CLOTHIER SPRINGS
Capital Management

Improving Investor Outcomes

PremiumPoints 3Q-2021

Timeless Truths | New Perspectives | Endless Evolution

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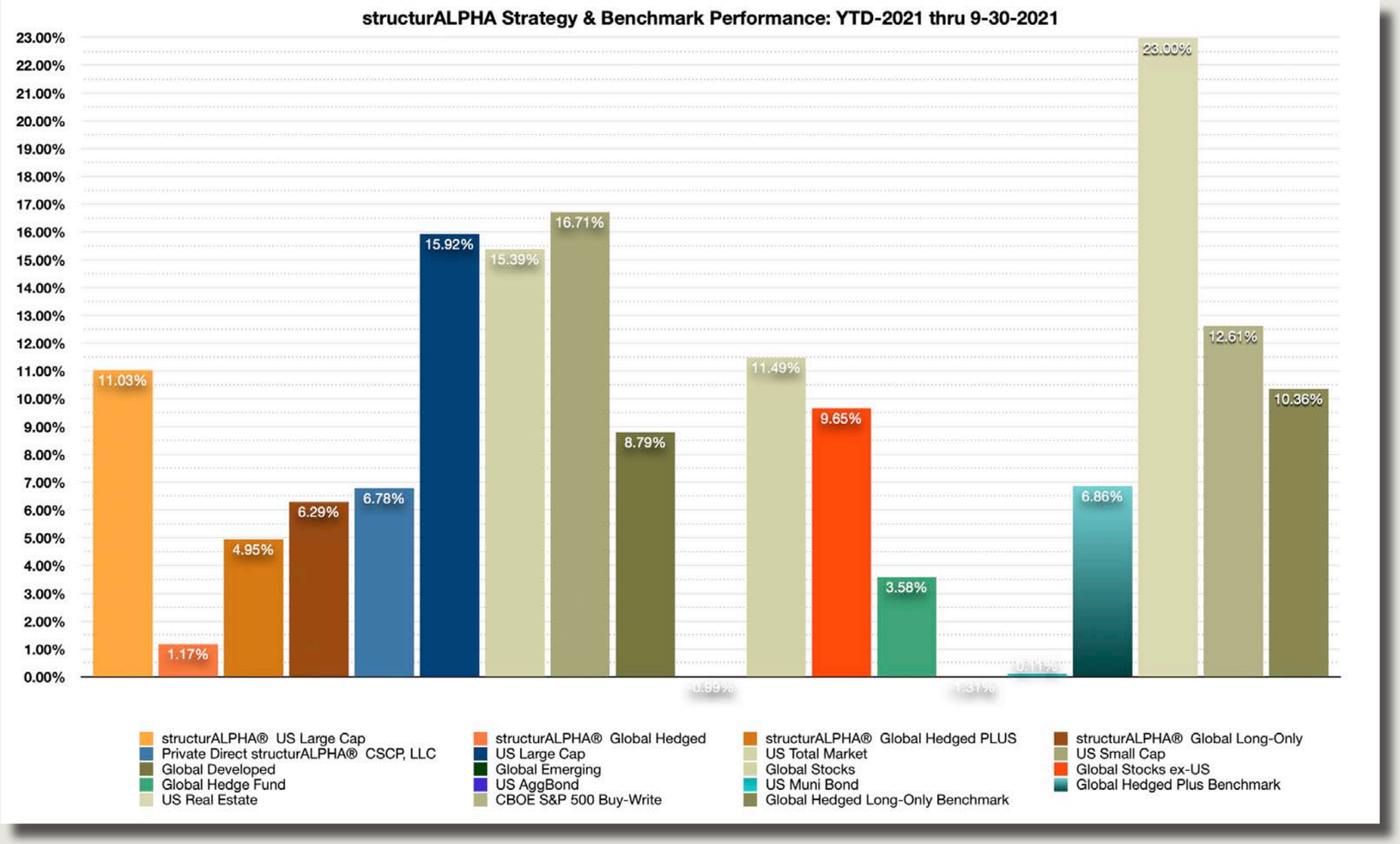


3Q-2021 Review & Outlook

The equity markets ended 3Q-2021 on a sour note apparently driven by budget standoff, inflation and general market valuation concerns. Still, equity markets are broadly ahead for the year more than the historical average annual total return…so we are not complaining.

This old school money manager & investment advisor can't help but think that some of the newfangled trends we have observed in the markets recently are unsustainable and perhaps illegal.

