December 2021

Cognitive Biases

As long-term, strategic investors, the general trajectory of risk markets is most often supportive of our goals. What can often work against us is our very own set of cognitive biases. Defined as a systemic pattern of deviation from rationality that allows individuals to create their own "subjective reality" based on their perception of an input, cognitive biases can lead to sub-optimal investment decisions that are not consistent with a strategic plan formed in calmer times.

According to School of Thought, a non-profit dedicated to spreading critical thinking, there are 180 distinct cognitive biases. Among the most disruptive to rational decision-making is the Availability Heuristic, or bias, that states how 1) recent, 2) unusual, or 3) emotionally powerful your memories are, can make them seem more relevant. This, in turn, can cause you to apply them too readily. For investors today this may pose a number of challenges.

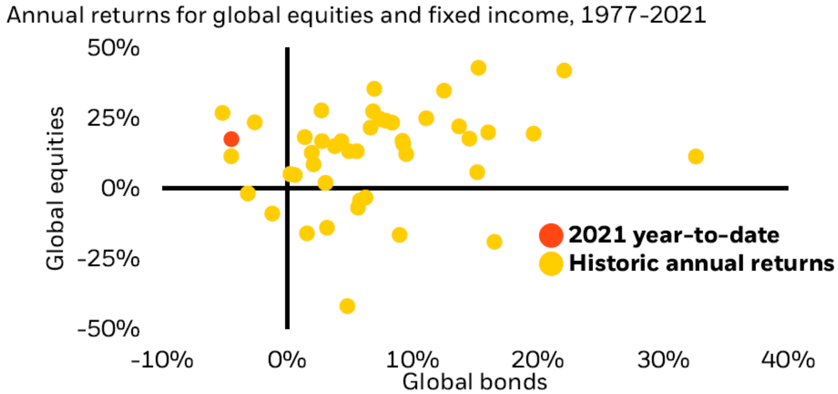
The most *recent* memory involves a hawkish Fed message detailing an acceleration in the pace of its asset purchase tapering, and signaling the likely onset of fed fund rate hikes in 2022. This may feel *unusual* for investors given the protracted period of barely discernible inflation and historically low interest rates, despite above trend growth and a strong labor picture. While the most *emotionally powerful* memories investors currently possess involve the awareness that much of their recent market and economic fortunes tie to the seemingly serial flare-ups of new variants of COVID. Taken together these factors leave market participants without a reliable roadmap to point to, and heightened stakes on all fronts.

The shift in the Fed's stance was reflected in their collective set of forecasts for the coming year, which now includes a call for 2.7% core inflation (versus the previous 2.3%), a projected unemployment rate of 3.5% (versus the previous 3.8%), and a GDP growth outlook increased to 4.0% (versus the previous 3.8%). By bringing forward the end of the Fed asset purchase program to March, and with a median market prediction of three rate hikes in 2022 with the futures curve reflecting a near-50% probability of a March liftoff, the Fed is following Powell's guidance that they strive for a "tight, but stable" labor market.

Fed Policy Boosts Stocks, Hurts Bonds

It seems reasonable to expect that the Fed will get what it wants, at least in the short-term, just as it has been able to generate inflation while nominal rates have ticked up. To date in 2021 this nominal yield up/real yield down paradigm has been fostered by most developed market central banks, and has led to strong equity market returns paired with negative bond performance. If 2022 also sees global stock gains paired with global bond losses, it will mark the first time this has occurred in consecutive years since BlackRock began keeping tabs on such data in 1977.

A Rare Combination



Index proxies are the MSCI All-Country World Index for equities (MSCI World before 1988) and Bloomberg Global Aggregate Index for bonds (U.S. Aggregate before 1991). Sources: BlackRock, "Weekly Commentary" as of December 13, 2021, with data from Refinitiv Datastream and Bloomberg.

While the broad US equity market appears set to cap a strong year, it was once again a year of 'haves' and 'have nots'. The last time we witnessed a market with strong overall returns but a significant percentage of stocks suffering big falls was '98 and '99. Perhaps a warning with respect to high valuations, and stocks that seemingly only move in one direction. Unlike recent years this wasn't necessarily a growth versus value dynamic, but a divergence that took place within the technology sector between 'safe' tech and 'risky' tech.

