LNWM Quarterly Commentary – Q4 2021

By Ronald G. Albahary, CFA® and LNWM Investment Strategy & Research

Let The Good Times Roll…

> "Let the good times roll, Let them knock you around
> Let the good times roll, Let them make you a clown"
>
> **– The Cars**
> "Let the Good Times Roll,"
> Release Date: June 6, 1978

With the tragic consequences of the COVID-19 global pandemic, the last way to describe the current environment would be "good times." With that said, if you were to wake up from a deep sleep that started toward the end of 2019 and the first thing you saw was the cumulative performance of the equity markets since then, you would think these times are the best of times.

But, as the Cars' song intimates, good times can make you "a clown" especially ones during which markets resemble a funhouse as they continue to levitate without the semblance of much downside risk. How? Well, over my 30 years managing portfolios, I have seen time and time again investors fall into the trap that this time is different. Today, prognosticators cite so many reasons for the markets to continue to rise – low interest rates, unprecedented stimulus, TINA (i.e. there is no alternative), blah, blah, blah.

While the talking heads on the financial media of your choice are striving for zingy quotes and sensational predictions, we are in the goal achievement business. As professional investors, we take comfort in our ability to thoughtfully construct and manage portfolios with discipline and dispassion, infused with specific investment strategies to address the most likely risks, opportunities and scenarios that could arise. If we do our jobs well, hopefully you can let the good times roll in your non-financial lives while your financial lives are being stewarded through good and bad markets.

LNWM Investment Process & Philosophy: A Strategic Business Plan for Investing

Those who think they can predict the future in any facet of the capital markets are either hubristic, delusional, or inexperienced. Instead of focusing on forecasting, we apply our intellectual energy and time to helping each of our clients accomplish their goals through what I call a "strategic business plan for investing."

We start by establishing an overall asset allocation that aligns with each aspect of a client's financial plan (long-term goals, needs, constraints and aspirations) and the multiple facets of risk the client can, should, and wants to take.

Next, we populate that allocation with a variety of investment strategies — what I like to call "ingredients" — that when combined create a portfolio with the resilience to navigate bull and bear markets, minimizing the risk of derailing the client's long-term plan. Finally, we focus on reducing the impact of taxes and fees, and when a client desires, enhancing the portfolio's impact on environmental and social issues.

Our process is in effect a strategic business plan for investing because it brings vision, structure, and discipline to the management of wealth, regardless of the unknowable curveballs the future can throw at us.

Antidote to Market Timing

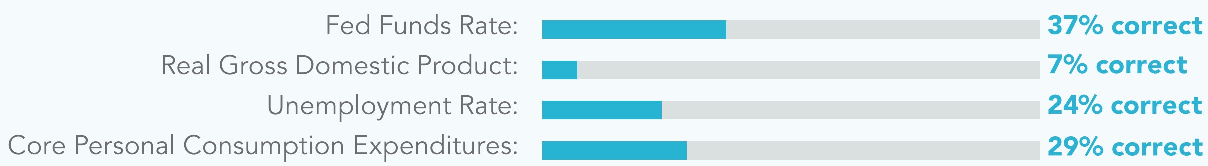
Doing our jobs well means adhering to our investment process and philosophy for preserving and growing wealth over very long periods of time. A core part of our process is maintaining well-diversified portfolios even when this may be frustrating or seem boring. During the past decade and into 2021, US equities have generally been in the pole position (see Q3 2021 Roundup on facing page). And it can be frustrating to see that you have other asset classes in your portfolio, such as emerging markets recently, that are lagging.

It's important to remember that today's market leaders can be tomorrow's laggards, as I have seen many times during three decades of investing. A well-diversified portfolio may seem more tortoise than hare; it will seldom – if ever – be a top performer in any one year. It's also likely to have exposures that are lagging relative to the others and/or relative to their benchmark in any given time period. That is both the power and one could argue the weakness of diversification. In my experience, without the benefit of perfect foresight, portfolios thoughtfully constructed with a well-diversified range of exposures, each with its own purpose, have been able to withstand market cycles—bull and bear—and stay well-positioned to accomplish client goals.

LOW BATTING AVERAGE EVEN FOR THE BEST & BRIGHTEST ECONOMIC FORECASTERS

The heralded Federal Reserve has armies of PhDs in economics, mathematics and finance, yet more often than not, their forecasts are generally unreliable. A recent study conducted by Rosenberg Research from 2012-2020 evaluated the Fed's accuracy in forecasting the four key economic variables shown below. Considering the Fed's record of forecasting growth is below baseball's Mendoza line (.200 batting average), I would say the FOMC's track record leaves a lot to be desired.

Federal Reserve* Quarterly Forecasts 2012 – 2020



Similarly, Wall Street forecasters consistently get it wrong, sometimes by staggering amounts. A recent *New York Times* article cited research from Bespoke Investment Group from 2000 through the end of 2019 and presented the following results:

Market Performance

S&P 500 Return Next 12 Months (2012-2019)

Wall Street Forecast: ▲ +9.8% avg. annualized
Actual S&P Return: ▲ +5.5% avg. annualized

Market Direction

S&P 500 Up or Down over Next 12 Months (2012-2019)

Wall Street Forecast: ▲ Up 19 years in a row
Actual: ▲ Up 13 years; ▼ down 6

*Based on Summary of Economic Projections from Federal Open Market Committee (FOMC) produced quarterly. Includes 110 total datapoints for each variable from 2012 to 2020, with the threshold for "correct" at +/- 10 basis points. Source: Rosenberg Research; *The New York Times* (Dec. 18, 2020).