Take "Meme" stocks for example. A meme stock is one where hordes of market participants communicate on the internet and select a stock that they believe is ripe for manipulation. They then collectively trade the stock, pushing its price either up or down, but generally somewhere far removed where the market had previously priced it. The example that brought meme stocks to wide attention was probably GameStop, in early 2021.

GameStop is a failing retailer of computer games and has been losing money since 2019 and trends do not look good. A few hedge funds had taken short positions (bets that the stock price would decline) in GameStop. Sometime in late 2020 and early 2021 on a social media sub-site that discusses stocks and investing, someone raised the possibility of coordinated purchasing of GameStop stock which might have the effect of causing the hedge fund to cover (buy back) its short position at a loss. This indeed did happen. FYI, this is classic market manipulation.

In the coordinated purchase of GameStop stock, the priced soared from barely $10/share in 3Q-2020 and ultimately peaked at $325 in late January 2021—a thirty fold increase in price and value for a failing company.

Part of what drove the success of this manipulation is the plethora of new, novice investors in the market now working from home (thanks Covid) and trading on new market access brokerage platforms like RobinHood. Presumably, many of these folks frequent the internet investing chat rooms and were willing participants in this meme manipulation.

Some people made money, some people lost, one prominent hedge fund failed, but make no mistake, this is not investing.

Gamification of the Markets

Between the new trading platforms like RobinHood, the meme stocks, the crypto hustle and the now omnipresent marketing of online gaming sites, we have real concerns that investing, trading and the markets are being portrayed as sure-thing, entertainment style activities. Indeed, RobinHood was forced to remove the elements of their online app that mimicked games.

We are all for low-cost, transparent access to the capital markets. In that direction our primary custodian for client assets is Interactive Brokers, an ultra-low cost portal to the world's markets with a robust technology platform for both clients and us as advisors. But ample experience and history inform us that the markets have a way of extracting the maximum pain and penalty from novice and uninitiated investors and traders. Investing is not a game. There will be severe pain when the music stops.

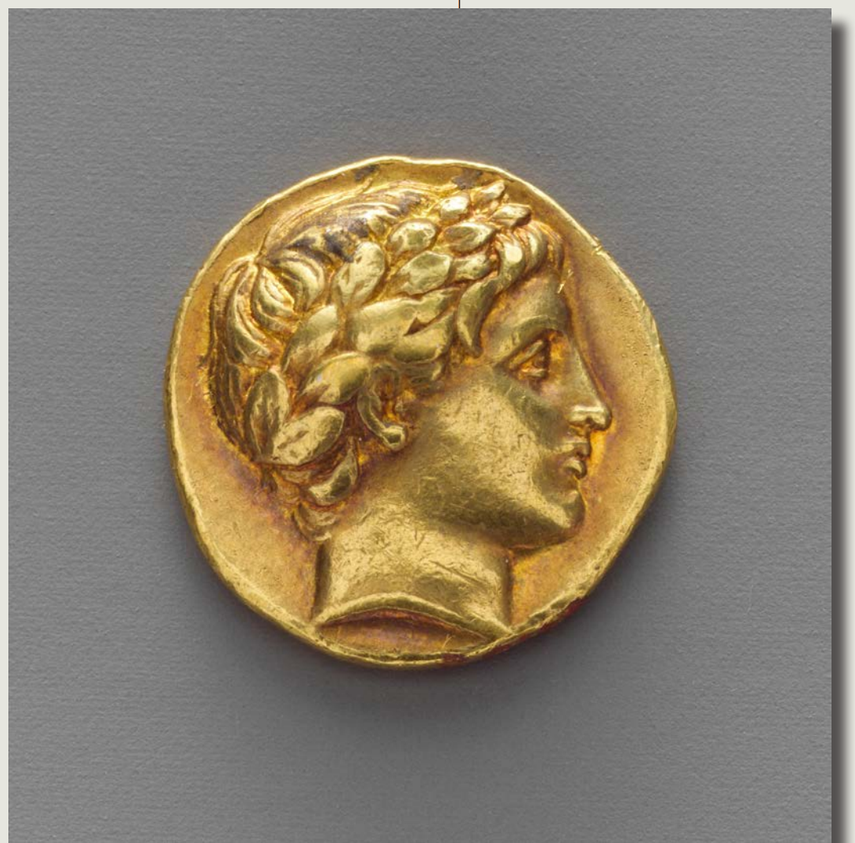
Crypto's: Shut 'Em Down

Never in my 40-plus years in the markets have I seen the endless promotion of something like the current hype around so-called "crypto-currencies." There is an obvious reason for that promotion—something with zero intrinsic value needs an endless supply of greater fools to support and drive prices. And mark these words: ***A market value that relies on an infinite supply of greater fools will eventually have neither….fools or value.*** And if we have learned anything in this American life is that people will believe and buy just about anything that is peddled to them, from pet rocks to eternal salvation.

