Quarterly Comments

Spring Has Sprung!

According to data from the Centers for Disease Control (CDC), over 190 million Americans have received at least one dose of the COVID-19 vaccine. The pace of U.S. vaccinations continues to accelerate to a recent pace of three million per day. Vaccine administrations are also ramping up globally, albeit varying cadences by region and country. While it is probably too soon to declare a final victory over the pandemic, it appears likely that the U.S. could achieve de facto herd immunity against this virus within the next 90 - 120 days. This implies that the "post pandemic" era could be upon us as soon as this coming summer or fall.

As our clients know, we at JAG work hard every day to unemotionally evaluate the trajectory of the capital markets and economy. But, occasionally we make room for simple celebration and appreciation. We think the thrilling prospect of impending scientific victory over COVID-19 is worthy of applause.

Source: Cartooncollections.com

Firm Highlights

- Last quarter, we welcomed two new members to the JAG team: Senior Fixed Income Analyst **Cynthia Ma** (St. Louis office) and Junior Equity Research Analyst **Tucker O'Neil** (Chicago office).
- Our **new 3-minute cinematic videos** of six members of the JAG team convey our personal values as well as insights about the firm. **JAG Video Link**

Equities Staging Historic Rally

Equities have been staging an historic rally for more than a year. In fact, the S&P 500's 56.4% return in 12 months ending 3/31/2021 ranks in the top 1.6% of rolling 12-month returns since 1926 — and the best since 1983 according to FactSet and Morningstar reports. Most of the gains were achieved well before vaccines had been approved, and despite the surge in cases, hospitalizations, and deaths that occurred last fall. At the time, some investors wondered why the markets seemed disconnected from then-current headlines. But capital markets are discounting mechanisms, and as such they reflect future expectations more than today's headlines. This is the historical lesson learned at every extreme period throughout human history. To quote the author Dan Carlin, "Sometimes reality can feel like the end is always near, yet human ingenuity and perseverance prevails." At the depths of 2020's violent bear market, no one knew how lethal the virus would be, how long the pandemic would last, or how policymakers would react. In those early days, there were some reports that the infection fatality rate could be as high as 2% - 4%. Thankfully, these estimates proved much too pessimistic.

Investors Concerned with Policymakers

Investors were also concerned that policymakers would repeat the mistakes of 2008, by failing to address the crisis before too much damage was done to the economy. Contrary to those fears, the COVID-19 crisis spurred the Federal Reserve, Treasury Department, and Congress, and their counterparts throughout the world, to quickly implement almost unprecedented amounts of fiscal and monetary stimulus. Focusing on only legislative actions, last year's CARES Act, and the recent passage of the American Rescue Plan (ARP) represent a combined $4 trillion of spending. ARP provides direct and indirect aid to nearly every sector of the municipal market and, in doing so, enhances fiscal stability in the months ahead. The $350 billion of direct aid to state and local governments is a significant sum and more than doubles the $150 billion awarded under the CARES Act.

Government Spending Ramps Up

More is on the way, as the proposed infrastructure spending bill would add another $2 trillion to the mix. Collectively, these actions alone add up to almost $6 trillion, representing more than 27% of U.S. Gross Domestic Product (GDP) of approximately $22 trillion. The net result is the biggest expansion in government spending to support the economy since World War II. Many of these dollars will be injected, however opaque the specifics, into an economy that is already showing signs of recovery. And we are likely to see some historically impressive economic growth statistics between now and year-end 2021. Our investment process continues to orient investments towards companies that benefit from stimulus and infrastructure spending.

Digital Investments Overtook Physical Investments

According to the old proverb, "necessity is the mother of invention." Corporations adapted adroitly to pandemic conditions last year and continue to invest heavily in innovation. Recent data from the U.S. Bureau of Economic Analysis and the investment firm Alger report that digital investments by U.S. companies overtook physical investments for the first time ever in 2020. Digital investments in software, research and development, and information processing equipment have grown to more than 53% of total U.S. business investment, while physical investments in structures and non-information processing equipment has fallen to less than 47%. The trend in favor of digital investments has been in place for years, the pandemic helped spur a substantial and unprecedented inflection point over just the past few quarters. The global lockdowns caused by COVID-19 provided the impetus for politicians, consumers, and companies to invent and adapt faster than ever before, and the resulting innovations stand to benefit the world for years to come.

