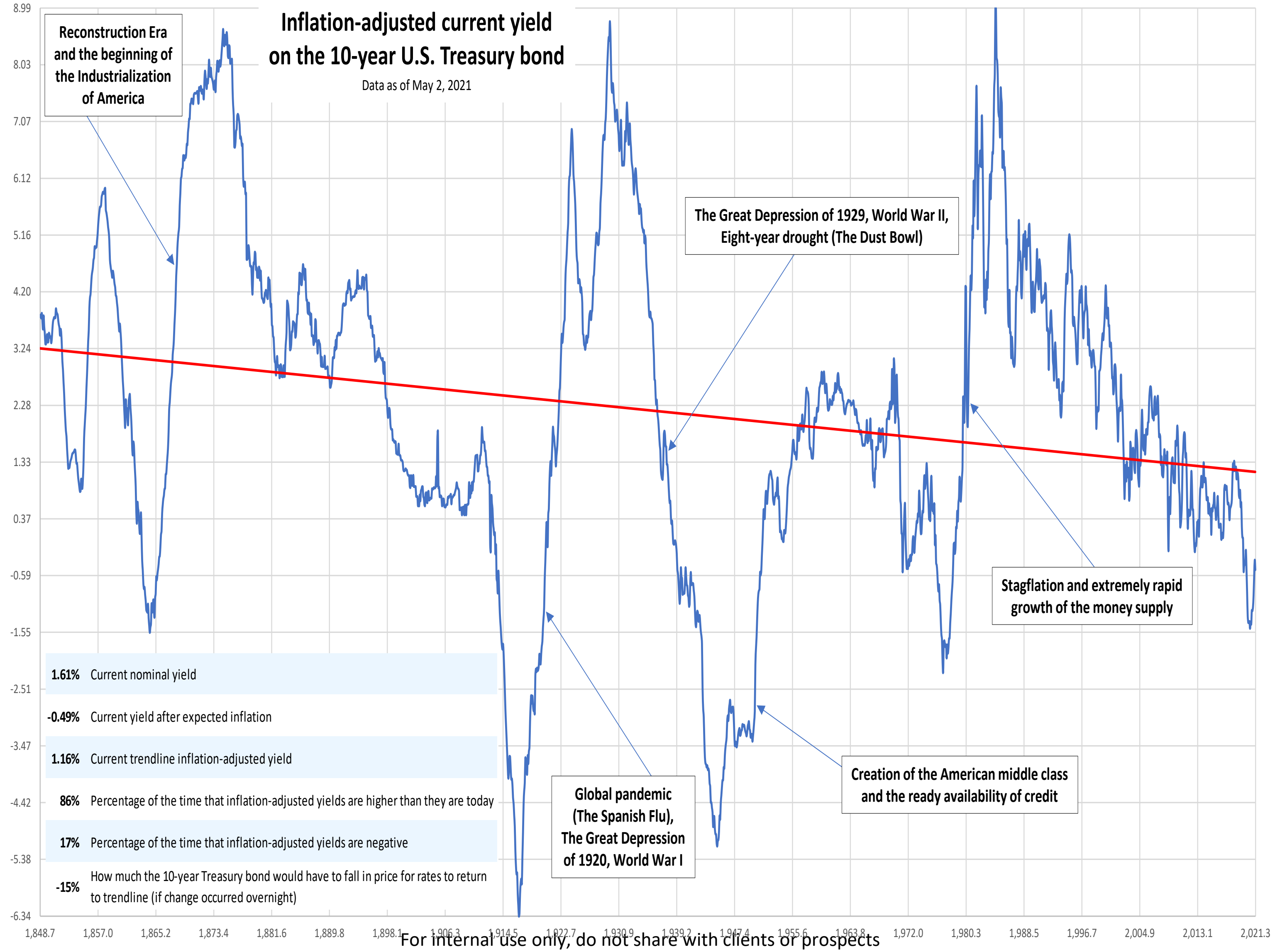


Velocity of money

- The velocity of money has reached an unsustainably low level and will have to rise (significantly)
- Velocity measures how long a consumer or business sits on their cash . . . Essentially, how long they keep a dollar in their wallet before spending it (or otherwise redeploying it)
- In the long-run . . . Velocity is determined by the inherent structure of our economy . . . and only changes when that structure changes
- Eventually . . . Velocity will have to return to its normal level
- At which point supply/demand . . . will clash

Interest rates

- Inflation-adjusted risk-free interest rates have reached unsustainably low levels and will have to rise (significantly)

