October 23, 2020

> *"When you sit with a nice girl for two hours you think it's only a minute. But when you sit on a hot stove for a minute you think it's two hours. That's relativity."*
>
> – Albert Einstein

Dear Client,

2020 has proven a challenging year for numerous businesses and individuals, Grey Owl Capital Management included. While most domestic stock market indices have fully recovered from the February and March Covid sell-off, many of our accounts are still down slightly on a year-to-date basis through the end of September. That leaves our relative position to indices and benchmarks worse off than when we wrote to you in early 2020. Nonetheless, our success in 2018-2019, bolsters our outlook today. The economy and markets are complex adaptive systems and investment processes need to adapt too.

At the beginning of the year, we described several process adjustments that led to outperformance in the 2018-2019 period. Today, a new examination of our process amidst the Covid pandemic has us enhancing our approach once again – this time to incorporate even shorter time horizons, specifically during periods of increased volatility. Our high-level objective is to provide a smoother ride through the ups and downs of the market and protect capital in times of volatility to avoid the cruel math of big losses.

While Covid is unique and the resultant economic and market volatility were and are extreme relative to most historical precedents, the lessons are applicable to less exceptional scenarios. Investment regimes are relative, just like Einstein's description of the physical world. In any regime of elevated volatility, investment time compresses, and space expands. Price movements are faster and can stretch farther (in both directions) than during periods of relative calm. The most robust investment processes take this into consideration, and our aim is to do that going forward.

Continual Process Refinement

Before delving into our latest process improvements, it might be helpful to summarize what we discussed at the beginning of the year. In our January letter, we described a successful two-year period covering 2018 and 2019 where a series of adaptations to our investment process resulted in our model accounts outperforming relevant benchmarks while maintaining diversification and downside protection. The process changes were developed over several prior years and were aimed at adjusting the Grey Owl approach to the realities of the current economic, political, and investment market regime. During that time, what began as an almost purist value investor approach expanded into a much more holistic method of investment.

What are the environmental realities we adapted to? On the economic front, slower growth and more debt are the current reality. Politically, it is a normalization and expectation of government stimulus and intervention at the first sign of economic difficulty. Regarding financial markets, it means suppression of short-term volatility that inevitably transfers instability to less frequent, but more concentrated bouts of extreme price movement. In US equity markets, there have been six bouts of volatile drawdowns in the past 2 years: Q4 2018 (21%), April 2019 (8%), August 2019 (8%), September 2019 (6%), Feb/March 2020 (36%), September 2020 (11%). The end result being the S&P 500 is up just over 13% in the 2 years ending September 30. Annualized that is 6.6% per year with six drawdowns that averaged 15%. Importantly, this includes the spectacular recovery from the bottoms in March aided by $3T of government monetary and fiscal support.

One of the core ideas behind the process changes was the need to make investment decisions with shorter time periods in mind. Since late 2017, our historical requirement to incorporate asset class valuations and big structural economic "challenges" like country debt-levels were no longer driving factors in our investment decisions – these are in fact "realities" too, but history shows they typically take decades to resolve – too long a time-frame for (almost all) investment decisions. Our approach since late 2017 added elements of market sentiment and intermarket analysis. To effectively express these signals in client portfolios, we expanded the investment pallet beyond stocks and bonds to include commodities, currencies, precious metals, and factors (e.g. momentum). Our time horizon shrank from three to five years or more to closer to one to two years. While we still maintain a "value investor" framework to inform our portfolio management and investment choices, since 2017 it is no longer the singular or primary factor guiding our decision making.

The adjustments worked well. Then the Covid pandemic hit. Here is what we wrote in April of this year:

> "Going into the Covid-19 pandemic, our portfolio had significant exposure to travel and hospitality businesses and financial services. Some of the hardest hit sectors, these positions negatively impacted performance relative to indices. While modest, our energy exposure hurt too. On the positive side, our focus on maintaining an 'all-weather' structure helped as long-dated Treasury bonds and gold rallied during this period. Balanced and fixed income accounts performed much better, though those accounts incurred drawdowns as well.
>
> When we became convinced the economic fallout from the pandemic and associated government reaction was likely to be as negative as anything we have experienced in our lifetime, we began a process of lightening equity exposure."

