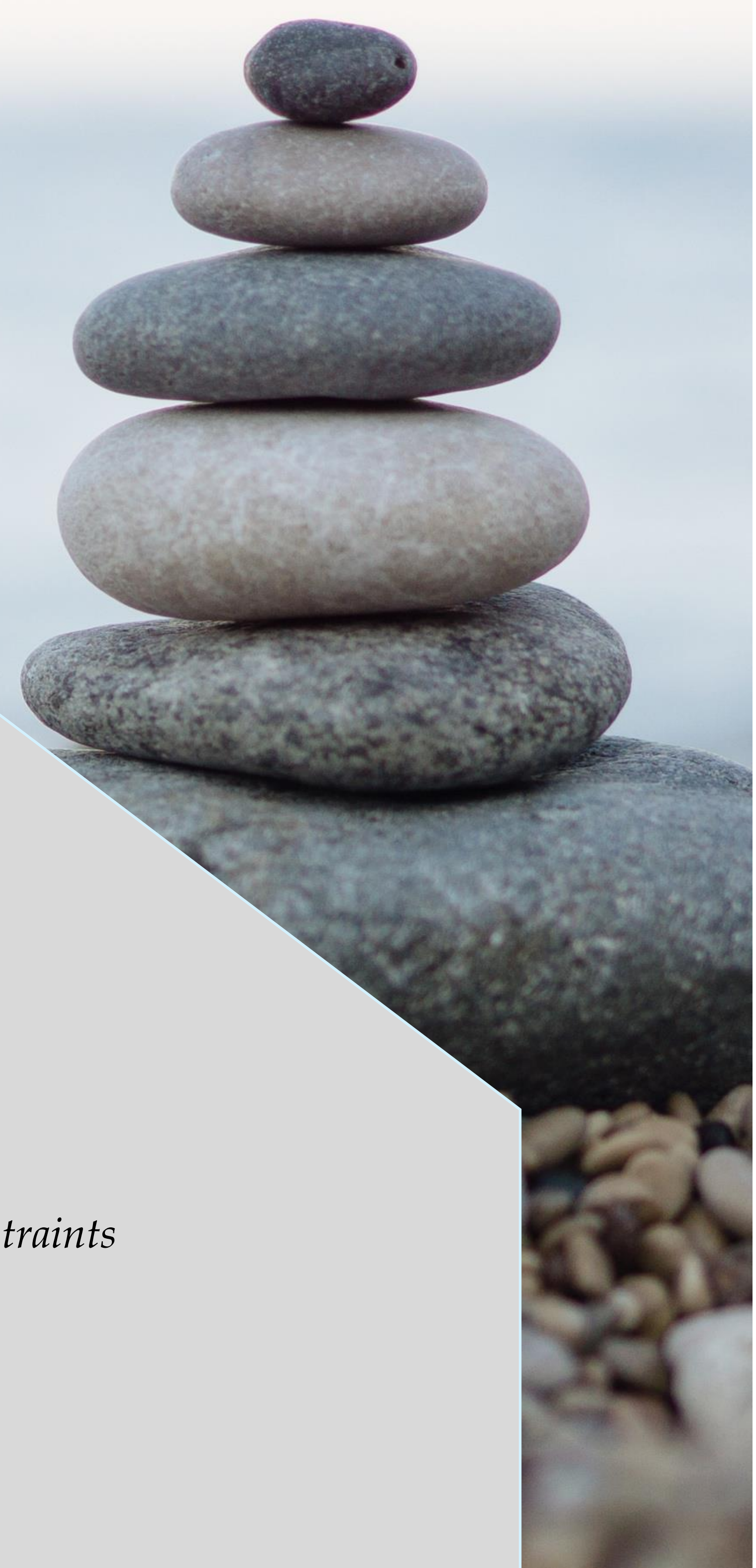


KALMUS
CAPITAL

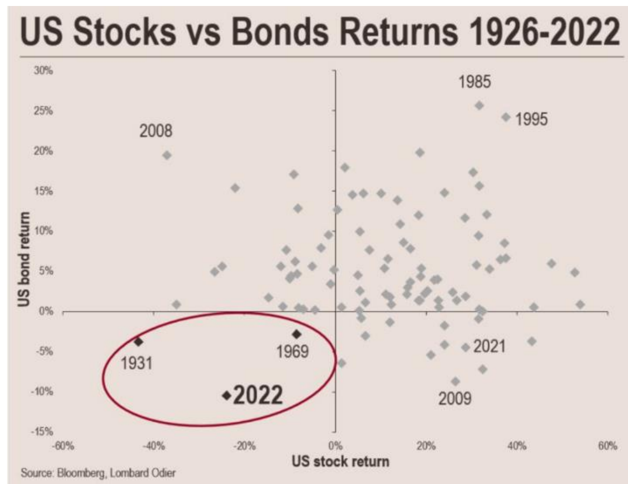
Market Perspective

Building resilience within natural constraints
December 2022

Adapting portfolios to a post TINA investment landscape

Global markets are adjusting to new realities and investors are adapting the way they think of their portfolios accordingly. As we rethink capital allocation models, we first consider the macroeconomic backdrop in the context of systemic adaptation to longer term imbalances. We then offer more practical insights for portfolio considerations.

2022 has clearly demonstrated the limits of structural imbalances within the global financial construct.



Over the last 50 years of continuously falling interest rates, the financial industry designed strategic asset allocations and implemented 60/40 type portfolio models , toolsets and industry norms based on the flawed assumption that stocks and bonds can offset each other. This may now prove to no longer be fit for purpose given the need diversification tools and a broader toolset.

Over the last 5 centuries, the evolution of our economic model was based on the structurally flawed assumption that natural resources, and our capacity to pollute, are unlimited and therefore have no value. As these are increasingly recognized as being limited and therefore of having a value. The black and white lens through which financial markets scrutinize our economic models is therefore no longer fit for purpose and require a new multi colored lens when reflecting this. Pricing natural capital across all investment activities will require a more sophisticated toolset with new investment vehicles and structures.

Incorporating a new toolset is therefore necessary to ensure long term capital preservation and environmental considerations are no longer a question of altruistic aspiration. We are excited about the transparency being enforced by regulators but are weary of the distraction this may have from the required underlying adaptation needed across the investment value chain. We take a step back and re-assess the lenses and toolsets needed to adapt to a more complex paradigm in the context of **market direction, market dynamics and risk factor positioning.**

Direction