I realize that I am running the risk of sounding like a fuddy-duddy and that I just "don't get it" and more than one crypto-proselytizer has let me know just that, in rather rough language, anonymously of course. But I think there is an inescapable, timeless truth about legitimate investing that must be acknowledged:

Durable investment market value must—repeat must—be related to productive, economic value: products & services, assets, equity, revenues, profits, earnings, dividends, interest, rent, brand value, etc. Otherwise, crypto's are just a price in the digital ether, unrelated and untethered to any intrinsic value, supported only by greater fools, themselves driven and bullied by myriad promoters and manipulators.

As a fiduciary entrusted to recommend, invest and manage portfolios of investments for clients, I must adhere to defensible logic and actions supported by market history, contract law, empirical data and academic research. ***"Cryptocurrencies" do not meet that standard. Full stop.***



Of course the prices of actual securities can fluctuate with numerous things: investor sentiment, interest rates, credit ratings, earnings, shareholder equity, etc. But underneath it all is an actual business or government and the securities they have issued have contractual relationships to their businesses or their legal authorities, and market value will ultimately reflect that. Again, "cryptocurrencies" have none of that.

The metaphor that keeps playing in my noggin is that crypto's are equivalent to seashells. Traders are exchanging seashells at different prices and the true believers are "Holding on For Dear Life (HODL)" in the hope of becoming crypto billionaires. Seashells obviously have no intrinsic value and an effectively unlimited supply. That crypto speculators can do so on the internet may lend it an air of legitimacy. And undoubtedly, some participants (creators, speculators, promoters, brokers, etc.) will profit while the music plays.

Here are a few questions about crypto's no one has been able to answer to anyone's satisfaction:

- ***What commercial need do they serve?***
- ***Why does the value of a "currency" fluctuate so wildly?***
- ***Why should they appreciate?***
- ***Why would a merchant or government accept as payment something that could devalue quickly and sharply—before they could convert it to legitimate currency like the good old greenback?***

I write this not because any client is clamoring for us to include crypto's in their portfolios—but because the stream of crypto promotion and hoped-for pending legitimacy flows from my computer screen almost endlessly. And so maybe we are just answering some unasked questions (about why crypto's are not a legitimate investment) with this piece, and asking a few questions about crypto's, with no good answers forthcoming.

Warren Buffett puts it this way about Bitcoin and cryptocurrencies: ***"You're just hoping the next guy pays more. And you only feel you'll find the next guy to pay more if he thinks he's going to find someone that's going to pay more."*** He adds, these schemes always end badly. But it explains why crypto's are promoted so aggressively…to keep on producing "next guys."

And to be sure: the crypto craze will not end anytime soon. The coterie of croupiers, manipulators and assorted other hustlers stand to gain too much to let it die.

"Investor" emptor.

Valuations, Perspective and Mean Reversion
Valuation Relationships Are Stubborn Things (to paraphrase John Adams)

Relationships are the underpinnings of the capital markets. Relationships to security issuers, their companies, relationship to government issuers, relationship between prices and some general notion of intrinsic value and more. Relationships describe contractual obligations between issuers and investors and also broad price relationships between security prices and fundamental drivers like shareholder equity, earnings, credit quality, interest rates, etc.

While it is impossible to predict when one durable market relationship that is trading within an historically average range is about to deviate, it is possible to observe when one relationship has exceeded historic ranges or parameters. When that happens an investor or advisor can bias investment towards or away from the investment that is currently at the extreme end of a relationship range. This offers the potential to add performance value by either allocating money towards an investment with a higher future expected return OR away from an investment with a lower future expected return. No guarantees but as Damon Runyan wisely stated many moons ago:

"The race may not always be to the swift nor the victory to the strong, but that's how you bet."

Inflation vs. Supply Chain Kinks and a Spike in Demand

The specter of inflation again hovers over the markets. Inflation fears tend to push interest rates higher which in turn tend to put a damper on security prices. To be sure, prices of many things have spiked higher during the Covid lockdown as well-trained consumers turned to online purchasing to ease their angst and fill their time.