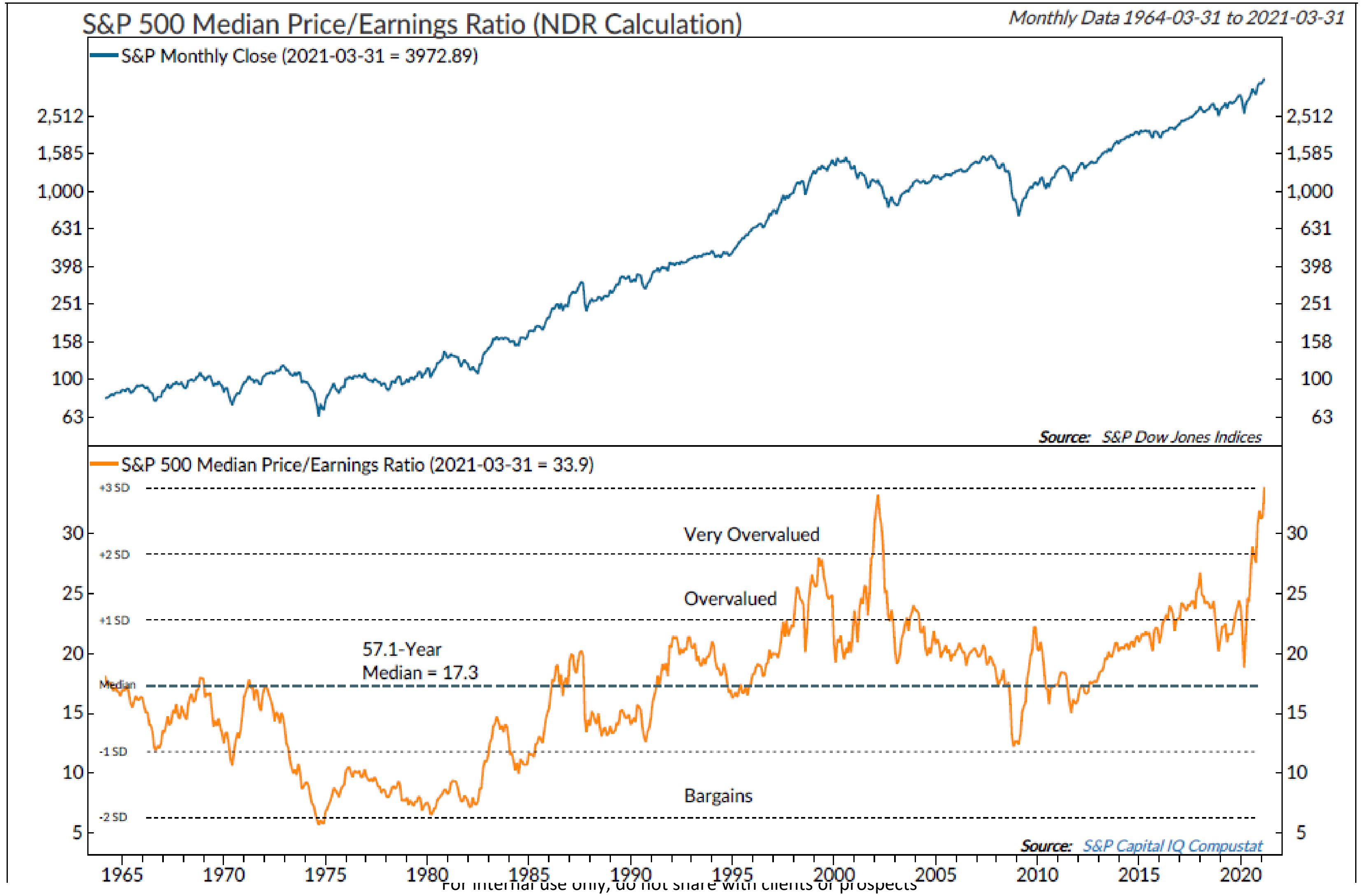


Interest rates

- Inflation-adjusted risk-free interest rates have reached unsustainably low levels and will have to rise (significantly)
- The inflation-adjusted current yield on the 10-year Treasury is about -0.49%
- Which essentially amounts to Mr. Market saying “Yay, the economy won’t ever grow again, and is in a permanent recession”
- This is not realistic
- In a growing economy, inflation-adjusted yields are positive

- The expected return for the most popular risk premia are overly compressed and will have to rise (significantly)

Median S&P 500 P/E hits a new record — 3 SD above median



Valuations

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- The expected return for the most popular risk premia are overly compressed and will have to rise (significantly)