In the same April letter, we discussed "Knightian Uncertainty,"[1] an occurrence that was out of historical bounds, and thus a limit to knowledge and a true unpredictability regarding future events. With that backdrop, our primary focus was to protect client portfolios from catastrophic downside. So far, so good.

Then, the government passed legislation providing trillions of dollars of direct aid to consumers and businesses and the Federal Reserve injected trillions of dollars of liquidity to allow financial markets to clear and for debt-strapped large businesses to refinance. These actions happened just weeks into the pandemic. This was lightening speed compared to the 2007 to 2009 "global financial crisis," when some of the most significant government aid took years.

In addition, the government reaction to the virus itself morphed. A 3-week lockdown to "flatten the curve" turned into six-months-plus of government edicts restricting movement and commerce. Digitally adept mega-businesses, the market leaders pre-Covid, thrived at the expense of "mom & pops." Momentum kicked in. And, the fastest bear market recovery in history developed.

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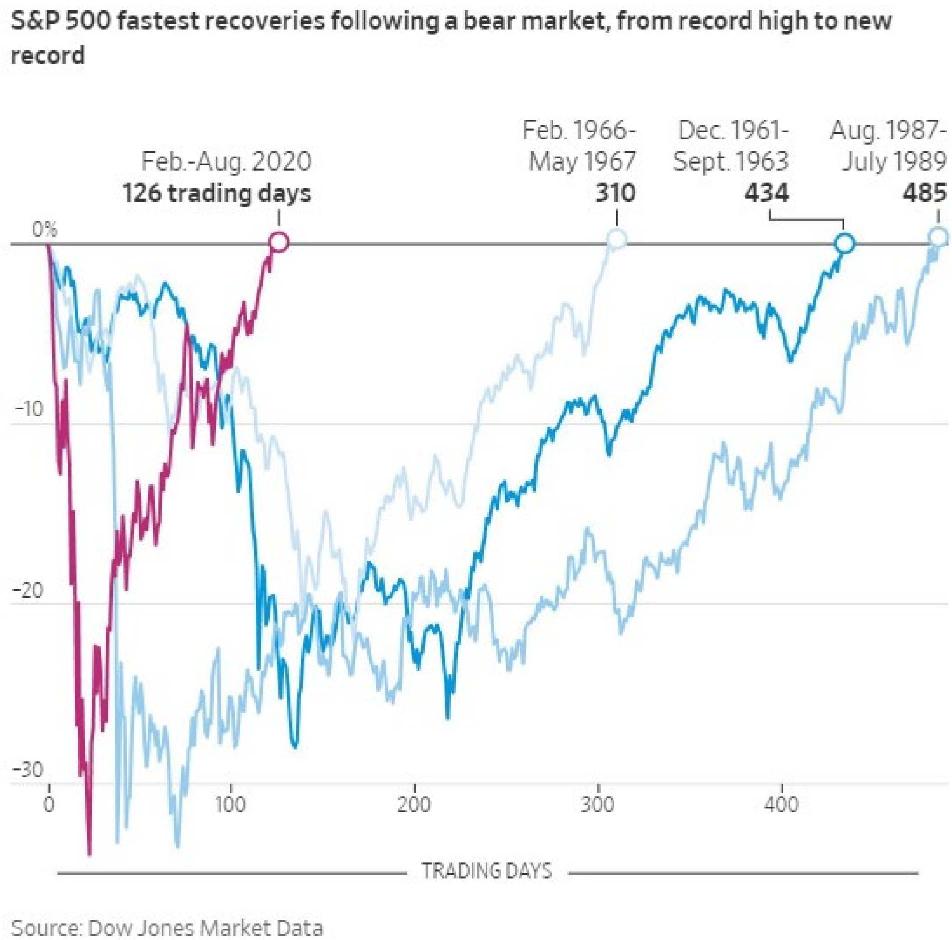
[11] From Wikipedia. In economics, Knightian uncertainty is a lack of any quantifiable knowledge about some possible occurrence, as opposed to the presence of quantifiable risk. The concept acknowledges some fundamental degree of ignorance, a limit to knowledge, and an essential unpredictability of future events. Knightian uncertainty is named after University of Chicago economist Frank Knight (1885–1972), who distinguished risk and uncertainty in his 1921 work Risk, Uncertainty, and Profit: "Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated.... The essential fact is that 'risk' means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating.... It will appear that a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all."