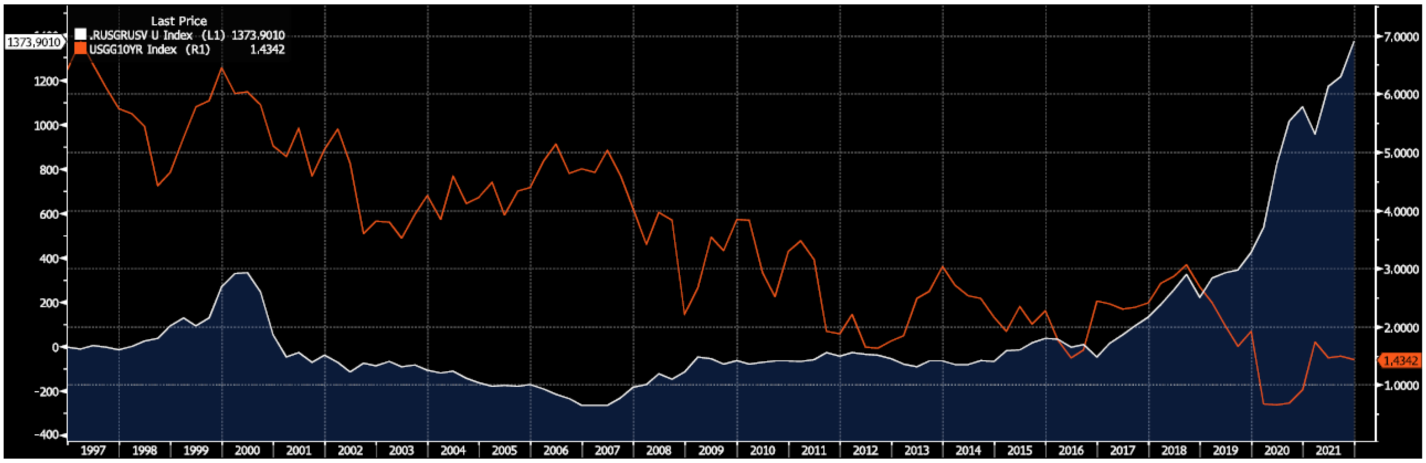
As with many of the market outcomes this year, this one appears to be driven by investors recognition that inflation and higher rates are looming and a determination that the highest valuation growth stocks should be avoided. For these stocks are generally valued by Wall Street using a discounted cash-flow model that compares growth to a risk-free rate. If the risk-free rate goes up than stocks whose growth is seen to be further out into the future are worth less, all else being equal. This is likely one reason that the most expensive tech stocks like PayPal, Twitter, and TripAdvisor have had periods in which they've gotten hammered this year while the biggest tech stocks like Apple, Microsoft, and Alphabet have generally rallied.

Lack Of Nasdaq Breadth

Sources: Blomberg; Crescat Capital LLC

Going forward if we're going to be moving into a new inflation and interest rate regime it warrants an analysis of how a portfolio could be tilted in an effort to seek tailwinds and avoid headwinds. The graph below depicts the positive relationship between growth outperformance and falling interest rates. If, as previously stated, rising interest rates could create a less favorable environment for tech stocks, it is logical to explore where might beneficiaries be found. Historically the answer has been that, broadly, the value style has fared better in such a rate environment. Within value there are three areas that appear compelling, each for different reasons: banks, industrials, and energy.

Falling Rates, Soaring Growth



Russell 1000 Growth Index price level is plotted on the left axis, and the US 10-year government bond yield is plotted on the right axis.
Source: Bloomberg, as of 12/6/2021.

Banks are poised to benefit from a steepening yield curve because it represents an opportunity to improve their net interest margin, derived from their ability to borrow short-term and lend long-term. Industrials should benefit from the seemingly intractable conditions of supply chain pressures and labor shortages. Companies are incentivized to invest in new capacity and automate production, which should bolster industrial and industrial tech stocks. Indeed, after languishing for the better part of two decades, capital goods orders have experienced a breakout. Further, non-residential investment was 6% below trend in Q3[i], an even bigger gap than that for consumer services spending. So, there is plenty of room for capex to increase further.