Q3 2021 ROUNDUP

Inflation concerns and rising interest rates were the predominant factors in determining the winners and losers in Q3 2021. It became increasingly clear in July that the Fed would begin to taper its $120 billion in monthly bond purchases, and this led interest rates to rise from August onward. The repercussions of reduced monetary stimulus weighed on the markets, with returns across the board turning negative for the month of September, although quarterly and annual returns remained strong. Developments of interest include:

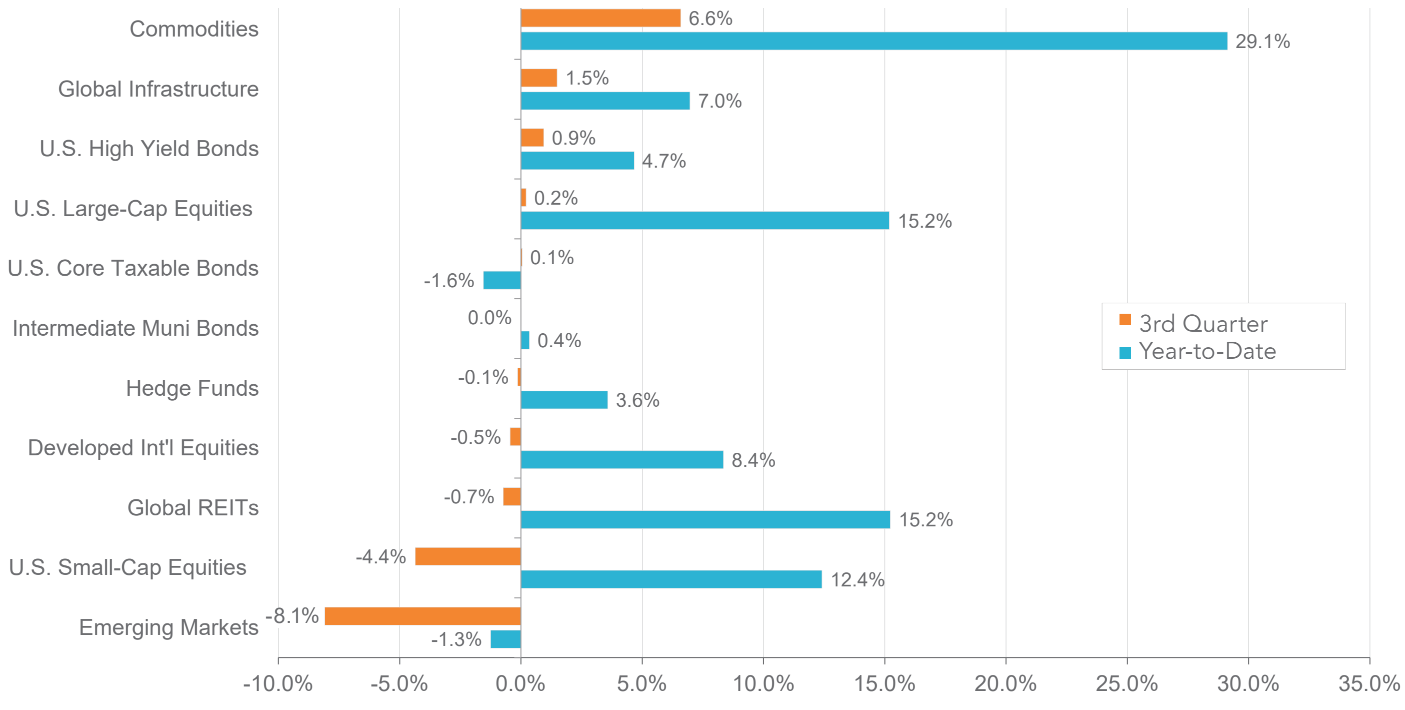
In Q3 2021, real assets (commodities in particular) were market leaders on strong demand stemming from the ongoing global economic recovery, rising prices due to high demand (in some sectors) as well as issues related to the clogged supply chain resulting in cost-push inflation.

Among global equities, US large stocks outperformed both US small-cap stocks and foreign equities. Emerging markets in particular are facing multiple challenges: slowing economic activity; struggles with reopening due to the Covid crisis; and regulatory reform and transition to a consumer-oriented economy in China, which has threatened the profitability of some industries and left others vulnerable without the perceived backstop of the Chinese government. Consequently, China (-18.2% in Q3), and countries thought to be reliant on China's growth, such as South Korea, Thailand and Australia, also had poorly performing equity markets.

Fixed income returns were basically flat in Q3, with lower credit quality debt generally leading bond markets. US high-yield bonds and floating rate loans were both up around 1% during the quarter.

Performance of Asset Classes Year-to-Date and 3rd Quarter

(As of Sept. 30, 2021)



Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

LNWM Portfolio Positioning

Will the good times in equity markets continue to roll and, if so, for how long? While we look around data corners striving to uncover the unknowns, the unknowable unknowns have a way of derailing bold forecasts. What we can do is assess that we have the appropriate mix of exposures within LNWM portfolios to mitigate key potential risks (aka "headwinds") and benefit from new opportunities (aka "tailwinds") that markets inevitably present. At the risk of oversimplification, I have attempted to demonstrate this concept by showing how we have prepared for the various types of "winds" through specific LNWM portfolio exposures. Keep in mind many of these "winds" are interrelated and the reaction of our portfolio exposures may vary based on other factors.

