CLOTHIER SPRINGS
Capital Management

Improving Investor Outcomes

PremiumPoints 1Q-2022

Timeless Truths | New Perspectives | Endless Evolution

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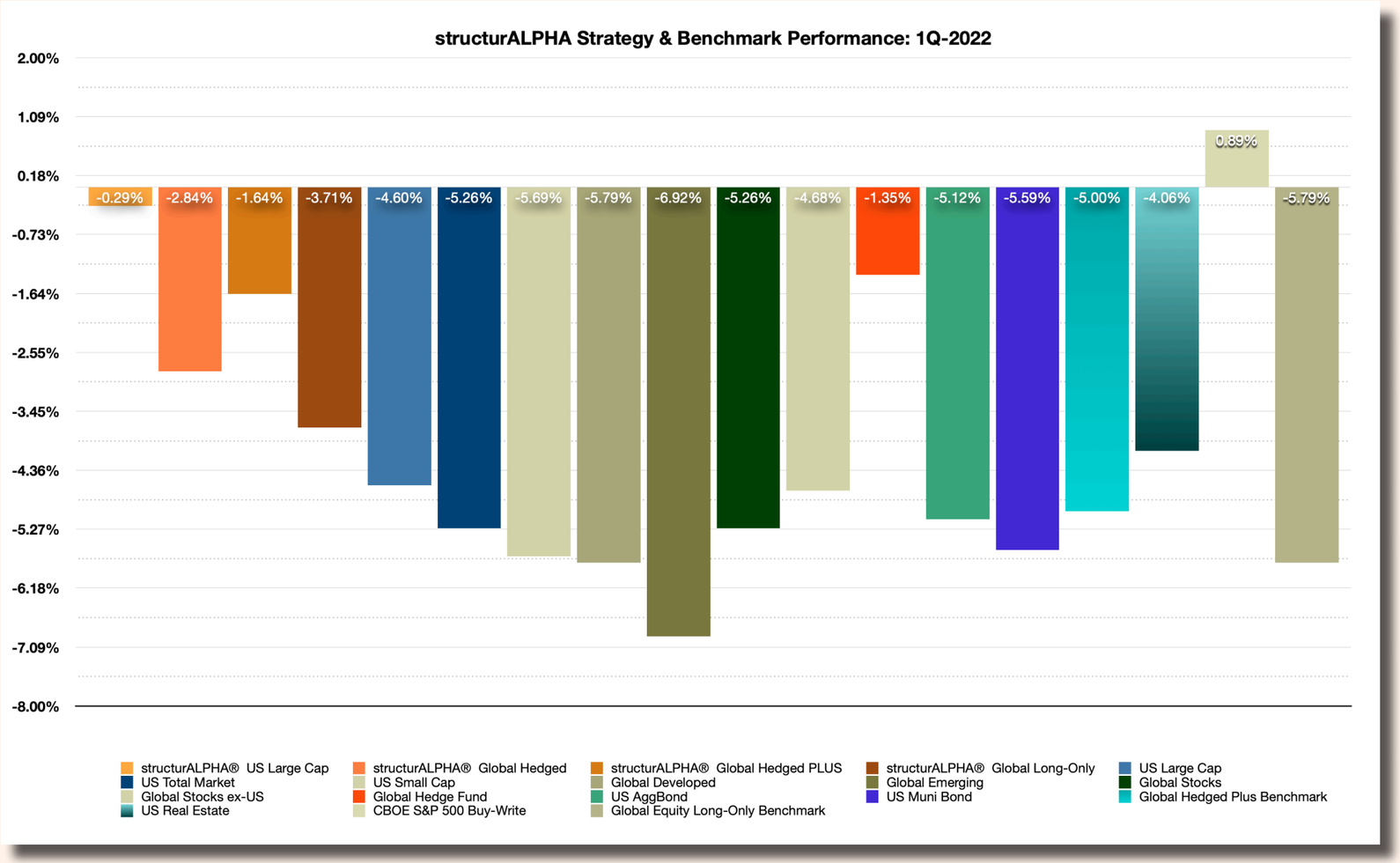


1Q-2022 Review & Outlook

1Q-2022 presented a relatively rare occurrence: both the stock and bond markets declined. The stock market has had a very robust rally since the Covid-induced market panic of 1Q-2020. It is not unexpected or alarming that stocks retreat a little bit, especially against the backdrop of inflation and rising interest rates. Those same dynamics also caused bond yields to rise—and bond prices to fall as well.