The end of cheap credit ushers in a long and painful adjustment period. Sideways to negative markets will tamper return expectations for most asset classes that will struggle to make up for stickier inflation. TINA (There Is No Alternative) was a trading mantra echoed amongst macro investors over the last decade of central bank accommodation. By artificially suppressing risk, unsustainable asset bubbles led to a global addiction to hopium. As this implicit guarantee disappears, markets are having to reflect reality once more. Multiple compression, increased cost of capital and supply side cost inflation will prove painful headwinds for all companies that have not built enough resilience and a return to fundamentals may continue to drag markets lower.

Counterbalancing this, some short to medium term factors do give us some optimism. China's less restrictive Covid policies, a potential easing of global tensions and some respite in the speed of rate hikes could encourage risk capital to be deployed. Given the lower base of some markets and the relatively lower market liquidity, it may not take much to trigger aggressive market rallies as we have seen already 3 times this year.

On a longer-term horizon, one perhaps longer than the current rate cycle, once monetary conditions ease again and we get past another period of hubris with stickier supply chain inflationary pressures that need to be addressed again, we see a structural increase in the average level of global interest rates. The central bank "put" that underwrote risk taking was assumed to imply their underlying desire to maintain extended low interest rates and protect their political capital. We take a contrarian view on this and suspect they will have no option but to want a structurally higher interest rate for the same self-serving political reasons. Though potentially naïve, we feel these political reasons will be as a result of them having no option but to address climate change. Having higher interest rates means there is a larger margin for targeted interest rate reduction for those that adhere to desired behavior, most notably reducing their emissions. The frequency, depth, breadth and speed of climate related regulation is unprecedented. The global synchronicity of institutionalization, standardization and , measurement technology will converge to creating a significantly evolved fixed income market where monetary policy will have a more sophisticated toolkit to discriminate which types of credit to re-risk, for example through capital adequacy and collateral management rules as the European Central Bank has already started to enact.

<u>Implications on the investment landscape:</u>

Investors will focus more of their attention on on downside protection and fundamental value which may lead to outflows from exposures to cyclical broad based market growth.