HEADWINDS

HIGHER INFLATION

- **Price increases prove to be not-so-transitory** due to a variety of reasons including: the dramatic increase in wages (do you think people will take pay cuts when Covid-19 is in the rearview mirror?); the complex supply chain issues that seem to be plaguing most industries may take longer to normalize, creating cost-push inflation; and substantial fiscal and monetary stimulus.
    - *Our Portfolios* - *Exposure directly to commodities or commodity related producers within the equity portfolio could benefit from an inflationary environment. Additionally, our holdings in segments of the equity markets such as infrastructure and to some degree parts of the technology sector (e.g many software contracts have inflation riders) stand to either benefit from an inflationary environment or can at least mute its effects.*

HIGHER INTEREST RATES

- **Accelerated growth gives a headfake and the Federal Reserve raises interest rates too soon** and too fast before the economy has fully healed from the Covid after-shocks and supply chain malfunctions.
    - *Our Portfolios - This shock to the system could elevate volatility creating opportunities for managers that can take advantage of asset mispricing relative to long-term fundamental value, including hedge funds if volatility does not get too high. Our core fixed-income allocations stand to benefit as proceeds from maturing bonds are reinvested at higher rates.*

SLOWER GROWTH

- **The reduction in the tremendous amount of Covid stimulus could reveal slower growth** and more economic stress than markets are anticipating. It is important to dig beyond the headlines. For example, in the recent University of Michigan Consumer Sentiment Survey, the "Large Household Goods Buying Intentions" sub-index fell to its lowest level since April 2020 and home buying plans are down to the lowest levels since August 1982. Also, a Bloomberg restaurant survey showed 51% of those businesses missed their August 2021 rent payment, an increase from the 40% printed in July.

- **Mounting government deficits and debts end up as drags on the economy** in the absence of surgically deployed public investments that can generate a positive multiplier effect. We have seen something economists call the "Ricardian Equivalence" play out during four of the last six decades (including the last three)—it's when people save more as government debts climb for fear of future tax liabilities. Increased savings leads to lower consumption. Keep in mind, the markets have in recent times shown little concern regarding deficits and debts issues, but we need to allow for the possibility of a reversal in this perception, meaning excessive debt is viewed as a risk.
- **The fight against COVID-19 continues to be challenging,** especially for emerging market countries that the world relies on for key commodities, manufactured goods, and industrial components. Merck's pill-based treatment for COVID-19 could potetially mitigate this risk if the rollout is accomplished with alacrity worldwide.
    - *Our Portfolios – Slower economic growth does not mean no growth. Active strategies that can either capture valuation mismatches or drive value creation (private equity and real estate, venture capital, etc.) could benefit, as well as exposures to certain higher-growth foreign markets.*
- **Tax regime changes (if they do occur) for both corporations and individuals.** Increases in the capital gains rate, if not retroactive, could lead to a wave of selling by taxable investors to lock in gains at current lower rates.
    - *Our Portfolios – Municipal bonds as well as tax-managed/tax-efficient investment strategies can generate more "tax alpha." Historically, capital gains increases have not affected equity market trends other than temporarily, which means disciplined rebalancing of portfolios that fall below their equity targets could be beneficial if a sell-off occurs.*

OUTLIERS

- **China's real estate developer debt problems could be a canary in the proverbial coal mine.** A possible default of Evergrande, a 25-year-old developer with over $300 billion in debt, equivalent to 2% of China's GDP (yes, that's one company's liabilities making up 2% of the 2nd largest country's gross domestic product) could generate material ripple effects across the neural network of interlocking global financial relationships. We saw how the impairment of individual nodes on that neural network (think Bear Stearns, AIG, etc.) can lead to a global crisis back in 2007-2008.
- **The US debt ceiling is not raised in time, causing a technical default.** Congress deferred this issue until December 3 via a stop-gap measure. A miscalculation by both parties, while highly unlikely, cannot be ruled out.
    - *Our Portfolios – Downside volatility mitigators such as core fixed income, cash, and exposures to hedge funds can help mute drawdowns in client portfolios. Additionally, some hedge fund exposure can take advantage of market dislocations. Last but not least, disciplined and regular rebalancing of portfolios to get them back in line with their asset allocation targets should yield benefits over the long run.*

TAILWINDS

- **Economic growth could continue to surprise on the upside and endure for longer.** Trillions of dollars of stimulus have either been already infused into the global economy or are on the horizon (Europe has a $1 trillion fiscal package ready to be deployed), even though some of this spending will inevitably generate less than a dollar-for-dollar benefit. With that said, equity markets have to some extent already priced in +$1 trillion in US spending on roads, bridges, transportation and the electrical grid (to name a few) as part of the basic infrastructure bill. If Congress fails to pass this into law, certain equity sectors could be negatively impacted.
    - *Our Portfolios – Our long-only equity market exposure should continue to benefit from the creation of jobs, increased consumption and significant capital investments, including our allocation to infrastructure equities. Continued economic growth could lead to higher interest rates enabling our core bond allocations to reinvest proceeds from maturing bonds at higher yields.*
- **Interest rates may increase but not dramatically, thereby providing a positive backdrop for equity valuations.** If rates are driven higher by stronger economic growth, this could mean corporate earnings may exceed expectations making current valuations less pricey.
    - *Our Portfolios – While bond values will generally decline when rates rise, maturing bonds will enable investors to reinvest proceeds at higher yields. Additionally, our equity exposures may continue to benefit from a Goldilocks environment in which rates rise but not enough to impair growth.*
- **Continued surge in demand for investments targeting positive environmental and/or social outcomes as well as financial return** (what we call "sustainable investing"). This demand is coming from governments, corporations, consumers and investors. If this trend continues, it could take the baton from pandemic fiscal support as the catalyst propeling economic growth and provide opportunities to invest in new growth industries and sectors, even as broader growth slows.
    - *Our Portfolios – LNWM's sustainable investing portfolios, thematic solutions, and our private impact strategies should benefit, but we cannot ignore the broader impact this trend can have on the global economy, thereby potentially extending the rally in risk assets.*
- **More opportunities for skilled active strategies to identify winners and losers** due to lower price correlation (higher dispersion) across and within asset classes.
    - *Our Portfolios – When massive government stimulus is supporting markets, passive exposure via stock indexes tends to perform well. This regime may continue for the foreseeable future. However, to the extent investors start rotating into different geographies and/or sectors searching for securities at compelling valuations, active strategies have a more favorable context in which to attempt to add value.*