The result for investors generally was a quarter with negative returns. In looking at long-term market returns and our own client portfolios going back to 2010, the ratio of up quarters to down quarters is fairly steady at a 3 to 1 or 4 to 1, up to down. Of course this is a rule of thumb and does not quantify the magnitude of the ups and downs. Still, investors should probably expect one down quarter out of every four.

Within the universe of stocks, we have biased client portfolios towards reasonably-valued, strong dividend-paying market exposures. In the scheme of things these "value" stocks lie across the arbitrary divide from "growth" stocks, whose revenue and profits are growing at above average rates and whose valuations are also somewhat extended. This bias worked very well in 1Q-2022 as the broad equity markets declined 5.3%, growth stocks declined 11.9% while value stocks gained 2.3%.

Many recent high-growth and high-tech darlings are coming back to earth. For example, tech darling Netflix is down 35% today (4-20-2022) and 65% from it's peak in October 2021. This is but one example of the reckoning that awaits stocks whose valuations have been extended since the Covid Crash—by what we believe are legions of novice investors. Ultimately, rationality and fair valuations always prevail and the pain for shareholders is usually severe. Cryptocurrency players beware....more on that later.

Quarterly Market Performance Barometer

	Performance %		
	Q1 2022	Q4 2021	1Y
Equities			
U.S. Market	-5.33	8.27	12.33
Value	2.35	5.66	12.80
Growth	-11.97	6.99	9.19
Developed Markets ex-US	-5.17	2.75	2.61
Emerging Markets	-5.90	-0.63	-8.27
Top Morningstar Sector Indexes			
Energy	38.47	5.74	64.37
Utilities	4.48	12.29	19.19
Basic Materials	-1.29	14.35	15.62

Source: Morningstar Direct, Morningstar U.S. Sector Indexes. Data as of March 31, 202
Performance shown in Total Return USD.

We expect to maintain this bias for the near term as growth stocks have had an extended period of relative out performance and do not currently present an attractive return-risk profile. The lower valuations and superior dividend yields of value stocks will

weather market volatility and rising interest rates better than expensive growth stocks.

The geo-political situation deteriorated significantly this quarter with the aggression in Ukraine. Russia is considered an emerging economy, or more accurately HAD BEEN an emerging economy. With the broad economic sanctions imposed on Russia, their economy and citizenry will suffer greatly. Their primary export has been petroleum products—oil and gas.

Since these are commodity products and fully fungible, they will probably still find their way into global markets in our energy hungry world. Russia is also a relatively small percentage of the global emerging markets universe, and headed lower as divestitures ramp up. Within the State Street Emerging Markets ETF (SPEM), exposure to Russian stocks was less than 2.0% of the portfolio as of 4/19/2022.

Inflation

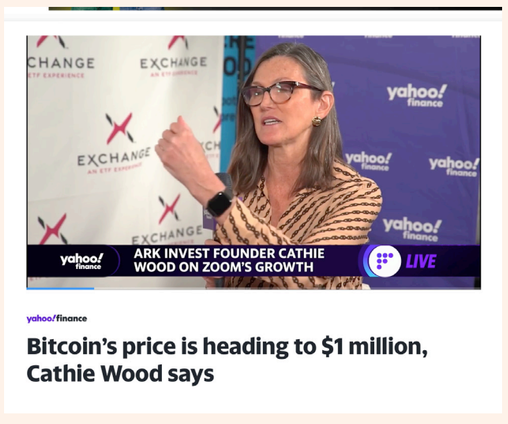
Is still running hot and is real enough for now. The Federal Reserve raised interest rates one-quarter point during 1Q-2022 and indicated perhaps more in the effort to constrain inflation. This was the main drag on both stock and bond prices this quarter. Much of the inflation was due to energy prices which themselves reacted to geopolitical turmoil. We continue to believe that current inflation is a function of a handful of anomalies related to Covid, lockdowns, production issues, logistics and demand. We don't think it will be the persistent, purchasing power destroying inflation of the 1970s.

