"This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." – Winston Churchill

Churchill delivered his famous line in November 1942. After 3 years of defeat, the Allies scored their first major victory in The Battle of El Alamein, driving German forces out of Egypt. The end was not in sight, but it was the turning point the Allies desperately needed. Churchill's intention was to celebrate the victory yet manage expectations for the challenges ahead. We write this letter with the same intention, though, lucky for us, the stakes aren't as high. While the rate of inflation seems to have peaked, modest softening in inflationary data has led some to believe the go-go years of the 2010s are around the corner. We believe this celebration is overdone. In this quarter's letter, we will discuss why this conclusion is premature and how to best position our portfolios for the turbulent years ahead.

The end of the beginning

We believe it is unlikely for inflation to revert to 2% without further economic deterioration orchestrated by the Fed. Several secular trends reinforce current inflationary pressures, rising wages being the dominant one. For the first time in decades, the balance of power between capital and labor is shifting towards labor due to three key developments. First, since the early 1980s, globalization capped wage growth as cheap labor, notably from China, supplanted more expensive domestic workers. China is no longer a source of cheap labor as its economy, and the livelihood of its citizens, has developed considerably. When Nixon established diplomatic relations with China in 1979, Chinese exports accounted for only 5% of the country's GDP. That number peaked at 36% in 2006 and declined to less than 20% today as wages in China have increased exponentially. Second, demand for domestic labor will continue to increase as governments and corporations bring critical supply chains onshore. Recent events exposed the fragility of complex global trade networks, leading governments to prioritize national security concerns over market dynamics. Finally, the working age population in the developed world is in structural decline due to a drop in fertility rates and a large swath of retiring Boomers. These three developments have changed the overall supply/demand dynamics for wages and employment. According to a recent survey by Willis Tower Watson, 70% of employers have spent more than they had budgeted on wage increases and 75% are having trouble recruiting and retaining staff[1]. The labor market reinforces inflation as more money, in the form of increased wages, chases the same amount of goods and services. Economic capacity takes a long time to catch up with increased demand, with higher prices being the immediate result.

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[1] Layoffs in the Tech industry represent a small subset of the US employment base. For example: Apple and Google employ 164,000 and 150,000 individuals, respectively. Walmart alone employs 2.3 million.

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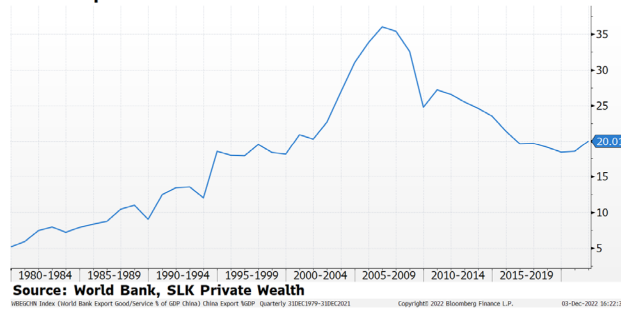
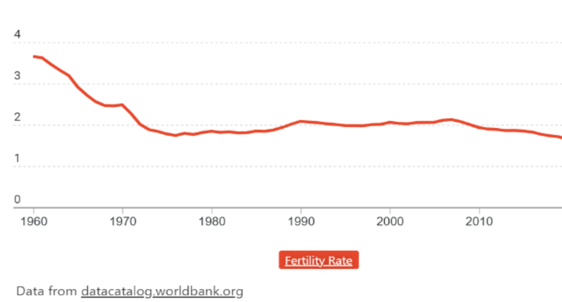
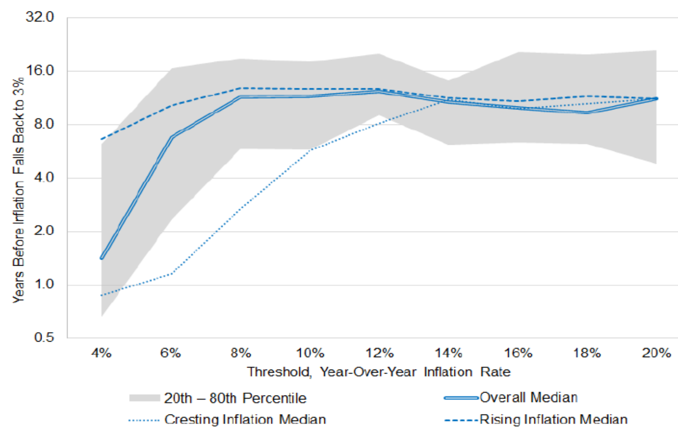