Source: Politicalcartoons.com

2021 Market Leaders Favor "Old Economy" Stocks

Although digitally-focused companies have led the markets over the past decade — and shined especially brightly in 2020 — the first quarter of 2021 represented a shift in market leadership in favor of more cyclical "old economy" stocks. As investors look forward to a global re-opening and the pandemic abates, investors are re-pricing the companies in industries that were more acutely impacted by the physical realities of lockdowns and work-from-home. JAG's equity strategies are built for long-term investors and are focused on companies that exhibit superior growth characteristics, solid fundamentals, and compelling price appreciation potential. In most market regimes over the past 20+ years, we have tended to avoid companies with a high degree of sensitivity to commodity prices or shorter-term business cycles. That said, our investment process is purpose-built to absorb and incorporate data as conditions evolve, and we will nimbly adjust our focused portfolio structures if and when changes are warranted.

The bond markets are currently feuding with the Fed. While Chairman Powell continues to signal that they will keep short rates near zero through at least 2022, longer-term Treasury yields are rising to reflect investors' expectations for faster economic growth and potentially higher inflation in the coming year.

Accordingly, 10-year U.S. yields have spiked to 1.74% as of 3/31/2021, compared to 0.93% at the end of 2020 as reported by Bloomberg. Since bond prices move inversely to interest rates, rising interest rates tend to cause mark-to-market unrealized losses in bond portfolios. The opposite holds true when interest rates are declining. The impact of interest rate movements on bond prices effect is exacerbated with longer maturity dates. The farther into the future until maturity, the bigger the effect of interest rates on market price. Since rates have been generally falling over the past several decades, longer-term bonds have delivered very strong total returns.

However, the recent spike in yields has been especially challenging for fixed income investors who have portfolios concentrated in longer-maturity bonds. As an example, according to Bloomberg the Barclays 20-year Treasury Index has fallen by almost 14% so far in 2021, providing an unpleasant reminder of the impact of higher rates on longer-term bond returns. Since available yields remain meager (30-year U.S. Treasury bonds yield less than 2.5%), double-digit declines like those of the Barclays Index can swamp years of forthcoming coupon payments. This is partly why JAG has always been cognizant of interest rate risk in our clients' bond portfolios. We favor short- to intermediate-term average portfolio maturities and employ a laddered-maturity structure to mitigate interest rate volatility. We continue to believe this is the correct approach for most long-term investors.

Two Cautionary Tales

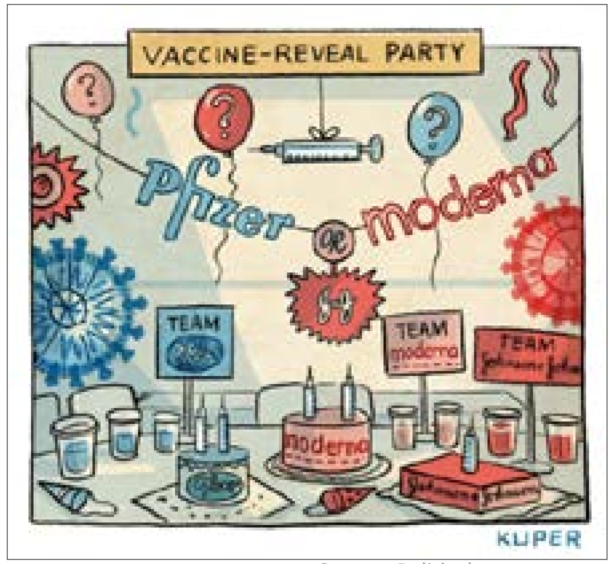
There are certain unfortunate investment stories that seem to be replayed repeatedly, with only the characters' names changing with each iteration. Generally, the plot lines of these familiar tales of woe are dominated by one (or both) of the following themes:

1. Leverage: i.e., the employment of borrowed money to enhance investment returns; and

2. The always-seductive search for attractive investment returns without normal short-term price volatility.

We have seen examples of both over the past few months, and we highlight them as examples of things to avoid in investment portfolios.

According to media reports in The Wall Street Journal, Bloomberg, and numerous other news outlets, in late March, a little-known family office called Archegos



Source: Politicalcartoons.com

imploded, leaving itself insolvent and several large investment banks with billions of dollars of losses. While the details are still being uncovered, it appears that the firm utilized derivative contracts known as Total Return Swaps to lever a concentrated portfolio of stocks by as much as 5x to 7x. In doing so, they were able to use approximately $15 - $20 billion of capital to control a portfolio worth as much as $100 billion.