Climate

We believe that mankind will ultimately need to transition to sources of energy that do not put more greenhouse gases in the atmosphere. We have a core equity position for client portfolios in ICLN—an iShares ETF investing in the various sectors of clean, sustainable energy production. And as global energy demands are not likely to wane, this is a trend that should play out for a generation or more. We hope to benefit our clients meaningfully with this exposure.

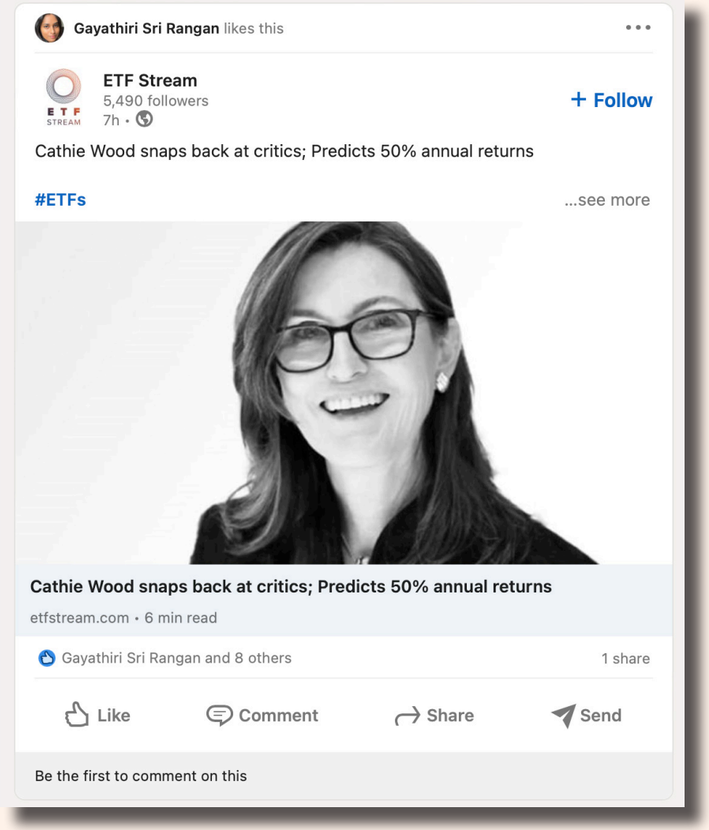
Manager of the Moment

The financial media is famous for anointing some "hot" manager and breathlessly parroting every utterance they make. This goes back to Peter Lynch from Fidelity, Michael Price from Mutual Shares, Bill Miller from Legg Mason, Bill Nygren from Oakmark



and others. Ultimately, they all turned out to be mere mortals and the (out) performance that gained them all the attention, vanished.

The Manager of the Moment is Cathie Wood, of the ARK Funds. Their claim is to deliver long-term capital appreciation by investing in the leaders, enablers and beneficiaries of disruptive innovation. They make the laughable claim that they "see things other investors don't." While it is refreshing to see a woman in a prominent place in the industry, she has turned to age-old fallacies about investment performance to try to stem the tide of sagging performance and investor departures. Her flagship fund—the ARK Innovation Fund (ARKK)—soared in the aftermath of the Covid lockdowns as investors and cash chased the "hot" fund. ARKK peaked in early February 2021. Since then, ARKK has fallen more than 63%.



Hair-Raising Volatility

The two-year performance of ARKK (from 3-31-2020 thru 4-19-2022) is now a very average 20% with enormous up and down volatility. Over the same period the Vanguard Total World Index ETF gained 48% and the Vanguard Total US Index gained 61%, both with far less market volatility.

As the Manager of the Moment, not a day goes by with some proclamation by Wood in the financial media about where she thinks her fund or some of her investments are going. She recently predicted that her ARKK ETF would deliver 50% annual returns and that the price of Bitcoin is headed to $1 million. Me thinks not.

These are outlandish predictions and now put her squarely in the camp of stock tout, shill or promoter: (see: disinformation). She may ultimately be correct, but logic, common sense and decades of capital market history inform us that these would be highly unlikely.