- Or in other words . . . Valuations are at an extreme

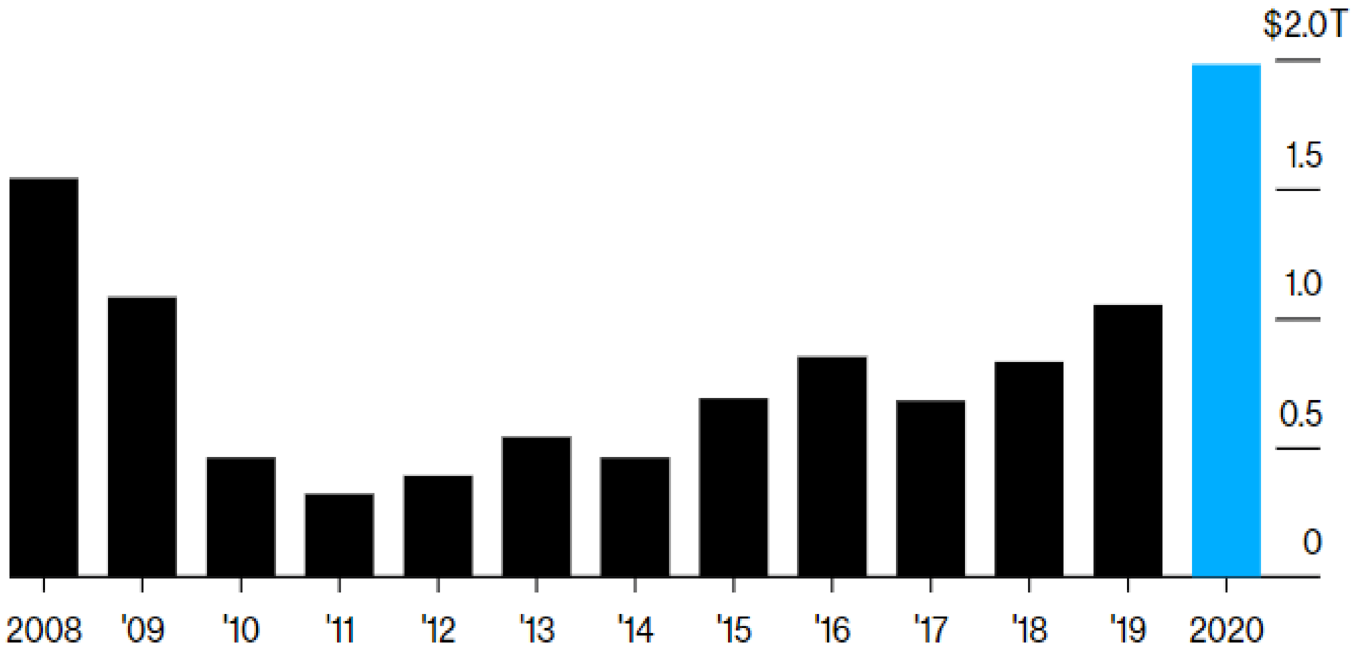
- And will have to revert to more normal . . . And sustainable levels

Zombies

- There is an unsustainably high number of zombie companies, this will self-correct