Final Thoughts

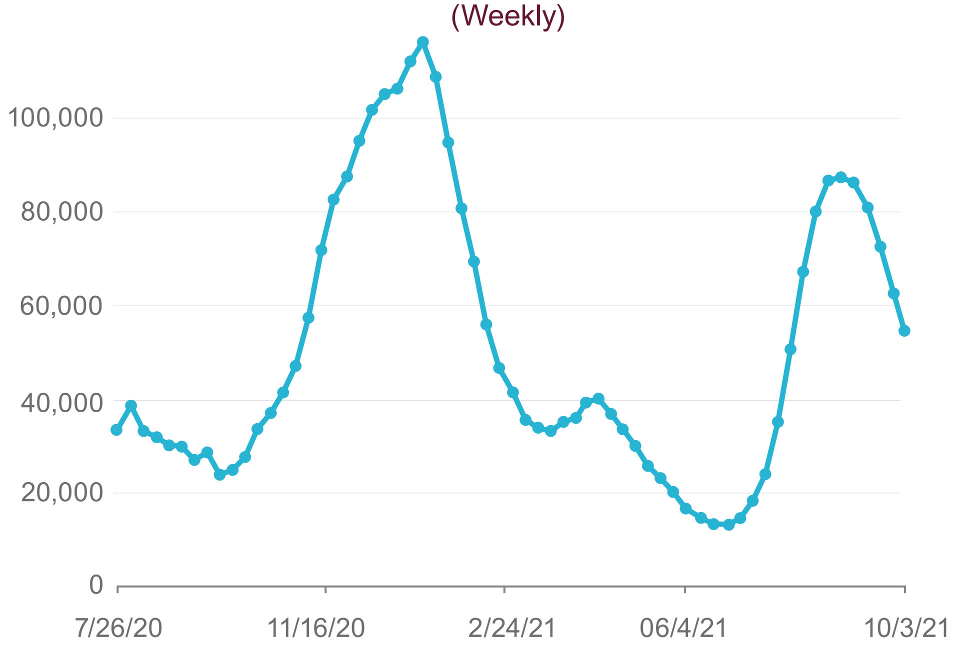
Prior to writing my first quarterly commentary as LNWM's new CIO, we polled all LNWM advisory teams on what is top-of-mind for clients. Responses centered on common themes: how long the bull market could last; why continue to own bonds; potential increases in taxes and inflation; mounting debts and questions about foreign markets lagging the US.

Interestingly but not surprisingly, client concerns match the risks we detailed in the "Headwinds" section earlier. That will likely continue to be the case. My team and I are here to partner with each of you to achieve your goals, and a key part of that is assessing whether your LNWM portfolio(s) is properly positioned for risks and opportunities as they arise. Our work is a balancing act. It requires ongoing vigilance and fine-tuning based on research and analysis across capital markets coupled with insights from the asset managers we invest with. A key part of my work as CIO is ensuring that personal emotional and cognitive biases (including my own) do not filter into our decision-making.

I hope to meet all LNWM clients in person before too long, as pandemic restrictions lift. In the meantime, my actual and virtual doors are always open.

CLOSER LOOK: CHARTS OF INTEREST

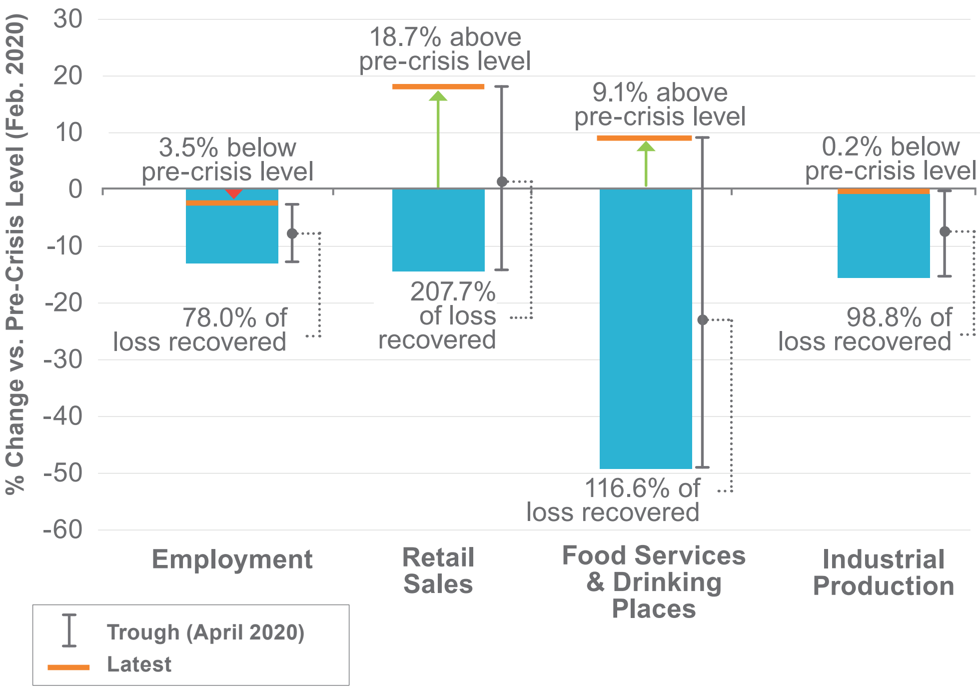
On the Decline: US Hospitalizations for COVID-19
(Weekly)



Source: OurWorldInData.org/coronavirus.