While banks and industrials represent segments of value that we are targeting for increased exposure, energy is a sector that we have allocated to via a concentrated manager who seeks out industries undergoing structural change. After decades of disruption to the status quo supply/demand dynamic, driven by the emergence of the US as the swing producer of oil and gas, COVID came along, shut global demand down in its tracks, and forced a significant swath of the domestic industry into financial distress. With the resultant structural change afoot, the excess supply has been taken out, prices have risen, and the remaining players are making money.

The industry has shifted from a growth model to a cash flow model, allowing companies to pay down debt while also boosting their buyback and dividend yield. As a group the valuations are also attractive—despite the fact that the average energy stock is on track to gain more than 50% this year the sector is still trading at a 65% discount to the S&P 500, or twice its historical discount[ii].

Value In Non-US Equities

Having lagged US equities for most of the last 12 years, post-Great Recession, will a shift in the macroeconomic landscape represent a shift in the relative fortunes of non-US equities? If indeed the value style is to return to favor, so too might the notion of geographic diversification. The three aforementioned pockets of value, plus materials, account for 45% of the MSCI All Country World (ex-US) Index but only 24% of the MSCI US Index. The opposite holds true for Information Technology and Communication Services, which represent 40% of the US index but only 19% of the non-US index.[iii]

A bottom-up analysis of major non-US equity markets paints a different picture depending upon whether the focus is on Europe, Japan, or emerging markets. In Europe we are starting to see the proverbial green shoots. After a decade of working to get their collective house in order, European banks are healthier, capex intentions have risen across the business sector, and somewhat inexplicably given recent fortunes, consumer confidence is even stronger in the euro area than in the US. Further, the troublesome conditions that have afflicted the economy here are somewhere between nonexistent and negligible there. Core CPI in the euro area has barely risen, firms are reporting few difficulties finding qualified workers, and wage growth slowed to an all-time low of 1.35% in Q3. Finally, the powerful twin engine effect of monetary and fiscal stimulus is still in close to full gear in Europe. While net asset purchases under the Pandemic Emergency Purchase Programme (PPEP) will end next March, the ECB is unlikely to raise rates until 2023. On the fiscal front, the IMF has estimated that the euro area will run a cyclically-adjusted primary deficit of 1.2% of GDP between 2022 and 2026, compared to a surplus of the same magnitude between 2014 and 2019.

Japan, on the other hand, may continue operating inside of the malaise that it has fostered for decades. COVID has meaningfully curbed growth, and while new Prime Minister Fumio Kishida has announced a stimulus package worth 5.6% of GDP, the impact of Japanese stimulus is often muted. Within the business sector capital expenditures materially lag other developed nations at this point in the recovery, primarily based upon the outsized role of the auto industry. What may be of more global significance than the fortunes of Japan is an understanding of whether Japan is an outlier or a harbinger. Many of its challenges are going to be faced by a myriad of other countries, including rapid ageing (by 2050 one in six people in the world will be over 65, up from one in 11 in 2019[iv]), secular stagnation, the risk of natural disasters, and the peril of being caught between China and the US.

There is a mixed bag of signals emanating out of emerging markets, but the most impactful determinants of performance will generally come from developments tied to China and the US dollar. Strength from the former and weakness in the latter would bode well for US investors participating in these typically high-growth markets. The Chinese economy itself faces crosscurrents. The positives include improvement in the state of energy affairs, as falling coal prices will lessen the burden on electricity production, where it accounts for 2/3 of generation, and a potential reduction in tariffs, as recently hinted by Treasury Secretary Yellen.

The peak pressure point for China remains the stress faced by its property market. Housing starts, home sales, and land purchases were down 34%, 21%, and 24%, respectively[v], in October relative to the same period last year. While steps including relaxed restrictions on mortgage lending and the outright cutting of mortgage rates should help, the longer-term problem is that China for many years has built too many homes. Their working-age population has peaked, and according to the UN it will decline by over 400 million by the end of the century. Japan faced a similar scenario in the early-90s and the problems it caused in the form of a gap in aggregate demand have been well chronicled. China has been more aggressive in delivering large-scale fiscal stimulus, so the hope there, and amongst its dependents, is that they will not be similarly afflicted.