Undead Debt

Zombie firms are sitting on an unprecedented $2 trillion of obligations



Source: Bloomberg
Note: 2020 figures are as of most recent quarterly data

Zombies

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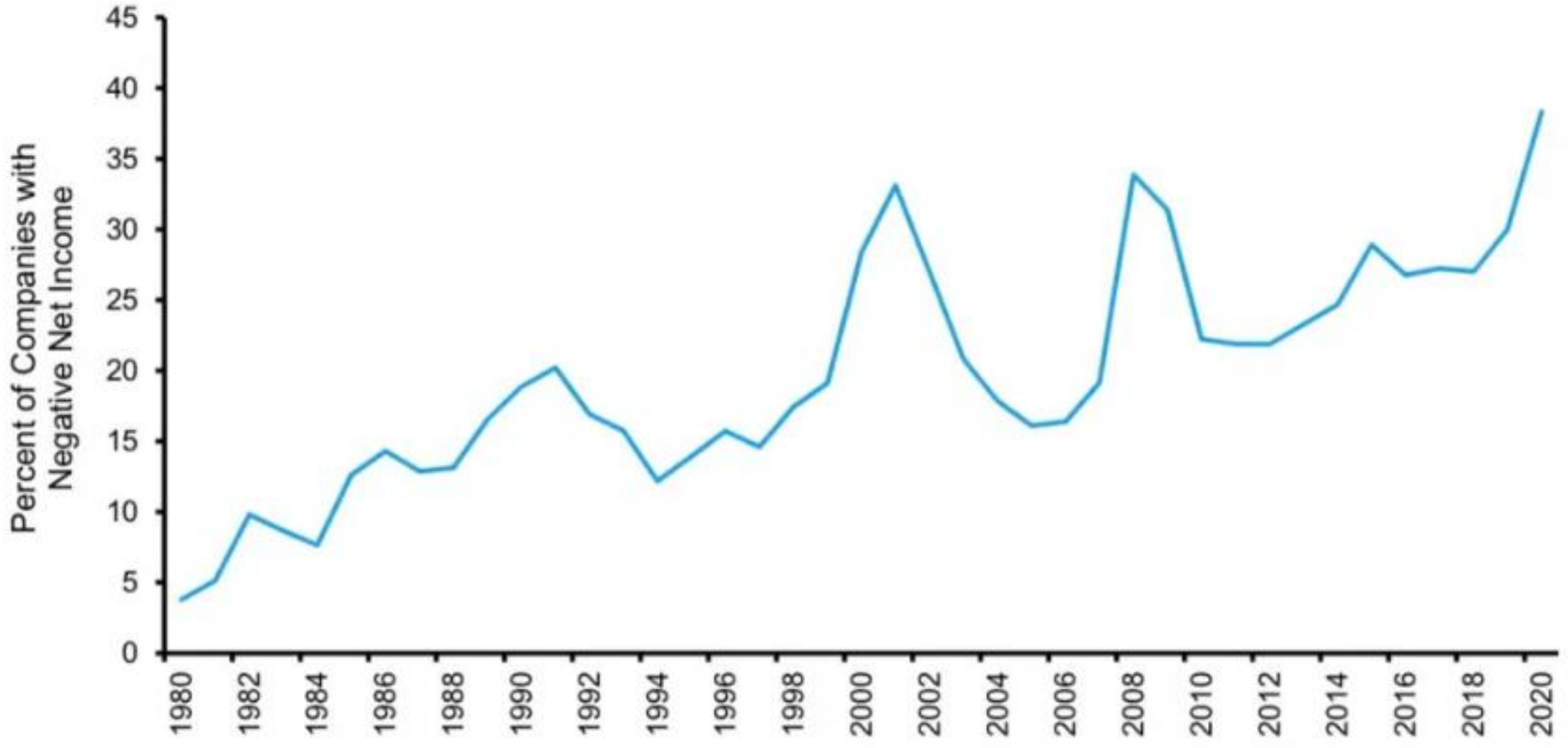
Exhibit 5: Percentage of Companies in the Russell 3000 with Negative Net Income, 1980-2020