The US appears to have reached another peak in Covid-19 cases and hospitalizations in most jurisdictions, including in states where masks are not mandated. Still, a longer Covid recovery period than generally anticipated means economic growth hasn't quite met the robust consensus expectations. Consensus now is for continued expansion, but at a bit slower pace.

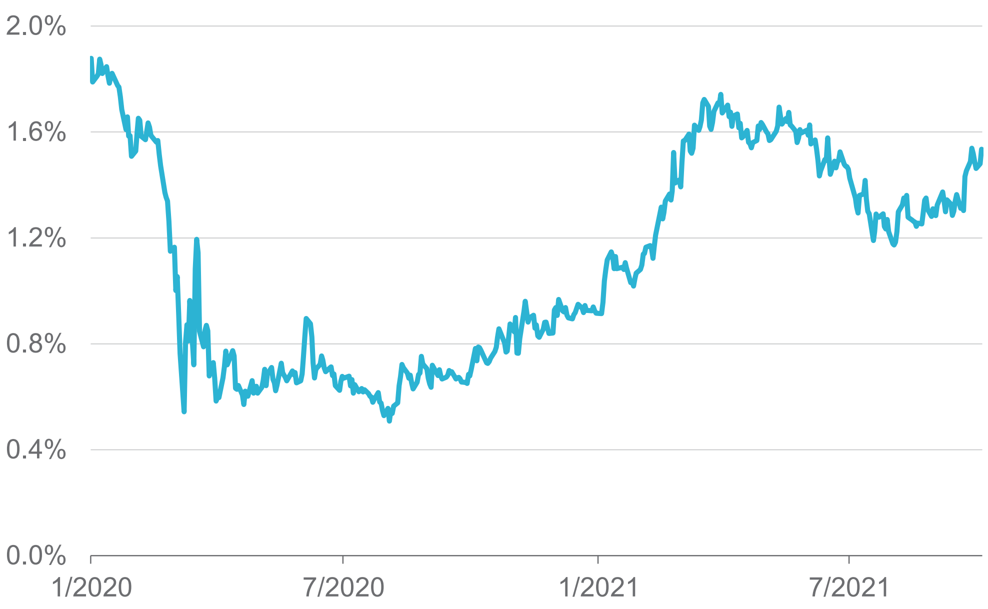
US Economy Has Largely Recovered from the Pandemic



Note: Employment as of Aug. 2021; Retail sales, food services & drinking places, and industrial production as of July 2021. Trough since Feb. 2020. Source: Macrobond, RBC GAM.

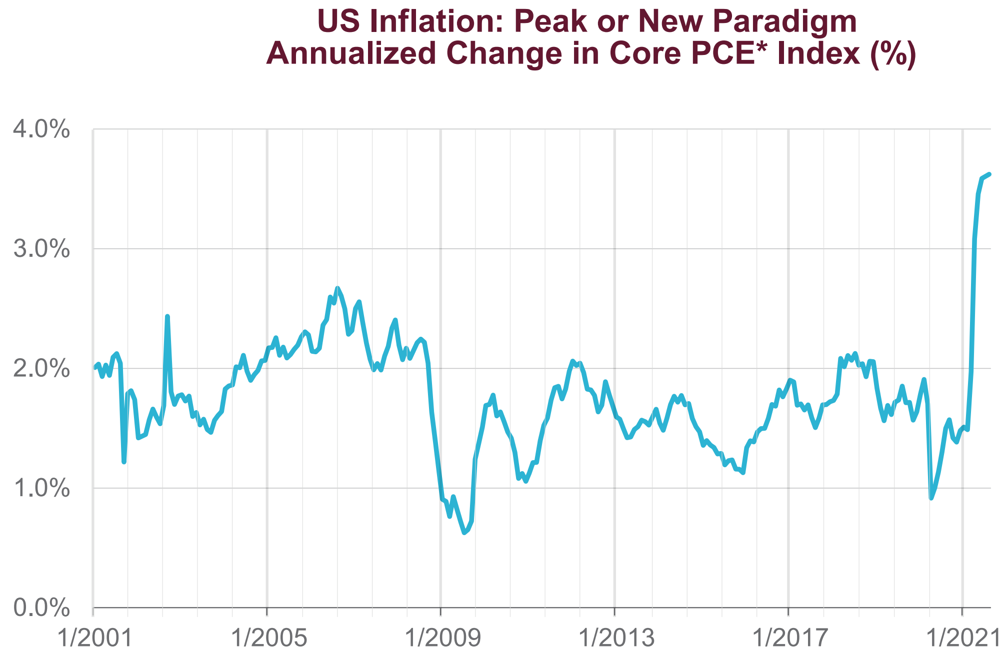
Many of the business segments hurt the most by Covid-related shutdowns and changes in consumer behavior have nearly recovered to their pre-pandemic levels or even further. For example: As of July 2021, US retail sales were nearly 19% higher than where they were prior to the onset of Covid. Spending at restaurants and bars was 9% higher.