Speaking of Crypto's

We have been very vocal about our belief that so-called cryptocurrencies are neither currencies nor an asset class and are a disaster in the making when the reckoning finally arrives. We recently came across a blog post written by a professor of finance that points out just how empty the argument for crypto's is and how the only thing holding up and driving prices is hype.

While the people on either side of this crypto thing tend to hold strong opinions, the opinions that confirm our beliefs always seem to be supported by logic and the impartiality of those who don't have a dog in the fight.

We recently came across this article by a college professor of finance who conducted this thought experiment with some of his students. His article is powerful and his experiment, logic and conclusions are eminently rational.

From RonRhoades.com AKA Professor Money Bear

Cryptocurrencies: Signed Pieces of Paper in Search of the "Greater Fool"

Does Bitcoin, or do (m)any other "cryptocurrencies," possess any true value?

A recent news article reported that Berkshire Hathaway invested over $1 billion in Nubank, a bank headquartered in Brazil.[1] Did one of the world's greatest investors, Warren Buffet, who in 2018 referred to cryptocurrencies as "rat poison squared," change his mind about cryptocurrencies?[2] This is doubtful, as Nubank (a highly diversified financial services bank) has an investment unit that permits customers to invest in crypto exchange traded funds (ETFs) – but not in cryptocurrencies directly.[3]

In my introductory Personal Finance class, several students mentioned how they could make a great deal of money by investing in cryptocurrencies. Hearing this, I asked my students, "What is Bitcoin?"

A student replied, "It is a cryptocurrency."

"What's that?" I asked.

"It is a digital currency to make payments."

"What backs this digital currency?" I inquired.

Another student responded, enthusiastically: "It's backed by blockchain and mining."

"Really?", I replied. "The fact is Bitcoin transactions are verified by, and new Bitcoins are created by, a process known as 'mining.' But mining is just a procedure. And blockchain is encryption software, now utilized by many financial institutions to secure transactions. But neither mining, nor blockchain, constitutes the intrinsic value of Bitcoin – they just enable Bitcoin to be created and traded."

To demonstrate a point, I pulled a ten-dollar bill from my pocket. "What is this?" I asked the class.

"Ten dollars," several replied.

I elaborated, "At the top, it says, 'Federal Reserve Note.' This $10 bill is backed by the 'full faith and credit of the United States.' This means that it is backed by all the assets owned by the U.S.– gold, land, buildings, etc. But even more important, it is backed by the taxing power of the United States."

I continued, "Is Bitcoin backed by a stash of gold, or does it have the ability to tax anyone?"

"No," said a few students, hesitantly.

"How many Bitcoins will there be?" I asked.

An astute student replied, "About 21 million, and only about 2 million are left to be mined."

"Great answer," I replied. "Suppose I take this piece of paper and place my signature on it" as I signed the paper with a flourish, in large letters, "Professor Bear."

Showing my signature to a student in the front row, I asked "How much will you give me for this piece of paper, if I promise I will create no more than 21 million of similar pieces of paper?"

The student looked uncomfortable. I said, "Be honest … you won't hurt my feelings."

The student said, "Nothing."

"But this piece of paper is scarce. There will only be 21 million of them! That means, this piece of paper could well become valuable," I replied.

A student from the back row chimed in, "You're not selling that piece of paper very well."

"That's right. I'm not very good at creating hype around this piece of paper. So, let me put it out for bid. The opening bid is one penny. Who will bid?"

No student bid.

I continued. "Unlike Bitcoin, which is hyped by many people, there is no hype about my signed piece of paper. Bitcoin is, in essence, only a signed piece of paper, of which there will only be 21million."

I added, "Does Bitcoin make any money? Does it generate revenue, through operations? Does it provide any goods or services that benefit individuals, or society?"

"No," said the class. I could sense the subsiding enthusiasm fading from the student's earlier excitement of investing in cryptocurrencies.

"So, in summary, cryptocurrencies have value because investors hype them. In general, they are not backed by anything. They have only the value that someone (foolishly) is willing to pay for them."

I added, "If you choose to invest in cryptocurrencies, you may make money. But only if, as time goes by, other people are foolish enough to buy the cryptocurrency from you, at an even higher price."