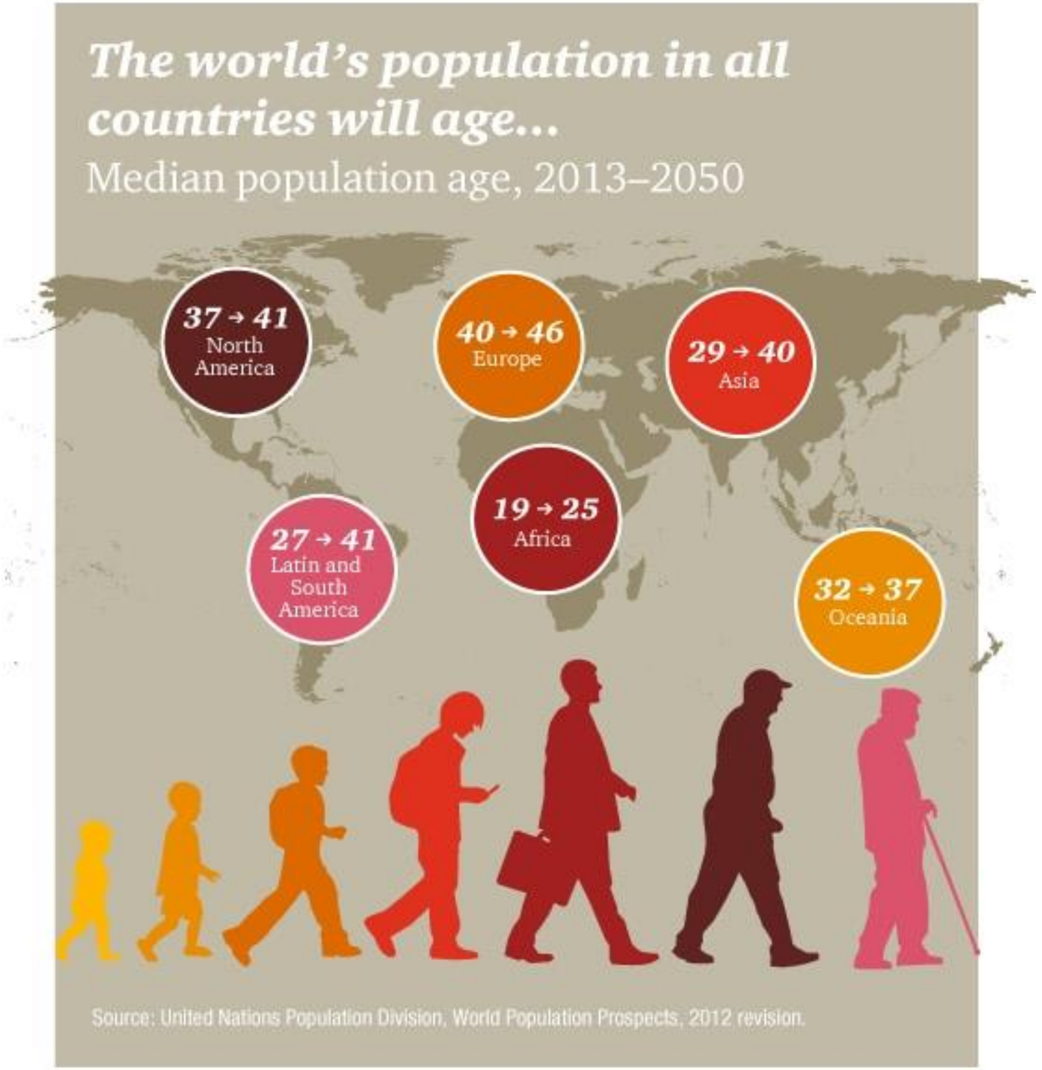
Source: FactSet.
Note: Constituents of the Russell 3000 Index as of year-end.

Zombies

- There is an unsustainably high number of zombie companies, this will self-correct
- Zombies are the walking dead
- Companies who are negative cashflow . . . And are only able to persist due to the temporary abundance of endless cheap credit
- Worse yet . . .
