January 31, 2020

"A rigid mind is very sure but often wrong. A flexible mind is generally unsure, but often right."

- Vanda Scaravelli

Dear Client,

It is probably hard to remember after a week or so of coronavirus fears, but during Q4 2019, "risk" assets once again outperformed "haven" assets.[1] This was after two quarters of "haven" asset outperformance. During the fourth quarter, equities led the way, up 9.0%, and commodities were a close second, up 7.7%. In the "haven" category, gold was up a modest 2.9%, while long-dated US Treasury bonds were down 4.7%. For the full year, all four primary asset classes were positive, and meaningfully so: equities were up 31.2%, gold increased 17.9%, commodities improved 15.6%, and long-dated US Treasury bonds gained 14.1%.[2]

For additional benchmarking purposes, we look at a global equity index and a broader bond index to get the most comprehensive perspective. The 60/40 mix is the basic asset allocation benchmark, and with good reason, it is a very hard standard to beat over a full market cycle.[3] For 2019, the MSCI All Country World Index[4] was up 26.6%. The iShares Core US Aggregate Bond Index[5] was up 8.5% for the same period. A typical 60/40 mix was therefore up 19.4%.[6]

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[1] We refer to US equities, long-dated US Treasury bonds, gold, and commodities as "primary" asset classes borrowing the language of HCWE & Company. The idea is that these four assets best capture two variables that explain a significant amount of asset price movement: global growth (explained by investor risk sentiment) and inflation. This framework is the basis for a permanent portfolio, an "all-weather" portfolio, risk-parity, etc. US equities and commodities are "risk" assets, while US Treasury bonds and gold are "haven" assets.

[2] The market (or asset class) returns are measured on a total return basis using index exchange traded funds (ETFs): SPY for the S&P 500, GSG for the S&P GSCI Commodity Index, TLT for 20+ Year Treasury Bond index (i.e. "long-dated" US Treasury bonds), and GLD for gold.

[3] A full market cycle would be either peak-to-peak or trough-to-trough.

[4] We use the ACWI ETF to measure the MSCI All Country World Equity Index.

[5] We use the AGG ETF to measure the iShares Core US Aggregate Bond Index.

[6] Technically, if one wanted to create a global 60/40 equity/bond benchmark they would use a global bond index. We are not aware of a global bond index ETF to track. We could incorporate IAGG, which is an international sibling of AGG, but that starts to get too messy and it would barely change the numbers above.

Where to from here?

Some observers believe 2019's significant price gains portend a pause in "the everything" bull market; "too far too fast," as the saying goes. Our favorite barometers of market sentiment actually suggest a continuation of the current bull market in equities, albeit at a slower pace, and notwithstanding a major global coronavirus contagion. HCWE's credit spreads & gold framework and Lowry Research Corporation's Market Trend Analysis both continue to signal an equity bull market that is intact. However, both research groups offer important context regarding the near term. 2019's significant equity gains came on the heels of a meaningful drawdown in the fourth quarter of 2018 when US equities (SPY) were down 13.5%. Additionally, in the recent move from the October 2, 2019 low to the January 17, 2020 high, US equities (SPY) gained 15.8%. That context means 2019 started at the bottom of a selloff and ended with a rapid move higher – two short-term extremes.

Perhaps the past two years combined offer a better perspective. 2018 followed a strong 2017 for equities, but US equities (SPY) finished 2018 down 4.6%. The combined US equity performance for 2018 & 2019 is 25.2% or 11.9% annualized. A solid performance, but far less extraordinary than 2019's 31% gain seems to indicate.

Grey Owl Performance in Context

Returning to the 60/40 blend of the MSCI All Country World Index and the iShare's Core US Aggregate Bond Index we get a two-year performance through 2019 of 12.5%. Or, 6.1% annualized. Again, a solid performance for a balanced, global benchmark. For that same period, a representative account of Grey Owl's "growth" strategy returned 19.6%.[7] Or, 9.4% annualized.

We think the two-year 60/40 index return is particularly relevant given its starting point marks a meaningful evolution in our investment process. Towards the end of 2017, we accelerated many process changes we were developing between 2014 and 2017. Clients have seen those changes in their portfolios, they have experienced them in their returns, and we have discussed them on an ongoing basis in direct communication and via these quarterly letters. Still, now is a good time to summarize.

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[7] Grey Owl runs essentially two strategies for clients. The "growth" strategy is heavily invested in equities, but continually adjusts a mixture of assets that also includes bonds, gold, and commodities. The equity mix includes both US and foreign domiciled securities accessed both directly and occasionally via ETFs. The other strategy is a low-volatility fixed-income strategy.

What drove the Grey Owl process adjustments?