Let's take a different approach. Let's forget about the fundamentals of today and ask a simple question: How have similar inflationary episodes played out historically? Research Affiliates published a great study in which they analyze periods of high inflation since 1970 across 14 developed countries. Their conclusion: "Reverting to 3% inflation, which we view as the upper bound for benign sustained inflation, is easy from 4%, hard from 6%, and very hard from 8%. Above 8%, reverting to 3% usually takes 6 to 20 years, with a median of over 10 years". While it's possible for inflation to revert to below 3% in the coming year, history tells us it's unlikely. The higher the rate of inflation, the longer it takes to tame because structural factors (i.e., wages) reinforce its upward spiral.



History might not repeat itself in the coming cycle. The Fed has taken drastic measures to curb inflation, raising interest rates at a faster pace than ever before. While it's possible they succeed at controlling inflation sooner than history suggests, it won't happen without further economic weakening, which is the only path to curbing demand-induced inflation. We strongly disagree with the exuberance around a "Fed pivot". The Fed won't cut rates until after the damage has been done. The era of economic growth alongside low inflation is over.

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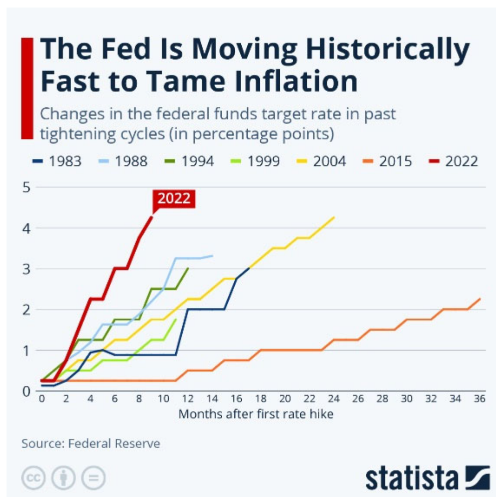

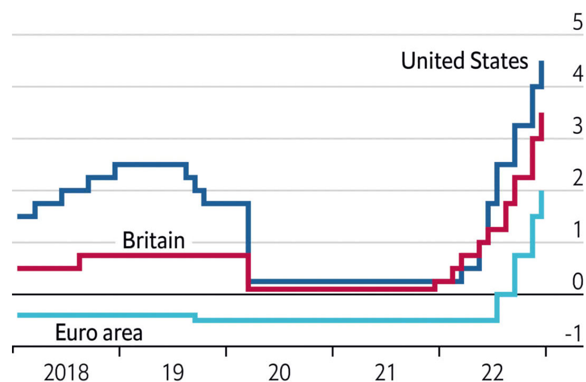

The 2010s were an anomaly

Growth and inflation are the two dominant macroeconomic forces affecting asset prices. As we witnessed in 2022, stocks and bonds lose their diversifying nature and correlate to the downside when inflation becomes the key macroeconomic risk. Stocks suffer as profit margins get squeezed due to companies' inability to fully pass-through increased costs. This is exacerbated by an increase in equity risk premiums to compensate for heightened economic volatility and increased investor concern. Bonds suffer due to their fixed-rate nature as buyers demand a discount to compensate for higher market rates. Put simply, a portfolio of stocks and bonds performs best during periods of low inflation and worst during periods of high inflation. Unfortunately, the low inflationary environment of the 2010s was an exception, not the norm. As shown in the chart on the bottom right, history is roughly equally split across the four growth/inflation quadrants. The past decade of persistent low inflation was an anomaly, yet many investors continue to position their portfolios for a return of that era. Rather than bet on an unlikely scenario, a better approach is to build resiliency into our portfolios by incorporating additional sources of return that are uncorrelated to any one particularly macroeconomic outcome.