  - They are an inefficient allocation of both labor and capital within an economy
  - Causing that economy to grow ever slower

Environment and demographics

- Environmental and demographic shifts will result in a meaningful increase in geopolitical conflict



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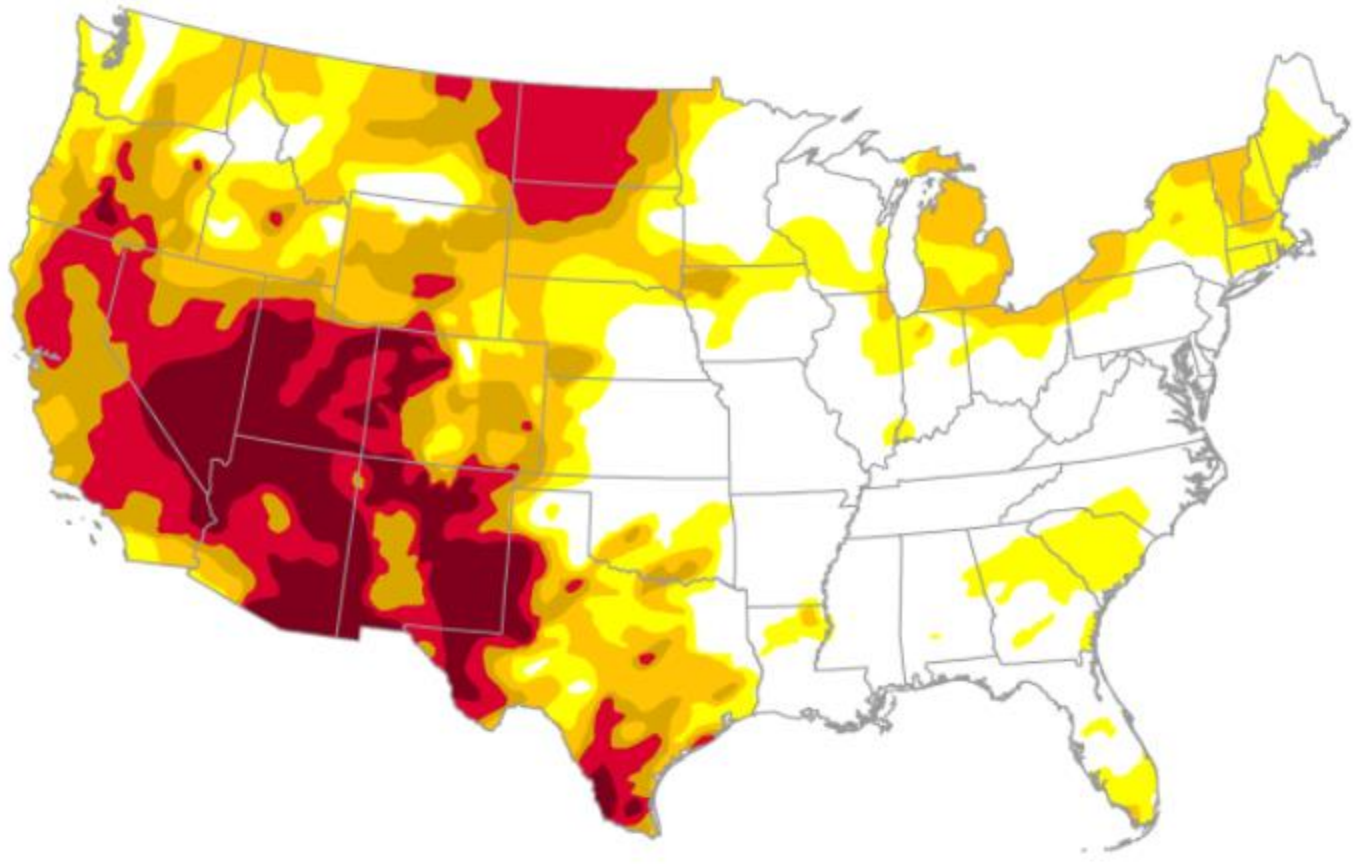
Drought Strains the Western U.S.