Although the firm believed that they had effectively "hedged" themselves, their hedges proved to be ineffective against short-term price declines in their large positions. When the firm was asked by its various prime brokers to post more capital ("margin calls"), they ran out of cash within a few trading days. When they could no longer satisfy the margin calls, their brokers liquidated these positions to protect their own balance sheets. Given the fact that all the capital employed (and extinguished) belonged to one family, it appears that the demise of Archegos may go down as one of the most spectacular implosions of personal wealth in history. We cannot know the motivations of the principals involved, but they clearly risked what they had and needed, all because they pursued what they did not have and did not need (to paraphrase a thought from Warren Buffet's 2018 Shareholder Letter).

A lesser known but still instructive mishap occurred in February, when a $1.7 billion mutual fund named Infinity Q shut down and suspended investor redemptions. This fund purported to be able to deliver solid investment returns with less volatility and low

Two Cautionary Tales (Continued)

correlation to the broader capital markets. It appeared to work as planned for quite a while. According to The Wall Street Journal, the fund outperformed 80% of its peers for the five years ending 12/31/2020, and investors deposited almost $800 million into the fund over the 12 months ending in August 2020.

Like Archegos, Infinity Q utilized swap contracts in its portfolio. However, in this case the eventual culprit was not excess leverage, but rather the opaque pricing of some of these swap contracts. Swaps are private contracts that are custom-built by investment banks, and they do not trade frequently. Therefore, the price and value of these contracts must be determined by a third-party pricing service. By prospectus, this fund's portfolio manager was granted the power to override the third-party prices in certain situations.

To make a long story short, on March 26, 2021, the fund re-valued its holdings in preparation for its liquidation and final distributions to its shareholders. According to a March 29, 2021 article in Institutional Investor magazine, the fund recently reported holding cash & equivalents of $1.25 billion, representing a loss of almost $478 million versus the last reported net asset value when the fund shut down. In other words, the strategy which optically appeared to be "low volatility" may, in fact, have been quite volatile. The takeaway: investment propositions that purport to offer the potential for strong, long-term returns, while at the same time promising to avoid the emotional messiness of short-term price volatility, should be viewed with a healthy amount of skepticism.

Market Outlook

We expect that ongoing uncertainties regarding tax legislation, fiscal policy, interest rates, central bank signaling, the pandemic, and geopolitical developments will continue to drive short-term volatility within the capital markets as we progress through 2021. In one sense, the daily interplay between emotions, headlines, and asset prices is as old as the markets themselves. But we also believe that it has become amplified and accelerated in recent years.

We think the growing ubiquity of social media — which adds to the constant background noise of data, information, and opinions bombarding us all — could be contributing to the tendency of many investors to quickly cycle through waves of pessimism and euphoria. As we have seen in various widely publicized market episodes, including most recently in the spectacular rise and subsequent fall of certain "meme stocks" that are heavily traded on platforms such as Robin Hood, emotions rarely increase the quality of investment decisions.

In a very real sense, we view the current noisy and uncertain investment environment as a potential source of long-term excess returns for our strategies and our clients. Accordingly, while we are cognizant of the many ambiguities and uncertainties that lie ahead, we remain sensibly optimistic in our forward outlook. Valuations in some of the frothiest areas of the equity market such as SPACs and newly public enterprise software companies have been corrected somewhat in recent months but remain quite extended.

Although we are long-term believers in blockchain technology and we recognize the potential mainstream utility of certain cryptocurrencies, the fact that there are now more than 4,000 cryptocurrencies in existence makes us wonder if speculative fervor is getting out of hand in this newer segment of the capital markets.

In our view, the effect of these potential headwinds could be muted by massive fiscal stimulus, very strong economic data over the next several quarters, and what we expect will prove to be substantial corporate earnings growth over the next 12 - 18 months.

We remain hard at work to position clients' portfolios for long-term success. Our responsibility is to successfully navigate these markets and develop the strongest investment ideas that survive and thrive within this environment.

Enjoy the Spring!

Warm regards,

Norm Conley
CEO, Chief Investment Officer
& Portfolio Manager

Mike Kimbarovsky
Managing Director
& Portfolio Manager

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