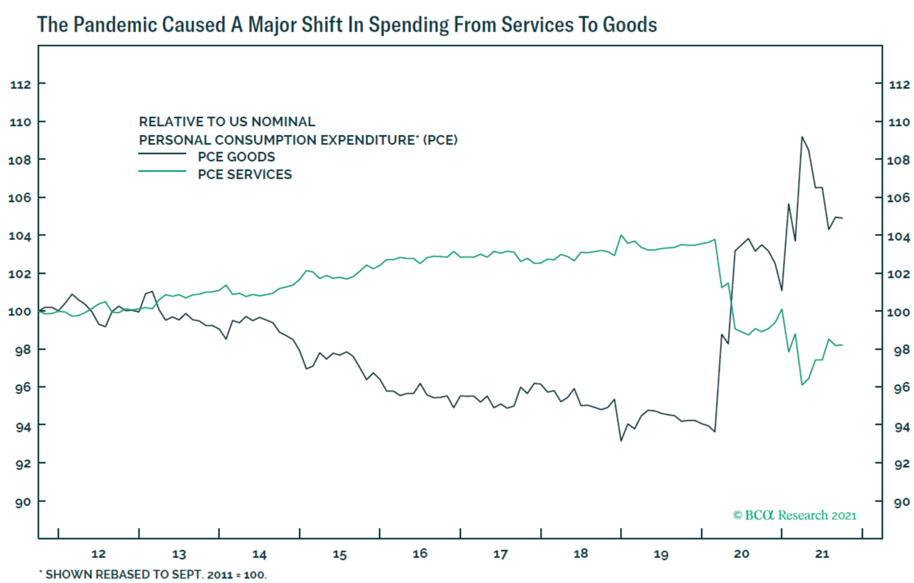
Of course, local market performance aside, for US investors what often matters most when investing in emerging markets is the strength of the US dollar. They generally fare best when the dollar is at its weakest. Today, near-term momentum favors the dollar in the short-term, but over a longer horizon when valuations take hold the dollar appears vulnerable. By Purchasing Power Parity (PPP) standards it appears overvalued by nearly 20%.

Of Shortages and Excesses

With the overdue recognition in early-December that inflation was not transitory, Fed Chairman Powell signaled that policy would be tightening while also admitting that, to that point, it had been misreading what was unfolding before its eyes. This sort of miscalculation by the Fed, causing it to fall behind the curve thus putting itself in a position to have to play catch-up, is precisely the type of action that could destabilize markets and the economy.

While dovish Fed policy created excessive liquidity in the system, leading to a surge in demand, COVID-related disruptions to supply chains and labor markets led to shortages and bottlenecks. Nowhere have shortages been more pronounced than in semiconductors, which has hit the auto industry particularly hard. The resultant decline in vehicle spending was responsible for shaving 2.2 percentage points off of Q3 GDP. Supply side pressures should abate over the coming months as some of these imbalances that have created shortages abate, but the respite may prove to be temporary, as the excesses enabled by the combination of easy fiscal and monetary policy won't quickly be drained from the system.

A Pandemic Driven Shift



Source: BCA Research, Global Investment Strategy, "Cross-Examining Our Inflationary Thesis," November 19, 2021