In our view, this has largely been a demand spike combined with a supply chain snarl that has resulted in a re-pricing higher of many consumer goods. Demand for consumer goods is 30% higher than pre-covid. Inflation per se is a persistent period of broadly rising prices, as consumers accelerate purchases to avoid expected higher future prices.

Indeed, both consumers and manufacturers have contributed to the problem as both overbought to ensure their needs were supplied (think toilet paper) which in turn stressed the supply chain creating shortages and a re-pricing higher for many goods. We will see what the next few months and quarters reveal, but we are not ready to agree that persistent inflation is upon us.

A little inflation would be a good thing, raising interest rates and the income that would flow from interest bearing investments.

Clothier Springs Capital Partners Update

Our deal sponsors are working through their value-added renovations, leasing up and increasing Net Operating Income. Some of them are dealing with Covid-19 related eviction moratoriums which may limit rent collection in the short-term. On the other side, housing remains in short supply and rents are increasing at a healthy clip.

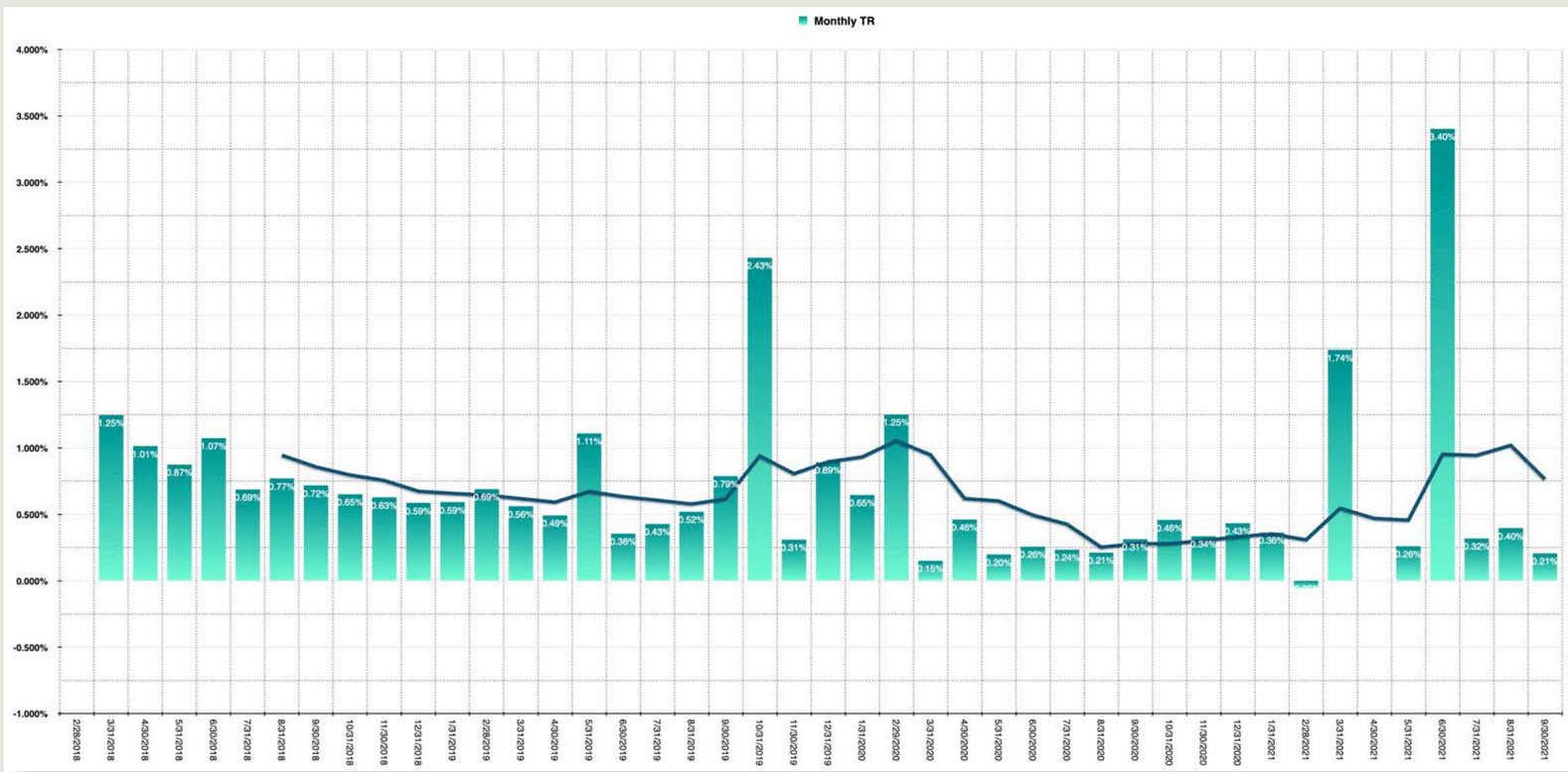
We have been informed that six (6) of our investments are for sale by the deal sponsors and are in various stages of marketing and due diligence. We have limited details and just recently received the Offering Memorandum (right) produce by CBRE to market a portfolio of Cross Properties Projects.