US 10-Year Treasury Yield: On the Rebound



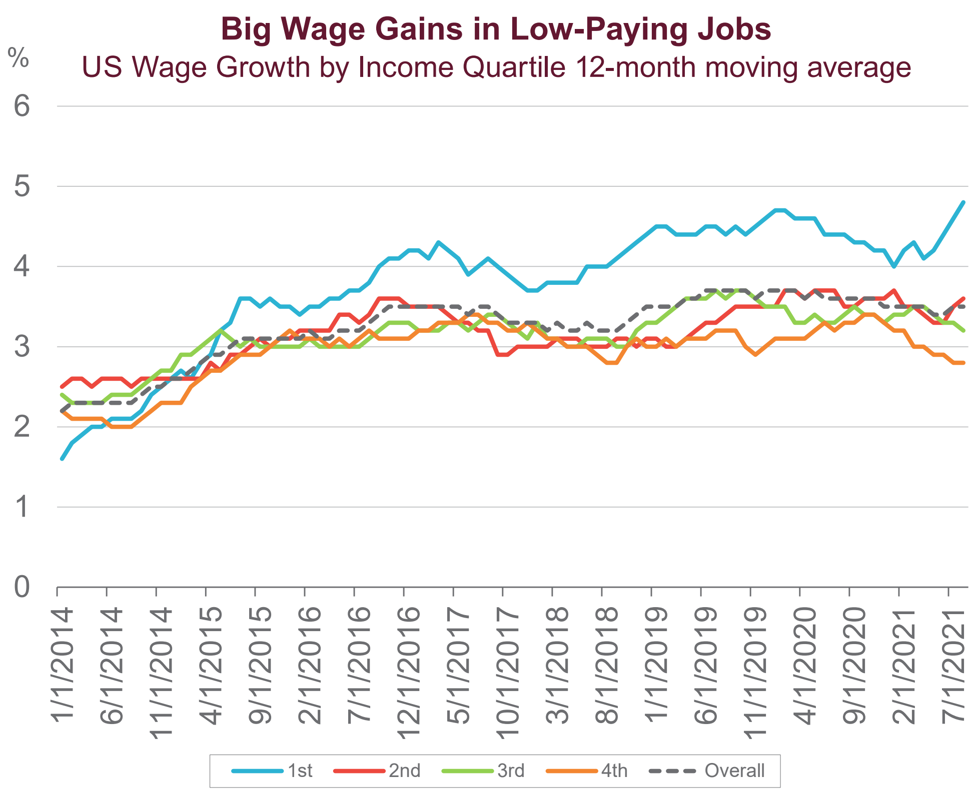
Source: Bloomberg, as of Oct. 5, 2021.

US interest rates rose steadily during the beginning of Covid recovery in 2020, but faltered early in 2021 before beginning to rise again last August. Renewed concerns over inflation and the dialing back of Federal Reserve bond purchases may continue to pressure interest rates upward.



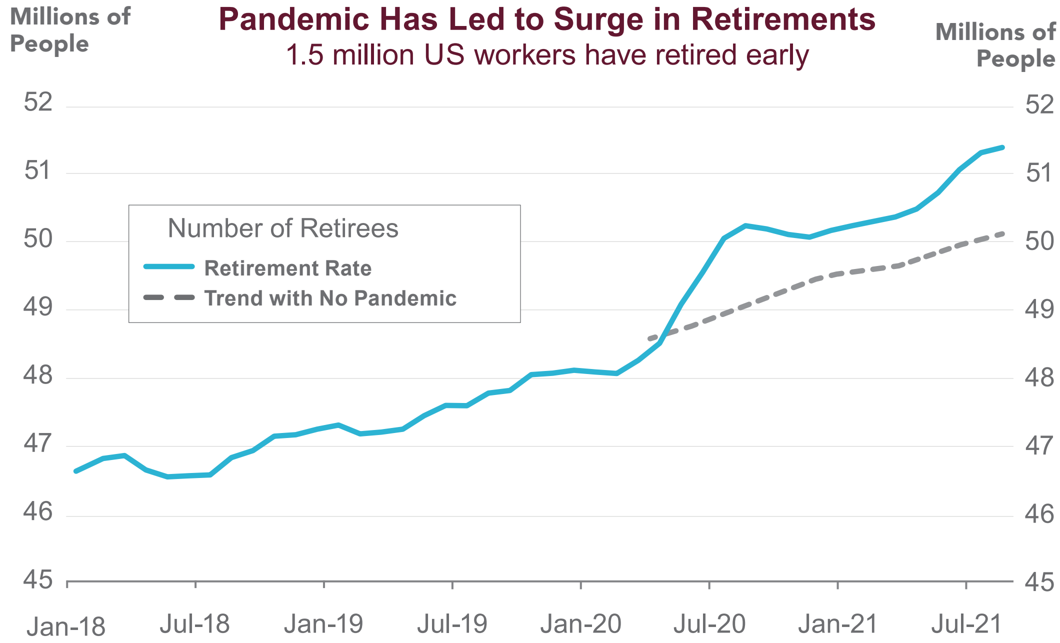
*Personal Consumption Expenditure (PCE). Source: Bloomberg, as of Sept. 30, 2021.

Measures of US inflation have broadly accelerated at a pace not experienced for many decades. Some causes of the spike are certainly transitory, such as supply chain shortages, expected to last through 2022, and "base effects" relative to the plunge in prices during the peak of Covid in 2020. We are closely monitoring US wage growth, which has historically been a driver of sustained inflation.