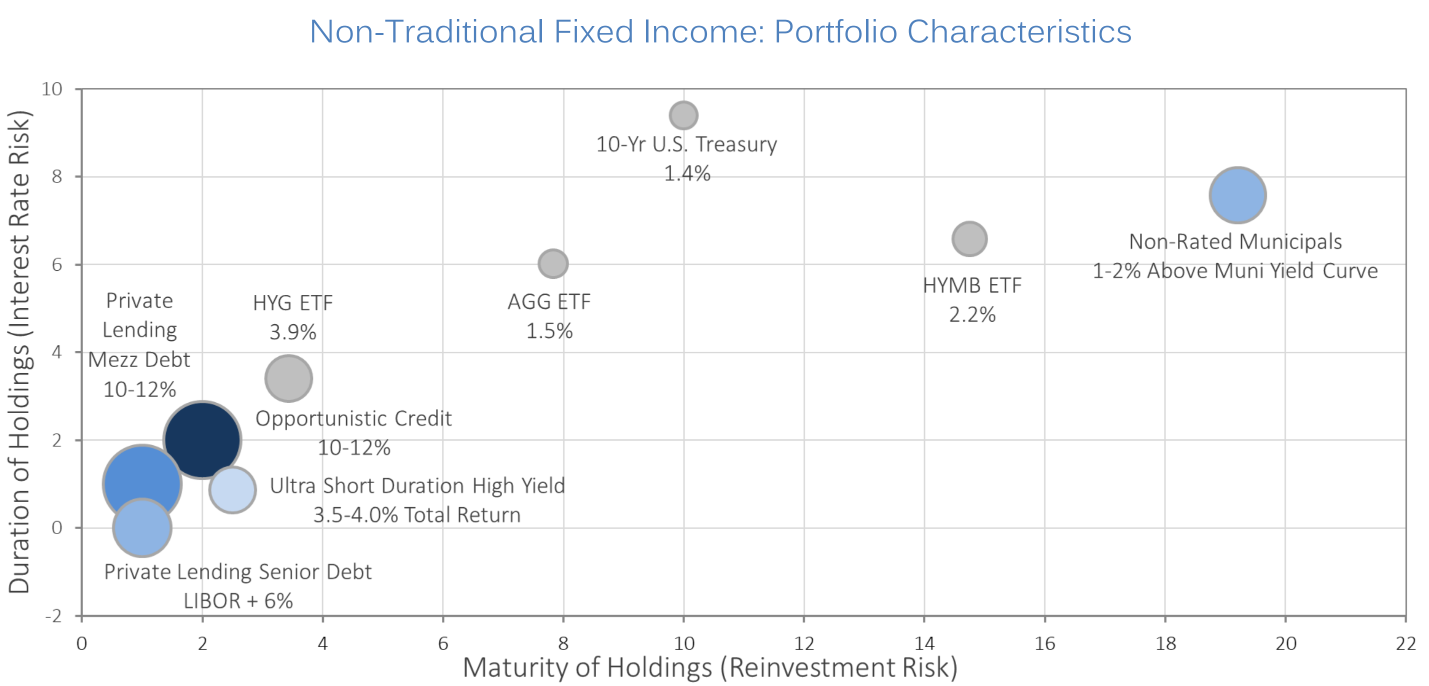
While access to goods was delayed by issues tied to supply, when most items hit shelves, they did not remain there for long. This was not the case with respect to services, many of which have been unavailable or unwanted due to COVID-related shutdowns and fears. This shift in spending from services to goods exacerbated the imbalances created by the pandemic and its responses. Demand for goods, still well above pre-pandemic trends, should moderate. The demand for services, below pre-pandemic trends, should continue to rebound with the spread of Omicron an obvious wildcard.

Aggregate demand should continue to be healthy because the financial standing of the US consumer is healthy. Households have accumulated $2.3 trillion in excess savings over the course of the pandemic, and after initially declining during the pandemic, credit card balances are rising again. With Wall Street excesses and home price gains layered on, household net worth has risen by 128% of GDP since the start of the pandemic. Estimates offer that this wealth effect alone could boost annual consumer spending by up to 4% of GDP[vi].

A New Era for Bonds

While, as discussed previously, different pockets of traditional equities can accrue benefit from shifting monetary policy regimes, almost all manner of traditional bonds are going to find rate hikes and reduced asset purchases to represent challenging conditions. That said, strategies that float with interest rates and those that benefit from a spread above fixed rates, such as private lending and collateralized loan obligations (CLO), appear poised to outperform.

With the financial wherewithal of many corporate borrowers buttressed by access to liquidity that may be in the process of becoming less plentiful, asset-based lending strategies where cash flows are not dependent on the performance of a corporate borrower, but instead on a pool of cash flow generating assets, appear attractive. They also have the benefit of greater yield and a shorter duration than many of their traditional fixed income counterparts. Also, credit and hybrid mezzanine strategies with flexible mandates across special situations and distressed are appealing. The unprecedented actions taken by governments and central banks kept the distressed opportunity at bay, but cracks in the system could be coming.



Source: Permit Capital Advisors, LLC, as of December 2021. The size of the bubble, as well as the number quoted in the label next to each bubble, indicates yield net of manager's management fee or ETF's expense ratio. The color of the bubble indicates PCA's approximate assessment of each fund's credit risk, with darker colors indicating relatively riskier portfolios.

We favor boutique-type managers that can take advantage of niche markets and originate differentiated financing opportunities in crowded markets. A sampling of these strategies and funds are reflected on the chart above. The chart highlights maturity (x-axis), duration (y-axis), yield (size of bubble), and credit quality (shade of blue).

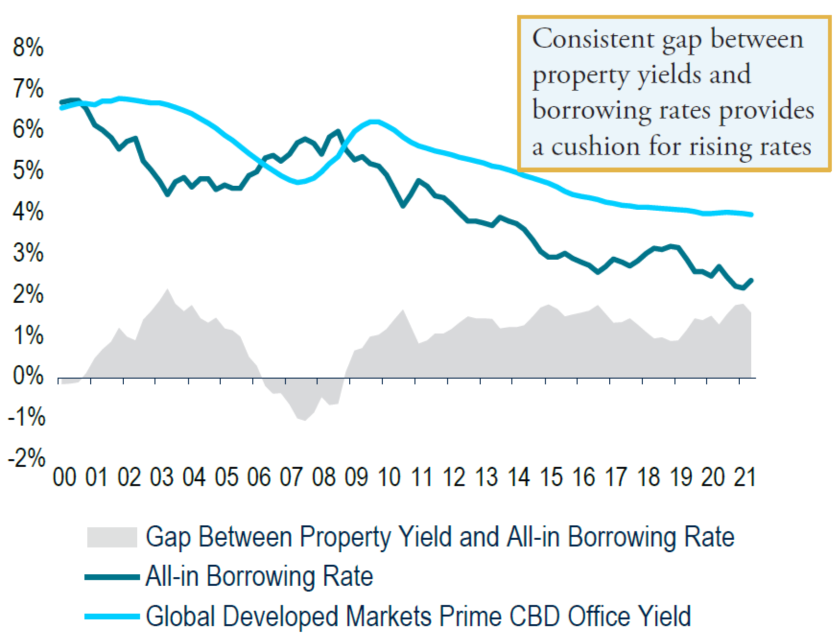
Portfolio Alternatives

Outside of allocations to equity and fixed income strategies, long-term wealth creation can be buoyed by exposure to alternative investments. Alternatives can be implemented that allow an investor to go on offense, by taking advantage of opportunities to generate outsized returns, or defense, by providing access to uncorrelated strategies that provide ballast to a portfolio and growth across market and economic cycles. We are currently focused on one in each camp – opportunistic real estate (offense) and absolute return hedge funds (defense).

After absorbing a body blow in 2020 as quarantines and closings wracked the landscape, in a number of real estate sectors the recovery that began in the second half of 2021 is on track to become an expansion, characterized by growing demand and rental growth. One driver of growth in the space is the proliferation of non-bank lenders looking to participate in real estate debt. Insurance companies, pension funds, and debt funds, have reliably stepped in and stepped up in the face of stricter bank regulation.

Across the capital structure, project participants are protected by the significant gap between property yields and all-in borrowing rates, providing significant surplus cash flows, putting them in good position to absorb the looming interest rate increases. Above-trend economic growth and demand for inflation-sensitive assets should continue to support real estate in 2022. On the public side, over the last 30 years REITs on average have returned over 16% when inflation was greater than 2%[vii], more than double their performance below this level.

Safety Spread



Sources: Bloomberg; Bayes Business School; CBRE; PMA; ACLI; Real Capital Analytics; PGIM Real Estate, "Trends for 2022."
Data is as of December 2021.