Smaller funds will be rewarded for their agility compared to large asset gathering funds that will find it difficult to navigate evolving markets. Investors are likely to favor portfolio resilience through well-constructed long term diversified low risk core exposures complemented by short-term fixed income instruments complements income that can be compounded.

Longer term fixed income solutions that have a greater sensitivity to risk assessment will be better positioned to sidestep capital losses. They will also do well thanks to the tailwinds offered by long-term government incentives to de-

risk desired behavior through blended finance structures. Backstopping investments that aligns to the interest of public policy, most notably those related to the environment are a win-win for investors that is poised to grow

Dynamics

With higher rates comes greater scrutiny on how capital is allocated. As fundamentals return to markets, so does dispersion and a greater polarization of returns between winners and losers. We expect a greater return on investment skill as active fund managers able to demonstrate the value of their acumen and be rewarded for picking the winners. Significant structural tends are emerging that will keep amplifying the dispersion across risk factors:

- Geopolitics, Ukraine, energy crises and Chinese Realpolitik
- Tightening credit conditions
- The transition to a multipolar world
- Nearshoring and shifting supply chains
- Wealth disparity and changing priorities
- Environmental regulation and supply chain implications

Whilst most of these factors are short to medium term in nature a new, long term structural driver of dispersion will emerge in the form of Carbon accounting and climate change resilience. The concept of credit is defined as "borrowing value from tomorrow to enjoy today" and is often only thought of in financial terms. Our black and white economic model was designed on the false premise that nature and its extractive capacity had been presumed to be unconstrained and the capacity to pollute had been assumed to be unlimited As science is proving these assumptions wrong and that there is a limit to how much we can pollute or extract, the laws of demand and supply imply that there is a value to natural capital. Applying this lens to global markets, we are concerned with the fact that we have underestimated ow much of tomorrow's natural asset value we have already enjoyed today. This highlights a credit bubble in unfunded liabilities on global balance sheets that have yet to be measured let alone valued and paid for. This natural asset deleveraging process will amplify market dispersion between those that have a lower natural asset liability vs those that have built a house of cards based on these flawed assumptions.

Investment implications:

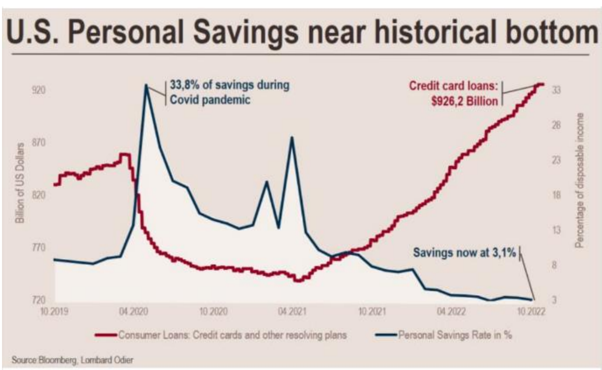
Active managers will attract more capital as investors realise the value of outsourcing the choice of risk factors to specialists with consistent risk adjusted returns net of fees even if their strategies imply more expensive active funds fees. Cheaper passive ETF investments or do it yourself solutions with no one at the wheel which will prove to be costlier in the frequency of capital loss than the fee savings they offer. end up costing more.

Allocators will favor a higher number of fund allocations to specialized managers who will themselves remain more concentrated as the complexity of investment decisions rewards those well-resourced to undertake the required depth of analysis. A larger number of the number of funds but select those that are more concentrated with more eyeballs per position. Hedging strategies and careful risk management is at a premium such as with some hedge fund strategies.

Positioning

Portfolio construction is key and we advocate shifting from a florist approach to that of a perfumer. A florist looks to select the most beautiful flowers in each garden presenting us with a large bouquet, whilst a perfumer carefully selects the combination of flowers to create the right scent for all seasons. Having a core and satellite approach helps manage overall portfolio risk, but satellites need to be evaluated in terms of their diversification benefits or long term beta potential in line with a new thematic prioritization.

Long term equity exposure in portfolios is designed to protect against inflation. The continuous decline in interest rates over the last 50 years has created a consumer economy. Demand for all goods and services has therefore been the primary determinant of price growth and preserving investor's purchasing power was best served through broad equity exposure. the choice of sector over the long term is secondary. As this long-term cycle reverses and supply side cost pressures not seen since the 1970's become the primary driver of inflation, long term thematic investments should be matched accordingly.