"In the end, the hype around cryptocurrencies will, inevitably, die down. Charlie Munger, the longtime business partner of Warren Buffet, and the vice chairman at Berkshire Hathaway, recently stated "it is a 'safe assumption for investors that over the next hundred years the

price of Bitcoin would go to zero.' "[4]

I concluded,

"All that happens in the end, is those who invested at low prices, and fortunate enough to sell at higher prices, were able to transfer wealth from those who were greater fools than themselves."

Professor Ron Rhodes, JD, CFP®

PAPSERS Kerfuffle

This is a story we have been following for a while, mostly from solid reporting by Joe DiStefano of the Philadelphia Inquirer.

Background

The general outline of the story is this. The PA Public School Employees Retirement System (PAPSERS) has a required return of 6.0% annual. If the return drops below that rate, both employees and taxpayers will have to increase contributions to the system. Recently, the rate was published and it was just above the required 6.0%. It was then discovered that the calculation was wrong, and the actual return was slightly below the required figure. This caused much distress and finger-pointing and unleashed lawsuits, counter-suits and prompted some new trustees to raise concerns about the overabundance of hedge funds hired by the pension, their poor performance and lavish fees.

This article details how PA State Senator Katie Muth—a PAPSERS Trustee—has sued the board to release information critical to her role as trustee and fiduciary, which the board has tried to keep from her . Excerpts are below.

From LeverNews.com

A Pension Official Blows the Whistle

According to Muth, her concern about how pension funds were managing workers' retirement money began as soon as she joined the cloistered, deferential pension fund board.

"Once I learned about the pensions, I learned that our dollars are being invested in really horrible things," said Muth. " And the returns just aren't good."

Indeed, Pennsylvania's $72.5 billion teacher pension fund would have $4 billion in additional money had it instead invested in low-cost index funds for the 10 years ending June 30, 2021.

The emergence of internal board member complaints like Muth's could signal a sea change in the fight to stop Wall Street from preying on public pensions, said Ted Siedle, a former attorney for the Securities and Exchange Commission (SEC) and pension whistleblower.

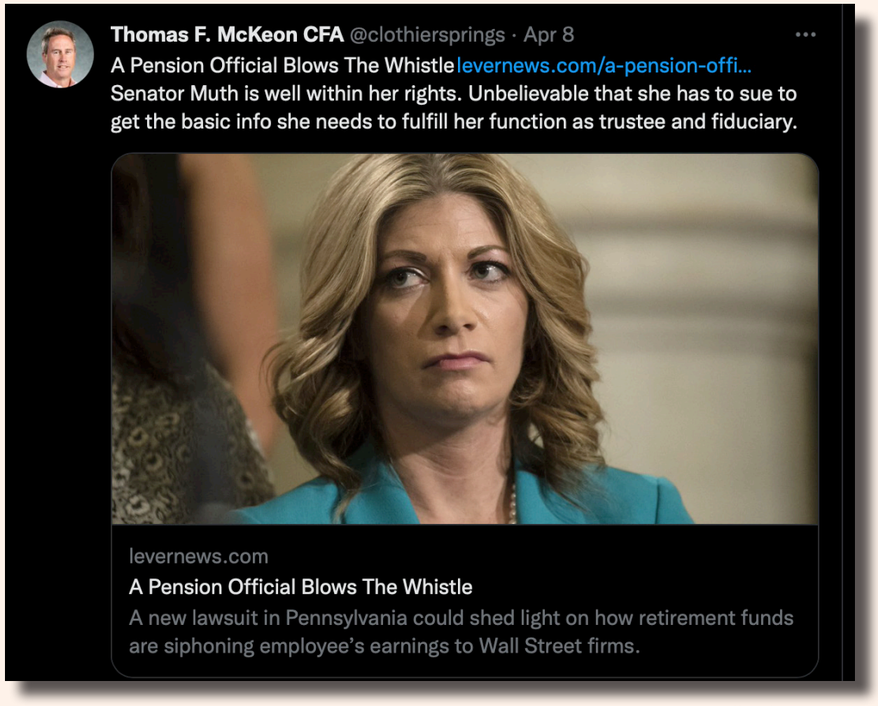
"It's long been known these board members lack investment expertise, but increasingly they are going the whistleblower route," said Siedle. "This is a new development. Every public pension I've

investigated lies about their fees and lies about their performance. But now, the board members are coming forward and are being stonewalled and threatened."