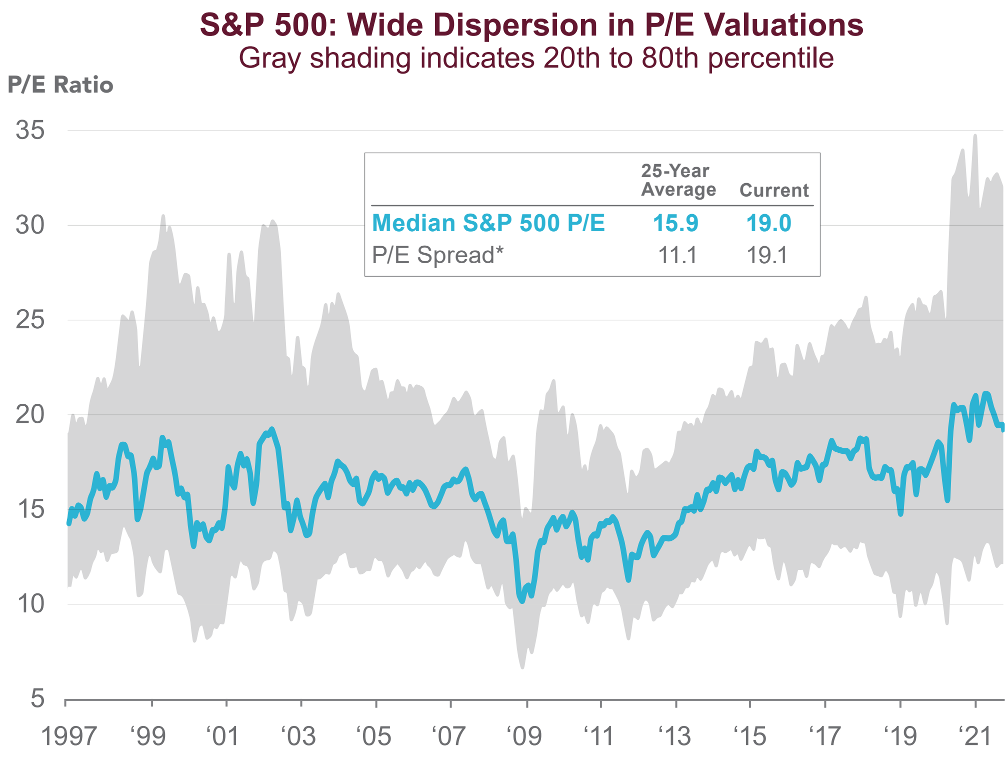
NOTE: 1st = lowest-paying quartile. Source: Current Population Survey, Bureau of Labor Statistics, and Federal Reserve Bank of Atlanta Calculations.

US wage growth has accelerated modestly in the past year but much more dramatically for those in the lowest earning quartile. Minimum wage hikes have likely been a factor over the last few years but the year-to-date 2021 acceleration suggests the changing dynamics of the market for less-skilled labor, which may mean the acceleration is unlikely to dissipate soon.



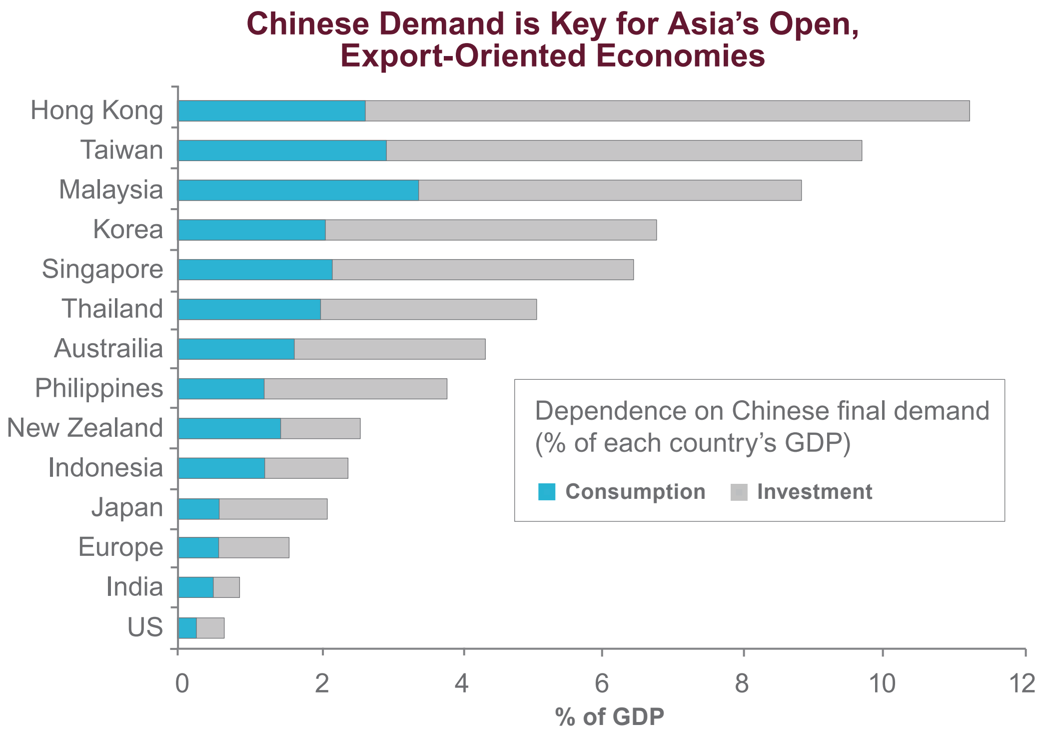
Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research (Oct. 4, 2021)

Another factor that is likely to keep upward pressure on wages is the impact that Covid has had on those nearing retirement. Many such workers have opted for early retirement for a variety of reasons, including strong gains in their retirement savings from US equity performance. The number of people retiring or otherwise dropping out of the workforce has reduced the supply of workers in the US labor force by an estimated 2.5 million.



