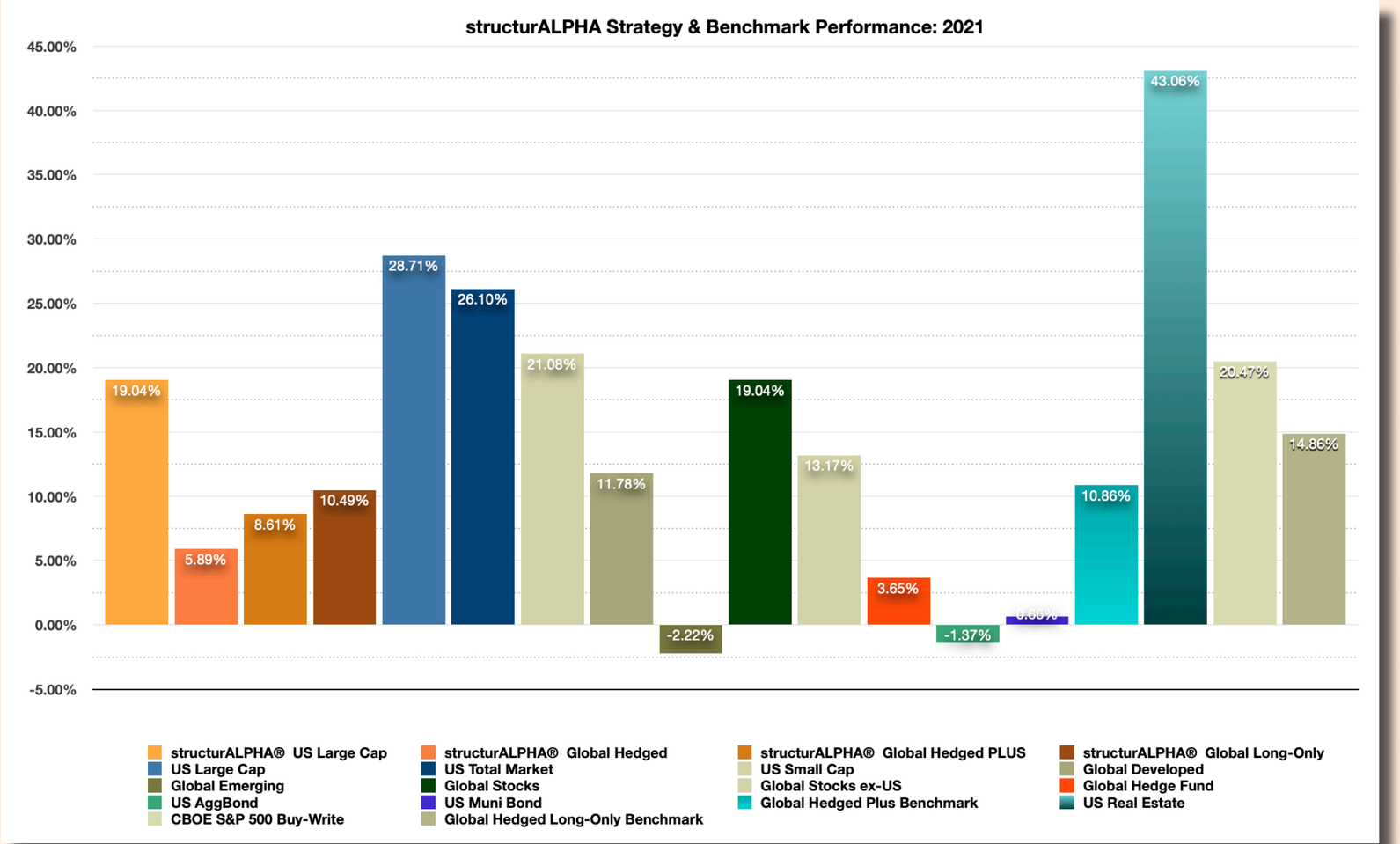
CLOTHIER SPRINGS
Capital Management

Improving Investor Outcomes

PremiumPoints 4Q-2021

Timeless Truths | New Perspectives | Endless Evolution

In this issue:



4Q-2021 Review & Outlook

With a smart rally in 4Q-2021, the equity markets posted a surprisingly good year in 2021. The U.S. equity bellwether (S&P 500) posted a 28.7% total return, against a backdrop of supply chain disruptions, price increases and pandemic uncertainty. For context, the U.S. broad equity markets have delivered an historic annual total return of roughly 10%, with half of that coming from dividends. As supply chain disruptions combined with increased demand, prices rose and the potential for inflation became an issue, real or imagined. This in turn caused investors to expect rising interest rates, which in turn puts downward pressure on prices across the bond markets. As such, the broad bond markets fared poorly, falling roughly 2.0% for the year. Muni bonds were flat. The surprise standout for 2021 was the U.S. Real Estate (REIT) benchmark, gaining 43.0% for the year. As always, the global aggregate hedge fund universe delivered a moribund 3.6%.

Navigating the Uncertainties

The pandemic has caused some serious disruptions to many aspects of our lives, the economy and the markets, and has caused many of us to re-examine how we live, work, play, consume and invest. There will be winners and losers in the world of commerce as incomes fluctuate and consumer preferences change. In reality, they are changing all the time, but recent events have sped up some of that. Technology drives much of the creative disruption. This makes trying to identify and pick winners in the stock market all the more futile.

Is Inflation Real?

Short answer: it is real enough for now. The latest inflation data revealed an annual inflation rate of 7.0% for 2021. We remember inflation of the 1970s as a persistent upwards price spiral. We are not sure that recent price increases are nothing more than the convergence of a spike in demand driven by delayed consumption caused by pandemic lockdowns coupled with sporadic product shortages driven by both supply chain disruptions and rolling worker shortages.

However, something is different about this recent inflation: the economy has experienced labor shortages even as employment approaches full pre-pandemic levels. The supply chain issues are now well-known. Unprecedented amounts of stimulus were pumped into the economy to both support lost wages, consumer spending and faltering businesses. Consumer spending habits shifted from services (restaurants and entertainment) to purchases of goods.

Moreover, the data indicates that much of the observed inflation is due to a handful of items like new and used cars and gasoline. The Federal Reserve is hinting that a few $^1/_4$ point hikes in interest rates will be warranted to constrain inflation. We will see. And in early 2022, the markets are already selling off—probably in anticipation of the expected rate hikes, among other potential proximate causes.

We believe that consumers will adapt and supply chain issues will resolve over time. A little inflation would be constructive for bond markets, as it would drive bond yields a little higher...investors would benefit from higher bond income.