From the Wall Street Journal's Why Did Stock Markets Rebound From Covid in Record Time? Here Are Five Reasons[2]

As the market recovery advanced, we remained focused on the realities of underlying economic and business fundamentals. Absent government intervention, the economy was in shambles and the decrease in corporate cash flow impaired the debt structure of multiple large business sectors. If the lockdowns continued, wouldn't additional stimulus be needed? Would it pass? Either way, the inflection was just months away. Wouldn't the market look forward skeptically? But, the market did not care. The government intervention created a few months bridge and that was all that mattered. Market sentiment indicators gave the all clear for an undefined period of time that might last weeks or months <u>but our shorter-term time horizon (one to two years) was still too long</u>. Upon reflection, we should have reacted faster and added risk assets in

[2] https://www.wsj.com/articles/why-did-stock-markets-rebound-from-covid-in-record-time-here-are-five-reasons-11600182704

the sectors that "benefited" from the pandemic and where market sentiment indicators were strongest.

Going forward, many of the same indicators we added to the process in late 2017 can function in similar fashion over shorter time periods. The new insight is that in periods of extreme volatility, we need to focus on shorter time horizons. The goal is not to remove volatility and drawdowns – that is impossible. Additionally, the new process enhancements will not impact the core of our portfolios, much longer-term allocations. Rather, they will allow us to confidently adjust around the edges and take some additional risk when appropriate. The downside (or cost) is that these positions are more prone to whipsaw – in and out with minimal gain or modest loss. The upside is the opportunity to better align with current market sentiment.

Implementation

Regarding traditional risk assets, we have already begun to slowly implement our process refinements. We added sector exposure to utilities (XLU) and most recently real estate investment trusts (XLRE). While we trimmed our exposure to big capitalization technology (QQQ) into the September frenzy, we will look to opportunistically add back that exposure pending the necessary sentiment indicators.

Refinements to our process are most easily seen in our recent actions in inflation hedge assets. The conclusion to our July letter included the following paragraph:

> "Speaking of inflation, we are slowly adding additional exposure designed to protect against nominal price increases that erode purchasing power. A weak dollar, rising commodity prices, and a continual bid for gold all corroborate the idea that the federal deficit ($2.7 trillion dollars in the first nine months of fiscal 2020[3]) will result in a currency that loses value. We recently initiated a position in IVOL. This security bundles a portfolio of Treasury Inflation Protected Securities (TIPS) with options that would benefit from increased inflation expectations. Look for us to opportunistically add commodities and emerging market equities in the weeks and months ahead."