Cross Properties wanted to take advantage of low interest rates and potential high values to sell the properties before they had to secure permanent financing, which always comes with a pre-payment penalty. We have invested in both the Grant (below) and the Dane. They chose to market as a portfolio for pricing and efficiency.

Penn Capital is expecting a November 2021 closing of the sale of their Mustang 101 project in suburban Houston. No valuation or pricing info has been shared by the principals at Penn Capital.

We expect healthy returns to result from these sales and we will have to reinvest their proceeds appropriately. The current value for the projects for sale represent more than 21% of our total portfolio.

We are set to originate a hard money loan to a builder right here in Phoenixville to build a spec town-house in the very desirable North Side-Town Center district. Land was acquired in 2020 and we will take a first lien position on the loan.



The Offering Memo from CBRE Properties to market a portfolio of Cross Properties projects. CSCP is invested in two of the five. Received by us on October 20, 2021.

The High Cost of Comfort

Investors Earn Returns Net of All Fees

Minding your total expense burden will serve investors very well.

At a recent client review meeting, our advisory client George (not his real name) mentioned a referral he tried to make on our behalf. He had a friend Louise (not her real name) who still had her investments with the firm (we will call them Gougem Investments) he used to have his investments with. He was in a unique position to understand the merits of each respective firm's business model. We were in a position to have had the opportunity to make an apples to apples comparison of the total services and fees of each firm with client reports provided by George before he moved his investments to Clothier Springs. Louise declined the referral saying she was "comfortable with her current advisor."

It is an inescapable Timeless Truth of investing that investors earn returns net of all fees and costs (advisory, expense ratios, brokerage, etc). Clothier Springs Capital Management has chosen to acknowledge this truth and as such, we have a purposely low advisory fee and we build portfolios exclusively with Exchange Traded Funds (ETFs) with ultra low expense ratios. The simple rationale for that approach is to provide our investors with the best possible net returns while also earning enough revenue to pay the bills here at CSCM.

Back to George. His previous investment firm charged an annual asset based advisory fee of 1.0% of assets and implemented portfolios with relatively expensive no-load mutual funds with a typical expense ratio of 1.5%. This adds up to an annual expense burden of 2.5%. The total expense burden for the typical CSCM client is only one-quarter of 2.5%. We have an advisory fee roughly half of Gougem and we use investments with expense ratios more than 90% less expensive than Gougem.

Here is the cost of comfort Louise is paying to keep her investments with Gougem vs. CSCM. We will assume a hypothetical portfolio starting at $500,000 and a gross average annual return of 6.0%. After fees, Louise's portfolio earns a net annual return of 3.5% (6.0% minus 2.5%). George's portfolio earns a net annual return of 5.4% (6.0% minus 0.6%).

With those realistic assumptions, Louis's portfolio will grow to $595,170 in five years and she will pay $27,429 in fees to her investment advisor. George's portfolio at CSCM will grow to $653,800 over the same five years and he will pay $14,433 in advisory fees to CSCM over that five-year period. Can you see the relationship?

In summary, Louise will pay an extra $12,996 to her advisor and with the drag on performance of the higher fee burden, her portfolio will be $58,630 behind George's. The total cost to Louise for keeping her investments with Gougem over that five year period is a total of $71,627, or roughly $14,325 annually.

For her comfort with her current investment advisor, Louise is spending $71,627 in direct fees and diminished total return for her portfolio over our hypothetical five-year period.

The assumed returns for our hypothetical scenario are realistic, the costs are real and the result is an enormous direct cost in both fees and lower total return for Louise. If Louise's account is significantly larger than $500,000, her comfort will be commensurately more expensive.

We think this is an enormous price to pay for "comfort" and reluctance to consider a new advisory relationship. Moreover, the fees charged by, and investments used by Gougem are highly typical of the advisory universe.