A Tale of Two Market Exposures

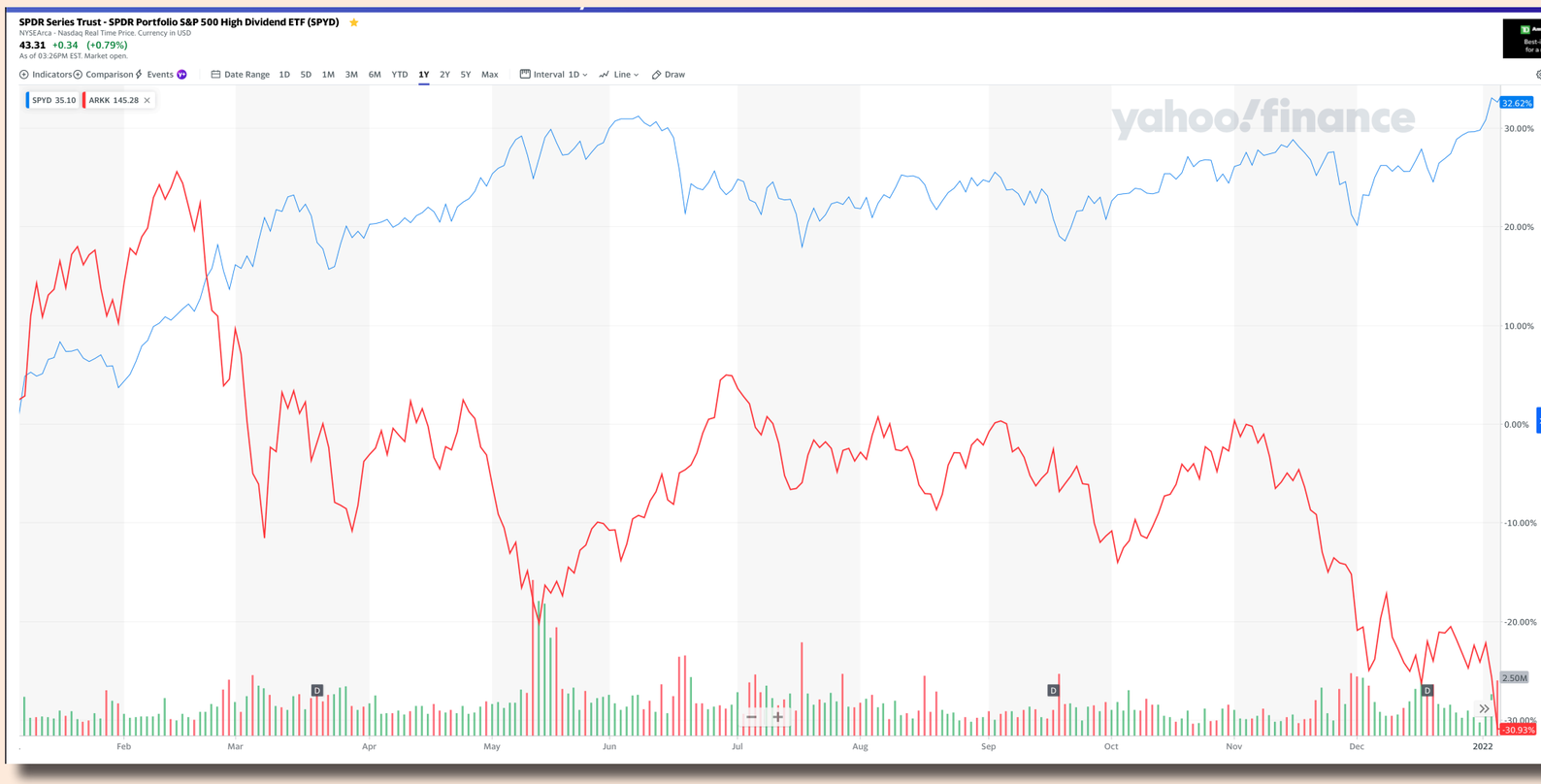
Equity Style and Factor Divergence Chart

At CSCM, we implement our recommendations and build portfolios exclusively of ultra-low cost and broadly diversified Exchange Traded Funds (ETFs). We aim to capture market returns as faithfully as possible. The objective is to build globally allocated and diversified portfolios that are maximally efficient: that is they optimize the return to risk tradeoff at any given level of risk.

This is not to say that there are not opportunities to bias portfolios towards or away from various different market factors such as: growth, value, dividend yield, momentum or low-volatility to name a few. They do present from time to time.

As ever in the markets, various market exposures can exhibit price appreciation or depreciation that overshoots the mark and provides us with an opportunity to lean into a cheap exposure with lots of return potential, or away from a market exposure that has gone to far and in our estimation, has limited short-term return potential.

Case in point. The exhibit below shows the one-year performance for two ETFs: One is the ARK Innovation ETF (ARKK)—focused on investing in disruptive innovation. The other is the State Street S&P 500 Income ETF (SPYD)—focused on stocks in the S&P 500 with superior dividend yields. We use this ETF widely as we believe the equity markets are fully valued and this is a way to be defensive while maintaining equity exposure. The chart shows the price action of these two ETF for one-year as of early January 2022.



To be fair the ARKK fund had a gang-buster 2020 as pandemic lockdowns took effect and hordes of bored folks at home piled into the fund. 2021 was however, a vastly different story for ARKK.

For that one-year period in the exhibit, the SPYD gained 32.6%. The ARKK declined 30.9%. While both ETFs are broadly diversified, the different market factors the funds were exposed to delivered vastly different results—a 63% difference in just 12 months. You read that right…63% difference.