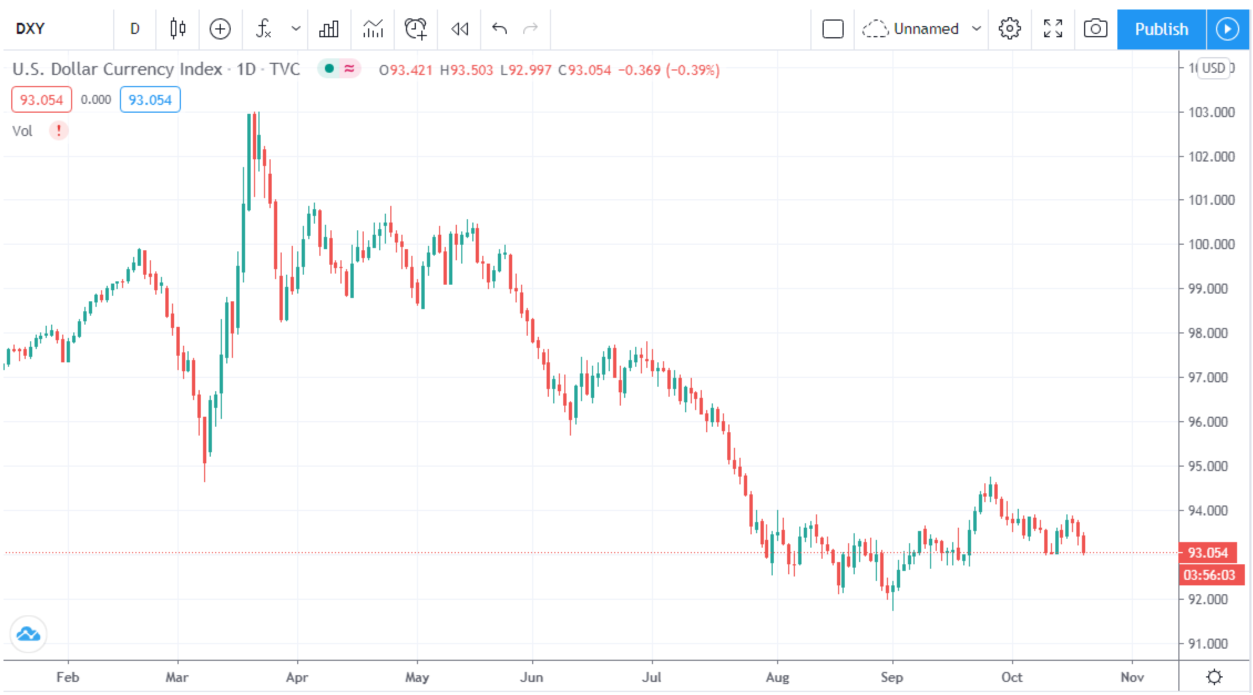
As inflation signals persisted, we increased our inflation exposure by adding TIP (Treasury Inflation Protected Securities), PDBC (a commodity basket), and EEM (emerging markets), and

[3] https://www.cbo.gov/publication/56458

increasing our core GLD (gold) holdings – all areas that historically performed well in weak-dollar, inflationary environments.

Yet, we recently sold our PDBC and EEM positions and slightly decreased our GLD holdings, a far more rapid reversal than anything we have done historically. While we think the odds of further inflation are good, we also recognize that everyone was concerned about inflation in the 2009 period of significant government spending and Federal Reserve "money printing," but it never came in the extreme form that worried folks. We also consider that while further fiscal and monetary stimulus are likely, they were not here when we made the sell decision, and markets can move significantly while waiting for lawmakers to reach agreement.

There are many indicators we watch, but the dollar index is a simple one to convey the concept. The dollar weakened from April into September, creating a tailwind for inflation and inflation hedged assets. This encouraged our exposure to inflation assets. Then, in September, the dollar stopped weakening and its stability (and even modest strength) persisted for weeks. That was a primary driver for us to lighten exposure to inflation hedges. A persistent move up or down would cause us to adjust again.[4]



It is important to emphasize again, as with all of our process changes, they are mostly incremental, not binary or all encompassing. We intend to maintain an "all weather" portfolio core throughout most environments. These adjustments are around the edges.

[4] As we write, the dollar appears on the edge of resuming its down trend, so you may see us adjust again soon.

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We continue to own equities whose businesses we believe can do well in a challenging economic environment. We still hold modest positions in excellent companies whose businesses have been hit directly by the lockdowns, but have staying power, and would be worth significantly more in a full recovery. We have added exposure to utilities and REITs, as discussed above. We still hold "hedged" exposure to equity via the Hussman Strategic Growth Fund (HSGFX). Recall, this vehicle is designed to gain some upside exposure should equity markets continue to rally, while offering significant downside protection.

We continue to hold "safe-haven" assets in the form of long-dated US Treasury bonds that should do well in a world where everyone is scrambling for dollars. They should also provide a positive return if the additional economic contraction we think is possible develops. Gold, another "safe-haven" asset, remains a core holding and should perform well in an eventual modern debt jubilee where the Federal Reserve (and other central banks) retire the excess debt via even more extreme quantitative easing. We still have some specific inflation-hedged exposure in the form of TIPs and IVOL.

Finally, we continue to hold a significant amount of cash as a source of stability and optionality, but are actively looking to put it to work as investor sentiment points to continued risk taking.

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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