Drought intensity: Exceptional | Extreme | Severe | Moderate | Abnormally dry

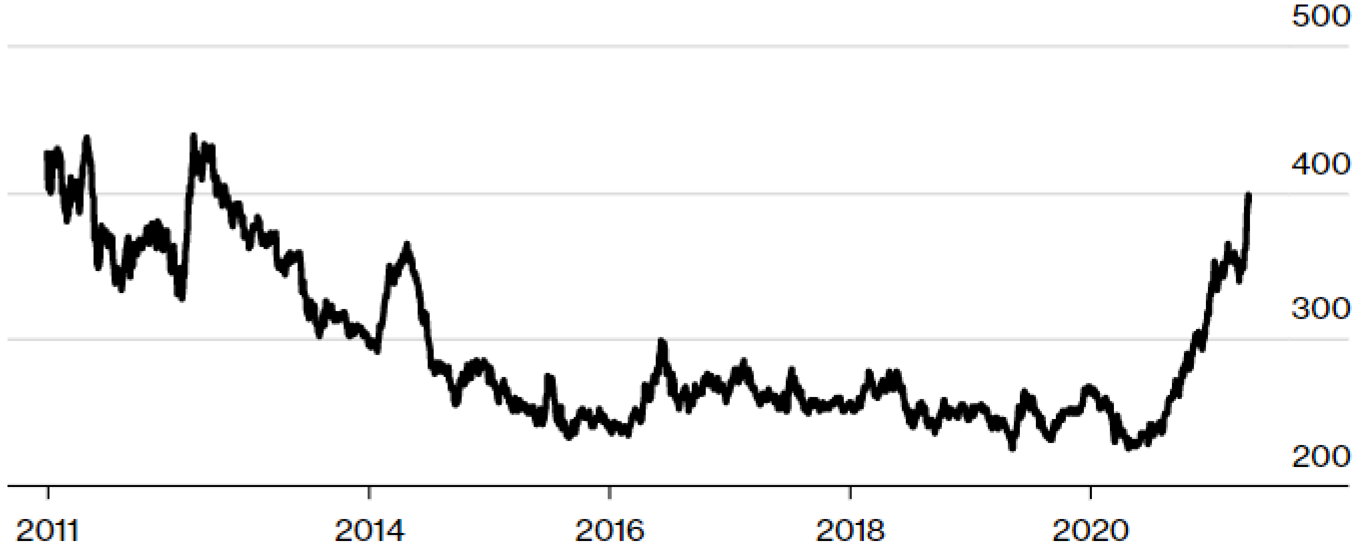


Source: U.S. Drought Monitor as of April 20, 2021

Crop Rally Stirs Food-Price Fears

Prices at multi-year highs stoke inflation fears

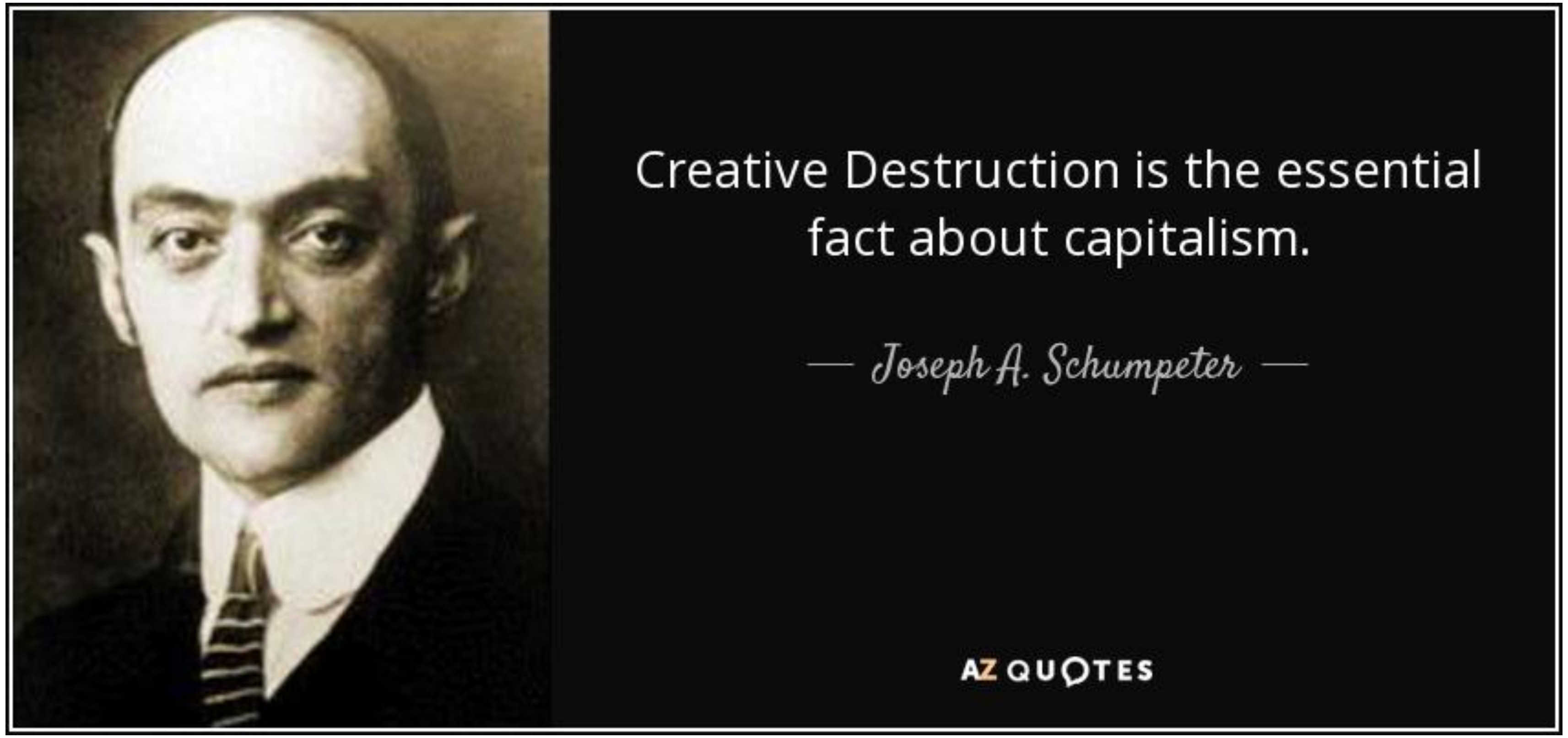
Bloomberg Agriculture Spot Index - Last Price



Source: Bloomberg

Creative destruction

- There is a large and growing gap between those countries who maintain a robust ability to adapt, innovate, and engage in creative destruction . . . and those nations who are becoming increasingly rigid and inefficient as they attempt to avoid the pain of reinvention



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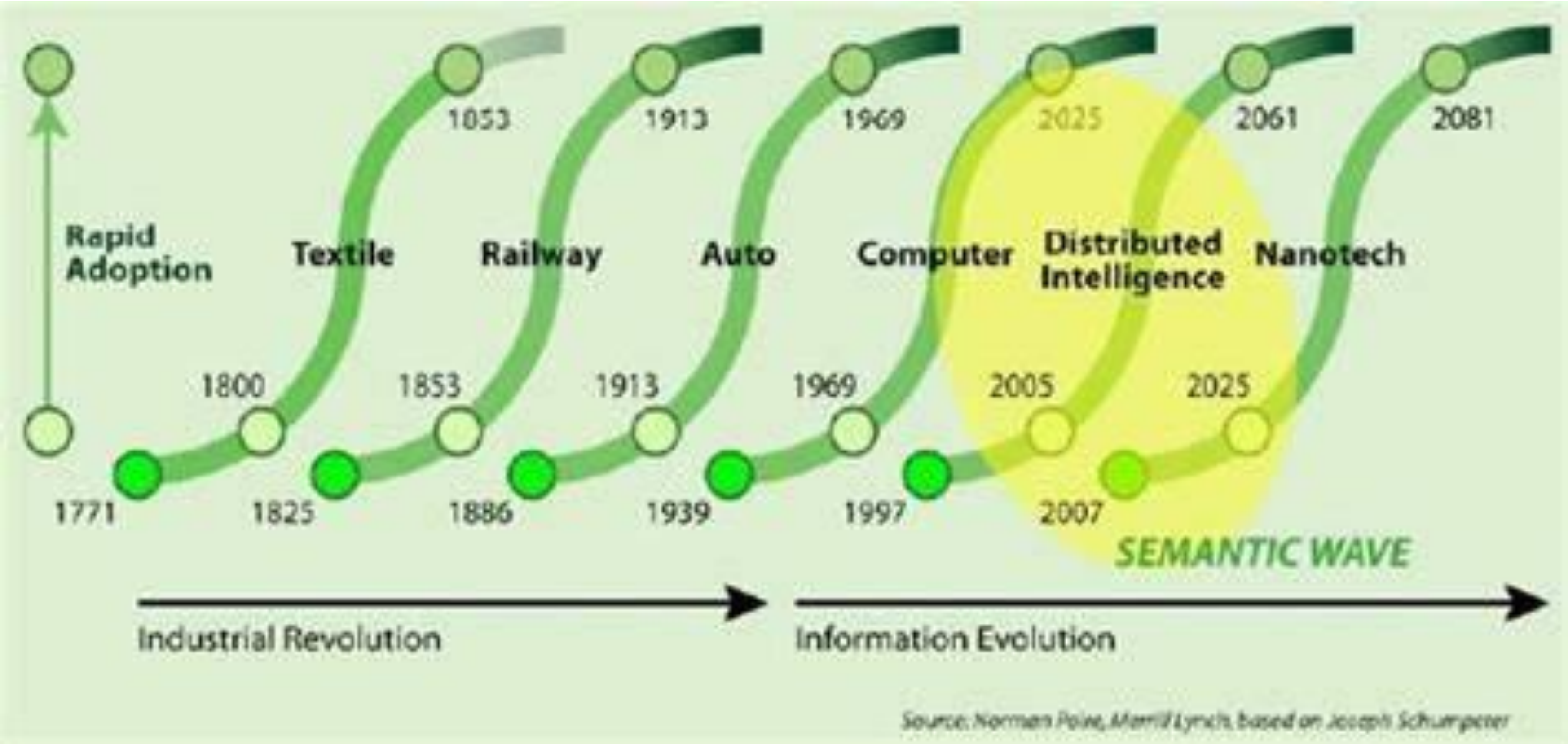

Creative destruction

- There is a large and growing gap between those countries who maintain a robust ability to adapt, innovate, and engage in creative destruction . . . and those nations who are becoming increasingly rigid and inefficient as they attempt to avoid the pain of reinvention
- The imperative need for controlled burns

Future investment success

What are the key elements?

Directional change of this type and magnitude is nothing new

- Looking back at history, we appreciate that the opportunity for a successful investment journey is neither diminished nor made less likely during such turbulent times

- Instead, as has been observed by others *“Change is the parent of opportunity”*

- Our experience teaches us that future investment success is likely to require:
  - Humility,
  - Forward-thinking,
  - Independent thinking, apart from the crowd,
  - Forbearance against “picking winners” or “predicting market turning points”,
  - Equal focus on possible market opportunities and potential market risks, and
  - An appreciation that the future will be quite different from the past.

Future success requires . . .

- Humility,
- Forward-thinking,
- Independent thinking, apart from the crowd,
- Forbearance against “picking winners” or “predicting market turning points”,
- Equal focus on possible market opportunities and potential market risks, and
- An appreciation that the future will be quite different from the past.

- And what strategy best encapsulates these six attributes?
- Tactical Asset Allocation

- Is there anything better?   YES, but they reside withing the purely institutional alts area

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Will these nine determine what happens over the next so many years?

Of course not

But, that's not the point

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