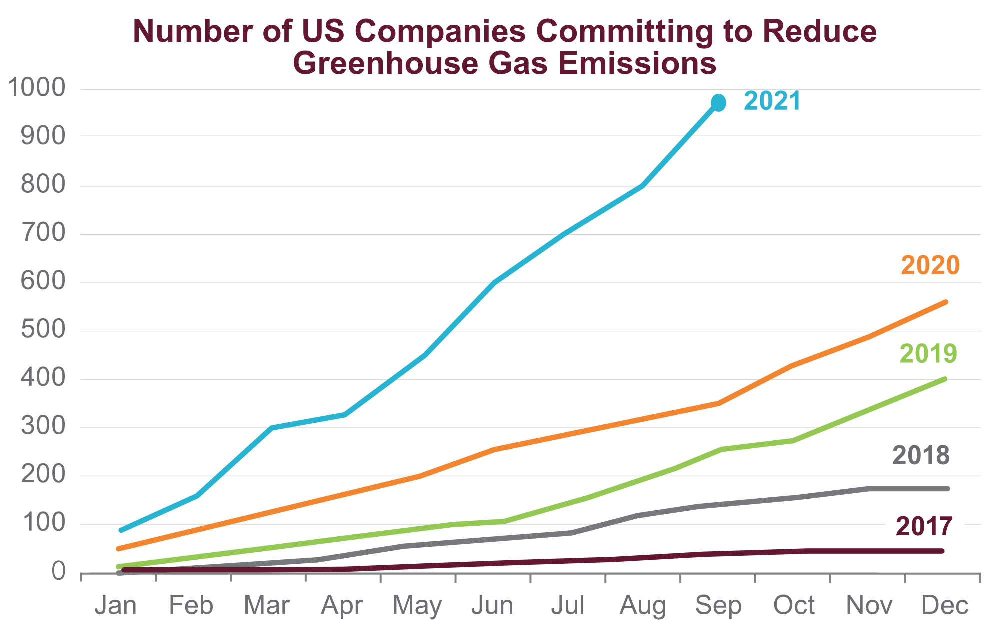
*Highest P/E minus lowest P/E. Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management (as of Sept. 30, 2021).

US equities are relatively expensive, with the price-earnings (P/E) ratio for S&P 500 stocks recently at 19 vs. 16 for the 25-year average. What is unique about the current environment is how broad the range of US equity valuations (P/Es) is relative to history. This underscores our perspective that even when the markets look expensive there are always opportunities to be had somewhere whether in cheaper sectors or overseas.



Source: World Input Output Database 2016, OECD Tiva 2016, Goldman Sachs Global Investment Research.

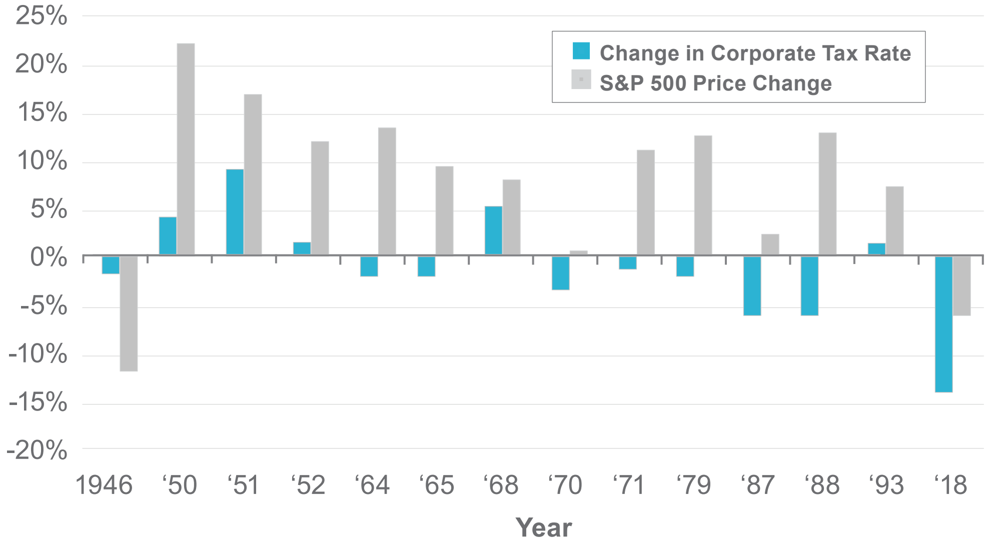
The Chinese government's recent social and economic reforms have broad implications for investment both within China and for the country's largest trading partners. In the chart, you see the degree to which many nations rely on continued growth in China to support their own economic growth.



Source: Bloomberg (Oct. 6, 2021)

The adoption of sustainable business practices and demand for sustainable investing is accelarating. For example, the number of corporate commitments to reduce emissions in line with Paris Agreement targets has spiked. According to Bloomberg, more than 971 US companies have set such targets in 2021, nearly double the amount for all of 2020.

S&P 500 Returns in Years with Change in US Corporate Tax Rate
(since 1946)



Source: BMO Investment Strategy Group, FactSet, Haver.

The possibility for a US tax increase beween now and 2023 is rising, although still uncertain. At this point, we do know the legislation is likely to target higher-income households and corporations, with details still murky. Higher taxes are not necessarily an obstacle to equity performance. In the past, US equities have posted positive results in years when tax rates were raised and when they were lowered.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management. As the head of LNWM's Investment Strategy and Research Group, Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with LNWM's client services teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNWM, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University
of Pennsylvania.

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INDEX DEFINITIONS

US BONDS: Barclays Capital US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

MUNICIPAL BONDS: Barclays Capital Municipal 1-10 Year Index - Tracks the broad market performance of tax-exempt bonds with 1 to 12 years remaining to maturity.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

US LARGE CAP EQUITIES: Russell 1000 Index - Measures the performance of the large-cap segment of the US equity universe and represents approximately 92% of the US market.

US SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

GLOBAL REITS: FTSE EPRA/NAREIT Developed Real Estate Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities; 4% Global Infrastructure; 13% Illuquid Hedge Funds; 2% Commodities.

DISCLOSURE