For the past 10 years, "value investors" faced a significant headwind. The chart below compares the IUSG ETF (US growth) and the IUSV ETF (US value) in a ratio since the beginning of 2010. The exchange traded funds (ETFs) use statistical attributes to categorize stocks into growth and value and then purchase a basket of each. Since 2010, stocks with "growth" attributes have outperformed "value" for almost the entire decade. (That is what the ratio moving from the bottom left to the upper right in the graph indicates.) While qualitative investors (e.g. Grey Owl) have more flexibility and therefore a meaningfully different profile than quantitative/statistical portfolios such as IUSV, any "value" bent has none-the-less been a headwind. There were many factors, but certainly, an "evolve or die" attitude drove our process adjustments.

The Grey Owl Investment Process Today

Today, our process remains value-oriented, though even less focused on mathematical or statistical value. We continue to worry a lot about downside protection, though we are less inclined to hold cash just because equities look statistically expensive. More explicitly, there are four areas where our process is meaningfully different today than it was two years ago.

1. **Allocating equity exposure.** When we started Grey Owl Capital Management, we used quantitative frameworks to measure the current overall stock market valuation compared to its historical variation. This meaningfully affected the percentage of equities we would hold in a portfolio. We still look at these measures but with far more skepticism and a belief that if they do matter, it is over very long periods of time (7-12 years). Today, inter-market and sentiment research plays a far greater role in determining the percentage of equities (and other asset classes) we hold in portfolios.

2. **Broader asset class exposure.** In addition to altering how we decide what percentage of portfolios equities comprise (allocating the remainder to cash or short-term bonds), we have expanded the number of asset classes we utilize in portfolio construction. Typically, ETFs provide exposure to other asset classes and segments that appear favorable based on a growth and inflation framework. These other asset classes include long-dated government bonds, gold, and commodities. Further, we also incorporate broad global equity markets and quantitative strategies that complement the "value" bent that has been our core-style historically (e.g. momentum).

3. **More holistic view of value.** Within the "value" framework, today we focus far less on beaten-up ideas that look mathematically cheap. If a computer can figure it out (e.g. low price-to-book) we are more skeptical we have an edge. We are less likely to invest in ideas that have "left-tail skew" (i.e. almost impossible to provide a 10x return, but very possible to provide a negative return, even if expected return is a solid positive number). Commercial banks frequently appear in value screens, but they are a straight-forward example of left-tail skew. It is very hard to see any financial lender provide the type of return a disruptive technology company can, so the right-hand tail is contained. The average bank will generate a positive return on equity, but every once in a while (barring government intervention) a lender's bad loans combined with leverage can lead to bankruptcy. Negative optionality is another way to phrase this concept. In most cases, we want to avoid that.

4. **Execution: timing and position sizing.** Today we incorporate a greater focus on sentiment and to some degree technical factors. Previously, "cheap" was enough to get us to buy a security. Now, we also want to have a sense of where investor sentiment stands regarding a particular security. For instance, we purchased Facebook (FB) in early January 2019 just after Mark Zuckerberg testified before the US Congress regarding privacy and "fake news." Likewise, we purchased Altria (MO) in October 2019 when vaping deaths were on the cover of Time magazine. In both cases, these names looked

> cheap to us for quite a while (tobacco for years), but kept getting cheaper. We wanted some indication pessimism was near a peak (e.g. a Congressional subpoena) before we acted. Today, we are more inclined to buy a rising trend than to try to catch a falling knife. Likewise, we apply a similar framework to our sell discipline.

We still like value.

As proof our process changes are more evolution than revolution, we submit our most recent purchases in the energy sector. In late December, we initiated a starter position in the energy space via three ETFs. If you look at any "value" index, the energy sector represents a significant component. After years of US shale oil growth flooding the market with new supply, the oil price has fallen from a peak of over $120/barrel in 2008 to just over $50/barrel today. In 2016, oil touched a low under $30/barrel. Despite an oil price increase over the last three and a half years to over $50/barrel, most energy equities are lower today. Sentiment is awful and at the end of 2019 when almost every equity was up, most energy names were down and proved a very limited source of tax loss selling that drove them lower still.

Our belief is that sentiment regarding supply and demand is near a trough. (This has clearly been exacerbated by coronavirus since we first initiated a position.) There are meaningful data that indicate US shale oil (the only source of global supply growth) has reached a peak. If this proves true, (barring a recession) the supply plateau could influence oil prices higher within the next six-months or a year. And, yes, at 3-4x EBITDA on operating companies and almost 10% yields on energy infrastructure MLPs, energy equities are cheap.

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Within "growth" portfolios, the bias is still toward risky assets but with an inflation bent. We will continue to adjust the portfolio as conditions change and opportunities present themselves.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC