Investment Update

HEAD INVESTMENT PARTNERS

Q1: SHOCK & AWE LEAD MARKETS LOWER

Had we told investors that Russia would invade the Ukraine, China would shut down several major cities because of their Zero-Covid policy, and the Federal Reserve would make one of the most hawkish pivots in recent memory, investor expectations for returns would have been low.

While it's tough to argue that returns for risk assets fared great in Q1, it's also quite easy to see how they could have been far worse. Below is a quick look at how some of the major indices fared in the first quarter:

- S&P 500: -5.3%
- Russell 2000: -7.5%
- Barclay's Agg: -6.0%

As you can see, the broad bond index lagged equities again in Q1. In 2021 the AGG lost 1.5% and looks likely to end 2022 lower. For perspective, the index has only declined 4 times since 1979 and the YTD decline is more than twice as bad as its worst calendar year decline (-2.92% in 1994). It has never posted consecutive losses but seems likely to do so this year.

During the quarter, inflation continued its move higher, only accelerated by the Russian invasion of Ukraine. After a surge higher in 2021, energy and agricultural prices, as well as industrial metals all ripped higher. A peace accord might relieve some of the price pressures, but it seems reasonable to assume a portion of the Q1 move will be persistent.

Risk assets (equities and credit-focused bond strategies) have performed in-line with expectations YTD. The disappointments YTD have largely been found in the "uncontrollable"…repricing of assets based more on short-term emotion and headlines than merit. Ultimately, we believe that such price movements will be reconciled and that investors will be rewarded for being patient.

A QUICK GLANCE AHEAD…

In our look ahead to 2022 last quarter, we addressed our thoughts on many of the key variables for 2022:

- The Fed, supply chain, and inflation
- Covid-19 and the global response
- Earnings and health of the economy
- Equity and fixed income fundamentals

What we did NOT anticipate was the Russian invasion of Ukraine and the consequent movements in commodity prices and further disruptive impact on the global supply chain. We also did NOT expect the Federal Reserve to pivot as violently as they did earlier this year. Candidly, we wished they had stopped the Taper a few hundred billion dollars ago.

Looking ahead, many of the primary market drivers remain in-tact. The Fed will be the single most important driver of 2022, follower very closely by corporate earnings. As long as corporate earnings and consumer spending remain resilient, economic growth will continue to provide a foundation for the Fed to feel able to tighten conditions (both via rate increases and balance sheet reduction).

Entering 2022 we anticipated that we would see some inflation relief in the back half of 2022. The Russian conflict has extended the period of elevated inflation, but our base case remains that we will start to see inflation decline in the back half of 2022. It will not return to “normal” levels but should drop back to less imposing numbers later this year. Furthermore, as Covid restrictions are eased and global travel starts to normalize, spending on goods will likely shift more to services. Not only will this relieve some of the inflationary pressures on goods, but it will also likely provide a welcomed relief for the supply chain.

Unemployment levels are near record lows. Wage inflation has exceeded 5% over the last year. “Extra cash” on the sidelines relative to pre-Covid data suggests that the consumer has an additional $2 Trillion of resilience. Nobody is denying the headwinds consumers face (mortgage rates, home prices, auto prices, oil shock) but we simply believe that there is sufficient staying power given what we know today.

RISK/REWARD IN 2022

This is a follow up to a similarly named section of our year-end update. Our hope is to walk through some key asset classes and the role we feel each plays in the current environment.

Credit-sensitive fixed income: Despite the YTD selloff in bonds, we don’t believe investors can afford to abandon fixed income. Instead, we believe strategies that have limited/short duration and greater credit sensitivity are preferable. With a backdrop of record-low corporate and consumer defaults, we believe a strategic overweight to credit is both appropriate and essential.

Cash: In our opinion, cash is only a temporary repository for investors and has limited value as a strategic asset. The likelihood is that the cash real yield will be something worse than -5% in 2022 (when one factors in yield minus inflation). Rather than trying to time markets with allocations to cash, we believe resilience and patience are warranted. Cash has no way to generate excess returns.

Commodities: As we’ve said throughout this update, inflation is high and likely to remain elevated for some time. Commodities can serve as a potential hedge against further geopolitical tensions, as well as a strategic hedge against rising inflationary pressures. After a 12-year period of index declines (2008-20), commodities look to have momentum and a place in investor portfolios for the foreseeable future.

Growth Equities: A significant portion of the early ’22 narrative spoke to the demise of growth equities (think Nasdaq stocks like FB, MSFT, NVDA, and TSLA). Many such names fell 30-50% from last fall to their March lows. While arguments can be made about valuations of these companies, it is also quite feasible that herein lies the next drivers of economic growth and cost efficiencies. We do not believe investors can afford not owning quality growth equities, but that they should own them in the hands of an active and disciplined manager. Risk-aware investors may want to limit exposure to more speculative segments of the growth space.

Income-focused equity strategies: Strategies in this bucket can include traditional dividend growers, as well as covered call solutions. Conceptually, a strategy with a 4-6% distribution yield has a lot smaller gain required to reach an 8-10% target return. In practicality, these strategies are often among the most resilient and best performers in choppy / sideways market environments.