The hedge fund portfolio we manage, with a variety of underlying strategies, is designed to provide an "all-weather" return profile. We have had success utilizing the product in portfolios, partially in lieu of fixed income exposure which has more vulnerability in a rising rate, widening credit spread environment. While they are not as liquid as bonds in general, and they don't have an income component, they provide the low correlation to equities and the volatility dampener that bonds do in less extreme interest rate environments. We view them as a diversifier rather than portfolio insurance. The chart below reflects the performance of the fund in the face of equity market drawdowns since its 2002 inception.

Permit Capital Fund: Downside Protection Characteristics

Historical Cumulative Performance During Index Drawdowns

Time Frame	MSCI All Country World Index Performance	Permit Capital Fund, LP Performance	Difference
Sep. 2020 – Oct. 2020	-5.6%	+0.9%	+6.5%
Jan. 2020 – Mar. 2020	-21.4%	-5.7%	+15.7%
May 2019	-5.9%	+0.7%	+6.6%
Feb. 2018 – Dec. 2018	-14.2%	+3.5%	+17.8%
May 2015 – Feb. 2016	-13.4%	-5.3%	+8.2%
Apr. 2012 – May 2012	-10.0%	+0.2%	+10.2%
May 2011 – Sep. 2011	-20.5%	-0.6%	+19.9%
May 2010 – Jun. 2010	-12.3%	-2.2%	+10.0%
Nov. 2007 – Feb. 2009	-54.9%	-25.4%	+29.5%
Dec. 2002 – Mar. 2003	-9.6%	+4.5%	+14.2%

Historical Fund Risk Statistics Since Inception Relative to the Index

- Standard deviation of 5.9% for the Fund versus 15.3% for the Index
- Fund beta of 0.23 to the Index
- Around half as many down months (19%) as the Index (36%)
- During down months, average loss has been less than half of the Index's average decline of -3.5%

Information is as of 9/30/2021. Index is MSCI All Country World Index NR. Calculations are based on monthly data since the inception of Permit Capital Fund on October 1, 2002. For the purposes of the drawdown analysis, a drawdown is defined as a cumulative index decline of worse than or equal to -5%. Source: Permit Capital Advisors, LLC

Conclusion

Faced with volatile markets operating against a backdrop of a volatile world, the effort to mitigate cognitive biases is an important component of thoughtfully managing money. Another bias with relevance is the Dunning-Kruger Effect, which states that because those with a firm grasp of a situation know just how much they don't know, they tend to underestimate their ability. It is easy, on the other hand, to be over-confident when you have only a simplistic idea of how things really work.

From where we sit today, we are comfortable acknowledging the many unknowns, and dialing back risk given the wide range of prospective outcomes. We're in the midst of a secular equity bull market that began in 2009, making this one of unprecedented duration. Markets have had much thrown at them, but as we have reliably held, it typically takes a recession to create meaningful and sustained loss. If it is to come, it will likely be the deliverer of much of the cycle's positive developments, the Fed, that brings about this most negative of developments. If the Fed overreacts to events and raises rates too far too fast, resulting in a bear flattening of the yield curve, we'll have that outcome that we have avoided for over a decade. The most important real-time indicator to watch is the market's long-term inflation projections (TIPS breakeven rates), as the Fed takes great pride in keeping these expectations stable.

While we try to make sense of market and economic conditions, and the world around us, we are ever grateful for the support of a client base that continually challenges and inspires us to raise all aspects of our game. Thank you as always for your confidence, and please feel free to reach out to us with any thoughts or questions.

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[i] BCA Research, "2022 Key Views: The Beginning of the End," December 2, 2021

[ii] Barron's, Up & Down Wall Street, December 12, 2021

[iii] MSCI.com

[iv] The Economist, December 11-17, 2021

[v] BCA Research, "2022 Key Views: The Beginning of the End," December 2, 2021

[vi] BCA Research, "Cross Examining Our Inflationary Thesis," November 19, 2021

[vii] Cambridge Associates, "Outlook 2022: Flying At A Lower Altitude", December 2021