Whilst TINA encouraged us to just buy anything ahead of an "everything bubble", we are now entering the age of investing in TINO (There Is No Option) and avoiding TINN (There Is No Need). Rising rates and plummeting disposable income for the 99% will trigger a structural a shift from a consumption based economic system to a regenerative and production based one. We expect society to direct capital towards areas that address our basic needs as there simply is no option but for us to be able to eat, breathe, move, heat ourselves and safely visualize the world we want live in.

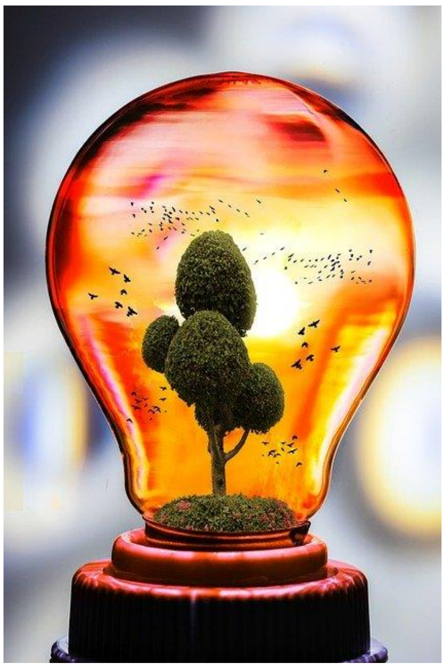
This is likely to prove to be a far greater priority for markets than focusing on activities where there is less of an actual need such as how we flaunt, entertain, indulge, and enjoy ourselves. Significant innovation and value have been created in these areas and earnings and adoptions will continue to grow thanks to the democratization of the digital revolution but we have a lower conviction in their ability to regain the lofty valuations they previously commanded.

Whilst portfolios will need to take on long term higher risk satellite positions to achieve overall return targets, these satellite "beta" positions will need to be realigned to those TINO thematic drivers.

The era of cheap credit was necessary to stimulate the required risk-taking entrepreneurial spirits to create so much innovation. Going forward, an extended period of scarcity in financial, human and natural capital will create the financial discipline that that will incentivize the adoption of these innovations. This implies shifting our valuation lens from the "what" to the "how" when considering portfolio satellite diversifiers that can help lower an overall portfolio's economic and market sensitivity.

The intensified market focus on longer term capital preservation will continue to direct capital towards stores of value such as Gold, particularly in the face of a narrowing set of trustworthy alternatives.

Exposure to digital assets will also grow in importance not just as a philosophical alternative to a fiat-based system but due to the real-world innovation Blockchain technology offers, most notably, removing the need for trust. Some painful more episodes may still be necessary in the meantime to accelerate the robustness of the infrastructure and overall ecosystem. This emphasizes the need to maintain exposure longer term, though through specialists better equipped to appropriately navigate these minefields and diversify their exposures enough to stay in the game.



Investment implications:

Many investors had increased their thematic exposures and are likely to start having to make some hard choices as to where they maintain longer term convictions or accept losses. This inevitably will be seen in the context of new realities and TINN type exposures are less likely to be supported than companies whose fundamentals are linked to TINO.

Given the longer term horizon TINO represents, there is likely to be a greater focus from investors on long term, less liquid asset classes whose time horizon matches these views.

This typically may include more "risk on" market sensitive beta exposures such as with technology linked areas linked to the energy transition, carbon reduction innovation such as DAC, mobility, cyber-security, Agg-tech, responsible mining, carbon, and natural assets markets as well less economically sensitive activities such as forestry, agriculture, recycling, healthcare and green bonds.

With all our best seasons greetings and wishing you a very happy 2023

Joseph Naayem, CFA
Managing Partner

Conclusions

The mass adoption of an ESG colored lens is equipping most market participants with the ability to visualize and manage their investment risk differently. Business models and market participants that have not evolved past the black and white, financial risk/return only lens may be liable to significantly greater financial loss as they try and navigate a post TINA market color blind.

"Toto, I have a feeling we're not in Kansas anymore"

Dorothy, Wizzard of Oz (MGM 1939)