Buffered “core equity” strategies: Whereas most strategies rely on manager skill to outperform an underlying index, buffered solutions structurally build in their potential for index-outperformance. By enabling an investor to maintain exposure to risk assets, buffered ETFs work al lot like most equity strategies. By structurally buffering against a portion of potential losses, they allow investors a concrete way to mitigate some market risk during challenging times. With a foggy crystal ball, we believe these reasonably new solutions are highly valuable.

Our team firmly believe that constructing a portfolio in 2022 must look different that it did 5 years ago. We believe the role traditionally played by long-duration core fixed income should be significantly transferred to other solutions. This shift will not be permanent but may last for another 3-10 years. When one studies risk/reward in core fixed income, it's quite feasible to see something akin to a "Lost Decade" for the Barclay's Agg (yield of ~2% with a duration over 6 years). Our preference and the odds, we believe, favor owning a well-diversified basket of risk assets alongside a diversified mix of liquid credit.

DURATION: WHY INVESTORS SHOULD CARE

In an industry filled with jargon and technical terms, ***duration*** generally fits that bill. UNTIL NOW.

Duration is among the least used terms during an equity bull market and falling interest rates. Duration is a measurement of a bond's interest rate risk that considers a bond's maturity, yield, coupon and call features. These many factors are calculated into one number that measures how sensitive a bond's value may be to interest rate changes.

With the Fed having raised rates once and the prospect for several more rate increases ahead, duration is the single best way of recognizing when a train may be headed toward you.

Many investors think of bonds as income vehicles that mature at par. While that may largely accurate, the price of a bond during one's period of ownership (or as part of a bond portfolio of an ETF or Mutual fund) will fluctuate largely as a function of its duration. The example below from PIMCO shows the potential impact on price of owning a long-dated bond when rates rise and fall. Earlier we referenced that the Barclay's AGG has a yield of ~2% and a duration of over 6 years. An increase of 2% across the curve would correspond to an expected drop of 12% in the price of the bond mix. With only a 2% coupon to offset the move, the likely pain would be severe and swift (as YTD 2022 has already shown).

Given the current expectations for rising rates, one might wonder why own bonds at all. Diversification is a key part of the "why." The other key element, we believe, is how you own bonds. For example, rather than a portfolio with a 6-year duration and a 2% yield, consider a mix with a 5.5% yield and a duration of 2 years. Such a portfolio, using the earlier 2% move in rates example, would project a +1.5% return expectation.

We cannot fully insulate a portfolio from all risks associated with bonds, but we can choose carefully where to intentionally maintain some level of risk exposure. In our portfolios' credit exposures, we believe we maintain exposure to assets that a well-secured, less rate-sensitive, and highly liquid. We continue to actively monitor our positions and maintain regular dialogue with our largest portfolio management teams.

GAUGING INTEREST RATE SENSITIVITY

Bonds with longer durations experience greater value fluctuations.

1% rise in rates		
Duration	**% NAV change**	**Resulting value**
1 year	–1%	$990
5 years	–5%	$950
10 years	–10%	$900

Initial value of $1,000

1% drop in rates		
Duration	**% NAV change**	**Resulting value**
1 year	+1%	$1,010
5 years	+5%	$1,050
10 years	+10%	$1,100

The duration figures quoted do not relate to any specific PIMCO product.

CURRENT POSITIONING

As you have read throughout this update, our portfolio construction in 2022 looks meaningfully different than many of our peers. Below are a few of the key elements we believe are both differentiated and critical for what lies ahead:

Fixed Income: Currently most of our allocations to fixed income live in one of 3 primary sub-classes: municipal credit, floating rate/limited duration, and high yield. Each of these offers meaningful yield advantages over core bonds and helps us shorten duration exposure. This led to meaningful outperformance in 2021 (vs. the AGG) and has outpaced the index again YTD.

Commodities: Beginning in February, we introduced a diversified commodity ETF into many portfolios. This strategy offers exposure to futures on agriculture, energy, metals and livestock with no leverage. We also have added to our commodity-sensitive businesses through the energy sector ETF and select energy companies.

Core Equities: This segment of our exposures is among the least changed in recent months. We continue to maintain exposure to time-tested and high-confidence active managers. We do not hire/fire these managers based on a tough quarter or year, but on their body of work and sustainability of their process. Overall, we believe this group will lead to meaningful outperformance as markets bounce around in the coming quarters.

Covered Call Strategies: This allocation is among the most increased exposures across portfolios in the past year. A combination of in-house strategies and active ETFs allows us to maintain greater equity exposure while still managing volatility and downside risk. Each of the ETF approaches varies slightly, but all seek to provide a stream of cash flow (ranging from 4.5-8% per annum) as part of their total return objective. In an environment where bond yields remain low and corporate earnings are slowing, the cash flow generated from covered calls can provide us a meaningful contribution to one's total return and cash flow goals.

Buffered Strategies: These solutions allow us a daily-liquid ETF exposure to index-based structured solutions. Buffered ETFs off a way to tilt the odds of an acceptable outcome from equity exposures in our favor. With expectations of volatility ahead, these tools can help insulate clients from "Murphy's Law." Ultimately, we believe buffered ETFs and Covered calls allow for greater equity exposure in a risk-conscious manner.

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