In the tight Republican primary race, Mehmet Oz, more popularly known as "Dr. Oz," has used problems at the fund to attack his opponent, David McCormick, a former official at the hedge fund Bridgewater & Associates. As Oz pointed out, while McCormick worked at Bridgewater, the hedge fund earned more than $500 million in fees for its work for the pension fund, but delivered returns so poor that the pension moved to divest its Bridgewater holdings in 2020.

Full disclosure: yours truly managed a $65 million equity portfolio for PAPSERS Developmental Managers program from 1998 through 2008.

It is very interesting that in the mudslinging going on in the current race for the Republican nomination for Senator in Pennsylvania, one candidate correctly pointed out that the other candidate—while working at a hedge fund hired by PAPSERS—collected $500 million in fees for the firm and delivered investment performance so poor that the hedge fund was ultimately fired.



This is not atypical. We have long held that the alternative investment universe, consisting primarily of hedge funds and private equity funds have in aggregate delivered poor performance with the highest fees in the industry. This is what they call in business school a "bad value proposition."

It is high time that more public officials and pension trustees grasp the realities of investing and take their duties as trustees and fiduciaries seriously.

Clothier Springs Capital Partners Update

Our real estate partnership invests heavily in private multi-family real estate rehab and development deals all over the country. One of our deal sponsors—Penn Capital—recently posted an article to their website outlining their rationale for this real estate focus. We re-print it below with their permission. Written by Penn Capital Principal Ed Rogan.

For the Love of Apartment Investing

So you've decided to take the leap and invest in commercial real estate – congrats! Now, where to get started? There are so many options to choose from!

Commercial real estate is a catch-all term for describing many different types of income-generating property. The primary product types include multifamily, office, retail, hospitality, industrial and land development. Each product type has its own nuances, and each can be equally lucrative. It is important to understand the differences between these before deciding to invest in one product type versus another.

Truth be told, we're partial to multifamily for all of the reasons outlined below.

Multifamily real estate is relatable.

Most investors have either lived in an apartment or owned their own home at some point in time. Many have done both. Therefore, it's relatively simple to understand the mechanics of multifamily real estate. Find a property. Run the numbers. Be sure the monthly rents exceed the net operating expenses (i.e., be sure there's a profit). Determine whether there's room for additional upside. Make renovations as needed. Show units to prospects, lease, and collect rent checks accordingly.

Sure, that's a gross oversimplification of multifamily real estate. But you get the point. Multifamily is probably the easier product type for people to understand. Units all include a kitchen, bathroom, and some combination of bedrooms and living rooms. Easy enough. There are HVAC and other building systems to maintain, but these aren't all that different than those in our own homes. Pay taxes and insurance, just like you would a single-family home. Multifamily is highly relatable, whereas the nuances of other product types can be much more difficult to grasp.

The lease structure makes it easy to add value.

Multifamily leases are typically short-term, running either month-to-month or for at most a one-year term that converts to month-to-month. Rarely do leases exceed one year. Compare this to office, retail, or industrial, for example. Leases for these other product types usually begin at five or seven years, often running upwards of 30 years or more.

One of the benefits to owning real estate with short-term leases is that it becomes easier to add value over time. As units turn over, you can turn on the throttle and inject capital before releasing the unit. This allows an owner to add value in a cyclical fashion where, unlike the other product types, you might have to wait 5-10+ years before going in and making improvements that will enhance the property's value—and when that time comes, the improvements must be done all at once, which can prove cost-prohibitive for some owners.

Many short-term leases lower risk.

Not only do multifamily properties have short-term leases, they also have many short-term leases. This is beneficial for several reasons. First, you aren't putting all of your eggs in the basket of one or very few tenants the way you might be with other product types. If one tenant defaults on their rent, you still have several others supporting the mortgage payment. Compare this to a single-tenant office building. If that tenant has a bad month and can't pay rent, the owner has to foot the entire bill in the meantime. Imagine a scenario where the tenant in a single-tenant property can't pay rent for months on end? An owner can quickly lose the shirt of his back.