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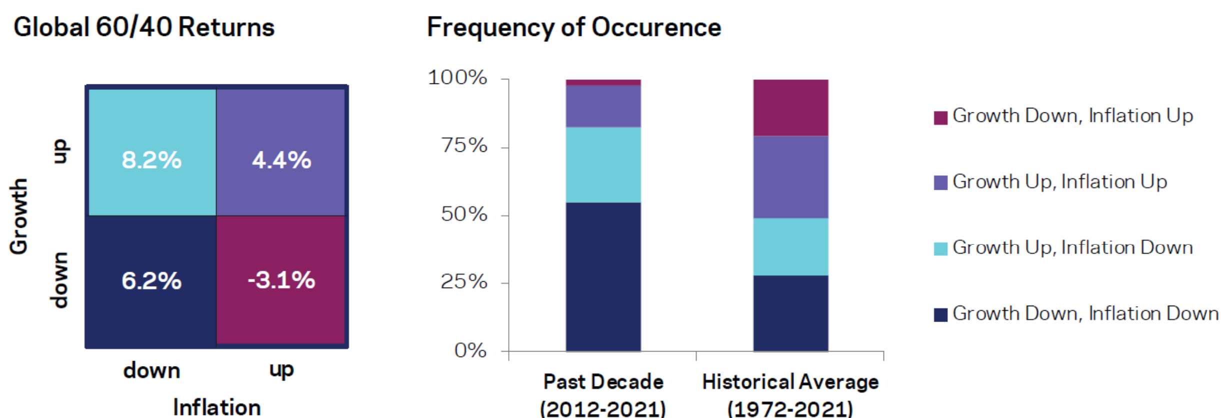
Exhibit B: Macroeconomic Conditions Can Have a Significant Impact on Traditional Portfolios

(January 1, 1972 – December 31, 2021)



Source: AQR, Bloomberg, Ibbotson Associates (Morningstar), GFD and Datastream. Global 60/40 takes 60% MSCI World Index and 40% GDP-weighted portfolio of G6 10-year government bonds from GFD (hedged to USD). Cash is represented by the BAML 3-Month T-bill Index from July 1992 to December 2021, and prior to this index an AQR Index is used which is constructed by extrapolating daily returns based on yield change and slope of 3-month T-Bills is used from January 1959 to June 1992. Prior to the AQR Index, the GFD 3-month Total Return T-bill Index is used. Please see Disclosures at the end for more details on the construction of the return series and macroeconomic environmental indicators. Hypothetical performance results have certain inherent limitations, some of which are disclosed in the Disclosures. Past performance is not a guarantee of future performance.

In Search of Alternatives

"Alternative investments" is an overused term lacking a common definition. It encompasses a wide range of asset classes and strategies from commodities and real estate to hedge funds, private equity, and venture capital. Since our objective is to diversify a stock and bond portfolio, we define Alternatives as investment strategies and asset classes that exhibit low correlations to growth and inflation, the two dominant factors affecting stock and bond prices.

Our Liquid Alternatives portfolio is comprised of eight funds that employ 15 to 20 unique strategies at any given time. Over a complete market cycle, we expect this portfolio to deliver returns comparable to a stock and bond portfolio, but with strong diversification benefits due to its low correlation. Let's take just one of the strategies we implement, Systematic Trend, to illustrate the benefits of this approach. The chart below shows performance for the S&P 500 and the SG Trend Index[2] since January 2000. Both generated similar results, but SG Trend did so in ways that were not correlated to the S&P 500. How do you benefit from this low correlation? Compared to owning solely the S&P 500, a portfolio[3] of 70% S&P 500 and 30% SG Trend would have achieved a higher level of return with a one-third reduction in risk[4] over the 22-year period. The risk reduction particularly paid off during challenging periods for the S&P 500 as shown in the final two columns. Whereas the S&P was down 37% in 2008, a portfolio with Systematic Trend was down 19.6%. And in the challenging environment of 2022, the same portfolio was

[2] The SG Trend index tracks the performance of the 10 largest daily liquid Trend Following managers
[3] Rebalanced each calendar year-end
[4] As measured by standard deviation