Vanguard Founder Jack Bogle wrote about the challenge of balancing professional values and business values in 2017:

> *But the reality is that no profession can be free of business pressures. As I noted in a speech at Cornell University in 2010, "If revenues fail to exceed expenses, no organization— even the most noble of faith-based institutions—can long survive."*
>
> *What about our own field? Of course, we are a profession, with investment firms that are committed to serving their clients. But we are also a business, driven to maximize the profits that our firms earn in the conduct of their affairs.*
>
> *Thus, the issue faced by CFA charterholders and other financial industry participants is not choosing between professional values and business values. Rather, it is balancing that ever-competing pair in a way that places the best interests of consumers and clients above our own corporate and personal interests.*
>
> *Such a balance is not easy to achieve. As Gardner and Shulman warned in their Dædalus essay, "Pursuing such a noble mission can often be painful, and is possible only for those who truly believe in the mission and have enough self-perspective to remain wary of dangers such as arrogance, megalomania, misguided beliefs, and distorted judgments." Those of us in the investment profession must be ever wary of these dangers.*

From our vantage point, very few of our fellow investment advisors get this balance right—placing client interests above their own. While they all give lip-service to that ideal, very few actually walk the walk. We scan dozens of competitor's regulatory filings routinely and can confidently report that our advisory fees are the lowest of all the advisors similar to us (and usually much larger) we have analyzed. Moreover, with the use of ultra low-cost ETFs in our client portfolios, the total expense burden borne by our clients is the lowest we have ever analyzed. The result, our clients earn the best net returns possible, relative to virtually any other advisor in our peer group.

This is our choice: to serve our clients by keeping their expenses as low as possible, and your returns as high as possible. We hope you, our clients, understand that.

P.S.
While writing this newsletter we received a random email from some unknown advisory firm. Always looking for competitive information, I went right to the S.E.C. website to review their business structure and fees. Below are the two screenshots of their fee schedules. This is public information, available to anyone. The firm-based in Florida-will remain unnamed. These types of fee schedules are all too common across the investment advisory universe.

While these fees are not illegal, we believe they are highly unethical and self-serving at the expense of their clients.

Wrap Program Name	Sponsor	Fee[3]
Lockwood		2.5%
TD Ameritrade Platform		2.5%
Schwab Platform		2.5%

ITEM 5. FEES AND COMPENSATION

In addition to the information provided in the Advisory Business section, this section provides details regarding our services along with descriptions of each service's fees and compensation arrangements.

DESCRIPTION OF FEES AND COMPENSATION

ASSETS-BASED ("AUM") FEES	
HOW ESTABLISHED	NEGOTIATED
RECOMMENDED MAXIMUM	1.5%
ABSOLUTE MAXIMUM	2.5%[7]

We appreciate referrals. Remember to tell your friends and colleagues who need investment advice and management... IRA's, pension rollovers, 401(k) rollovers, wealth, trusts, etc.

It could be worth real money to them.

https://www.youtube.com/watch?v=KOmmy04YBA8

Paul McCartney making a surprise guest appearance at the end of Billy Joel's "Last Play at Shea" concert in 2008. McCartney played a Beatles song he wrote at age 16 while playing hookey from school: ***"I Saw Her Standing There."***

Closing Thoughts

The markets ended 3Q-2021 on a sour note, but are still well ahead for the year. Supply chain issues and the specter of inflation make it clear how tightly interconnected the global product and capital markets are.

New cars are hard to come by, appliances are on back order. Even the shortage of musical gear has an acronym: GAS for Gear Acquisition Syndrome. I admit to a touch of that last one. Demand for hard goods is up more than 30% pre Covid and people sought to fill the social void in their lives with material acquisitions...this is America after all, where the Consumer is King.

This very day (10-20-2021) the Dow Jones Industrial Average rose to a new all-time, intraday high. And it will ultimately move higher over time. But it would be wise for investors to keep future return expectations modest.

We see much that can only be called FinPorn in the world today...glorifying billionaires, unicorns, crypto hustlers, online gambling.. anything that venerates wealth and promises a sure quick path to wealth. We are here to tell you..."it don't work like that."

Investing is a "get well over time" endeavour, applying the best practices and timeless truths of asset allocation and diversification within a low-cost, formal policy, and a behavior discipline framework. We hope we have you all well-trained.

A word about the artwork in these newsletters: it is all public domain artwork available for download from the NY Metropolitan Museum...a trove of items, both ancient and modern. One could spend a long time on their website, perusing hundreds of thousands of items.

Thomas F. McKeon, CFA | October 21, 2021