The benefit to having multiple short-term leases is that it lowers risk. If there's a problem tenant, it's easier to evict that tenant when you know there are rents coming in from other units. Worst case, the lease will only last through the year, in which case you can elect not to renew the lease and bring in a new tenant in their place. Multifamily is one of the only product types to offer such flexibility.

Multifamily is easy to underwrite (though tough to do well)

For anyone considering investing in commercial real estate for the first time, multifamily is a great option because of how easy it is to underwrite, relative to other asset classes. While we generally suggest you do more than a "back of the envelope" calculation, most multifamily numbers can be run with relative simplicity. An excel sheet is really all you need to create a basic pro forma. There are fewer, less complicated inputs than other asset classes. Multifamily really comes down to fixed expenses (such as taxes and insurance), variable expenses (interest rates, maintenance) and projected incomes (rents + any income from ancillary uses such as laundry, parking, etc.). These numbers can be easily calculated to project cap rates, the internal rate of return (IRR), cash-on-cash returns, and more.

Starting with multifamily is a great way to become more familiar with the numbers behind a deal and this is probably why there are so many players in the space. For a wary investor, it's important to acknowledge that there is a difference between a mediocre sponsor and a first rate one – and this stems from how they underwrite a deal. Here at Penn Capital, we have developed our own proprietary underwriting models that are derived from our experience in financial modeling for some of the largest institutions in the world. We utilize multiple data inputs to identify, not only undervalued locations for investment, but also to predict performance of individual assets.

Everyone needs somewhere to live.

Multifamily is a resilient product type. Regardless of where we are in an economic cycle, people need somewhere to live. During a strong market, people are willing to pay up for new multifamily buildings more so than they might be during a down market. Yet even in a down market, people need somewhere to live. In fact, one of the reasons multifamily holds its value so well is that even in a down market, demand for multifamily remains strong.

Consider the Great Recession. When the housing bubble burst in 2007-2008, hundreds of thousands of people lost their homes to foreclosure. Those who would otherwise have owned their own real estate were then pushed back into the rental market, creating further demand for multifamily. When the economy recovered, it took some time for these people to rebuild their credit in order to buy a home again. Some decided to forego homeownership altogether. This confluence of factors continues to drive multifamily housing to this day.

Conclusion

As you can see, there are many reasons to invest in multifamily as a product type. This isn't to say that multifamily is foolproof. Quite the contrary. For example, some may argue that multifamily is much more management intensive than the other product types. Yet at the end of the day, we still feel compelled to invest in multifamily real estate for the reasons outlined above.

https://youtu.be/9lCFaSL9aSE

Roger Waters and Company Performing "Mother" from remote locations early in the Covid lockdown in May 2020. Waters' father killed in WWII, grandfather killed in WWI. When he asks "Mother will they put me in the firing line" he knows explicitly how that might turn out.

Closing Thoughts

Coming up with content for a quarterly newsletter is both a challenge and an opportunity to crystallize our thoughts and share them in a way we hope resonates with you. I marvel at the people who create weekly, daily or more frequent content. It can't be easy.

We live in the age of disinformation. Politics, health, finance, climate you name it. Never have we observed more jibberish being promoted to serve some business or political agenda.

I'm not much for biblical references but my name is Thomas after all. My first instinct is always to doubt. Does something ring true? Does it reconcile to reality? Does it make sense? Is it rational? Whose agenda does it serve? Who has an axe to grind? Who stands to gain? There is of course always some objective truth somewhere. But never have there been more outlets to disseminate disinformation, much of it straight into your pocket. The objective truth does not always appear in plain sight.

Disinformation is rife in the financial services. The universe of alternative investments is especially dependent on misinformation, client gullibility and behavioral blind spots and inertia. Once an institution commits to invest in an asset class, they build an infrastructure, embrace and defend the decision, benefit from the numerous small corruptions bestowed by the hedge funds (trips, travel, meals, conferences, etc.). And the hedge funds collect so much in fees that a 3 to 5 year engagement rewards them exorbitantly. We are not fans. Neither is our State Senator Katie Muth.

Thomas F. McKeon, CFA | April 21, 2022