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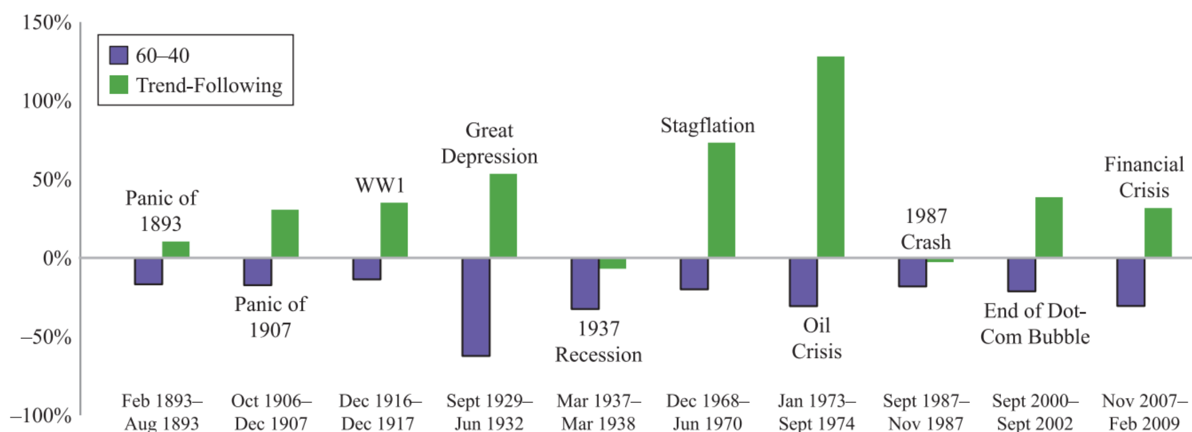
down 4.5% compared to down 18% for the S&P 500. Downside protection is a feature of Systematic Trend since markets typically trend during risk-off environments. The bar chart below shows performance of Systematic Trend during the 10 worst environments for a stock and bond portfolio over the past 150 years. In nearly every scenario, Systematic Trend generated positive returns.

The Diversification Benefits of Alternatives

January 2000 to December 2022

Index	Return	Std. Dev.	2008	2022 YTD
70% S&P 500 / 30% SG Trend	6.9%	10.8%	-19.6%	-4.5%
S&P 500 TR USD	6.3%	15.5%	-37.0%	-18.1%
SG Trend Index	6.1%	13.6%	20.9%	27.3%

Source: SLK Private Wealth



Source: Hurst, Ooi, Pedersen (2017)

We reap the benefits of diversification not just across asset classes, but amongst our Alternatives managers as well. Not only do our managers exhibit low correlations to stocks and bonds, but they also exhibit low correlations to one another, increasing the quality of the portfolio's return profile by significantly reducing risk. As illustrated in the chart below, if we add up the amount of risk each manager contributes to our portfolio, we end up with a standard deviation of 10.7%. Because our managers exhibit low correlations to one another, the standard deviation of our Liquid Alternatives portfolio drops to 5.7%, resulting in a less volatile return profile. The nearly 50% reduction in risk is due to the diversifying properties of our portfolio.

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Source: SLK Private Wealth

Last year serves as a great example of diversification at work. In an abysmal year where the S&P 500 was down 18.1% and the Bloomberg Aggregate Bond Index was down 13%, our Liquid Alternatives portfolio was up 13.1% with a standard deviation less than that of even bonds. The table below shows the return and standard deviation of our managers, portfolio, and the two market indices. Not only did our portfolio diversify stocks and bonds, but our managers also diversified each other, with performance ranging from -3.3% to +35.7%. As Nobel laureate Harry Markowitz once said, "diversification is the only free lunch".

2022 Return and Standard Deviation

Manager	Return	St. Dev.
Manager 1	35.6%	20.5%
Manager 2	16.8%	12.8%
Manager 3	17.1%	11.1%
Manager 4	-3.3%	4.0%
Manager 5	0.0%	3.1%
Manager 6	19.1%	18.4%
Manager 7	8.8%	24.7%
Manager 8	-0.7%	12.9%
Liquid Alternatives	13.1%	6.4%
S&P 500	-18.1%	23.0%
Bbg US Agg Bond	-13.0%	8.3%

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Resilience to Turbulence

Airplanes are built to withstand turbulence. During flight school, would-be pilots are taught to resist the urge to counteract the plane's movements since your delayed reactions add to the unpleasantness. Modern aviation has been around since the 1950s, with roughly 100,000 planes flying each day, and yet no plane has ever crashed due to turbulence. The next time you feel uneasy during a rough flight, bring this next picture to mind.

Factory test of the amount of stress a plane's wings can bear

Just as pilots can't control the weather, we can't control the macroeconomic environment. Actively shifting your portfolio to time markets leads to poor outcomes just as it does for the pilot trying to time the winds. A better approach is to build a resilient investment strategy that can withstand market turbulence. While we expect macroeconomic volatility to continue, we remain confident in our ability to achieve our long-term investment objectives. Fasten your seatbelts.

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