Avoiding Unforced Errors

For the record, ARKK is not something that CSCM is ever likely to use in portfolios. Its expense ratio is too high and it is essentially an active management wolf wrapped in the passive management vehicle of an ETF. Active management is the notion that a portfolio manager—or anyone else—can identify market winners, invest in them and consistently outperform the passively managed benchmarks they hope to compete with. This is a now well-established invalid premise. Some active managers will outperform sometimes: but consistently over time, after the expensive active management fees, no. And when active managers guess wrong, the downside can be very bad. See ARKK 2021 vs. S&P 500 performance.

This is not to indicate that our portfolio recommendations are mindless "set it and forget it" constructs. They are not. We do shift, lean and re-balance portfolios towards value and better expected returns and away from overextended market exposures as valuations and portfolio weights fluctuate.

So we will stick to the passively managed, rules-based market exposure ETFs that give our clients the best opportunity to earn market returns and achieve their objectives, within their risk budgets while keeping total costs as low as possible.

Structure IS the Strategy

When operating a small business, one is occasionally required to contemplate all things marketing, from positioning to branding to you name it. We are constantly trying to refine our story and positioning to market realities. After close to 42 years in the financial markets, we have a good handle on the moving parts of a fiduciary quality investment program and how best to package and price them. The challenge for us visibility. In that direction a tagline that we have been using for some time is this:

Structure IS the Strategy.

The financial services universe is home to numerous vendors, service and package providers, corporate structures and various levels of competence. Many of them rely on marketing that purports to have special insights into the markets and future events. Spend any time on a financial website and the shouts for clickbait are endless...such as:

What 5 stocks to buy now...
What is Warren Buffet Buying Now...
What (insert hedge fund billionaire here) thinks about the markets....
What (insert latest mutual fund manager darling) is buying now...
This (fill in the blank) will be 1,000 bigger than (XYZ)

Many if not most of my investment advisor brethren are selling (out)-performance, largely to justify their fee structure. Overwhelming historical data informs us that this is an invalid premise.

Rather, the best way for private and institutional investors to achieve their objectives efficiently and cost effectively is to mind the Structure of their investment program. Structure in a handful of respects:

Corporate Structure

Does your vendor operate under a multi-national corporate umbrella with all of its attendant embedded costs: layers of management, plush branch offices, lavish executive compensation, shareholders—who collect dividends—and ample support staff and other overhead? Or does your vendor operate a lean, low-cost, de-layered business model? Which do you think will ultimately serve investors better?

Regulatory Structure

Does your vendor operate under a broker-dealer regulatory regime with it's compromised standards (non-fiduciary) and conflicted (commission-driven) compensation arrangement? Or is your vendor a Registered Investment Advisor (RIA) operating under a required and ethical standard to serve client interests and

whose only compensation comes from the people they serve—the clients? Which do you think will ultimately serve investors better?

Services Structure

Does your vendor operate what is essentially a marketing organization, outsourcing most or all of the investment function to downstream turnkey platforms and other back office platforms so they can focus on asset gathering, or does your vendor organize and implement the bulk of the investment functions internally, responsible for the investment decisions, allocation, implementation and monitoring? Which do you think will have a lower total cost and accountability and thereby serve investors better?

Portfolio / Implementation Strategy & Structure

How does your vendor implement your investment program? Does your vendor's corporate, regulatory and services structure predispose him or her to bias portfolio recommendations? Who recommends the asset allocation? What securities go into the portfolio: individual stocks, bonds, REITs, mutual funds (load or no-load), ETFs, hedge funds, et cetera? It is widely understood that asset allocation does the heavy lifting in an investment program. Get this part right and achieving your goals becomes highly likely. Get it wrong and achieving your goals becomes an expensive, riskier and far more uncertain undertaking.

Fee and Total Cost Structure

Even if your vendor operates an optimal business, service and investment program model, if the fee and cost structure is too high, it eats away and degrades investment returns.

The asset management and advisory business is greatly scalable. We don't have to invest capital in factories or raw materials to manufacture our services. As such, margins and individual compensation in the industry has historically been quite robust and has attracted people to the industry who are highly interested in getting rich. And that goes triple for the grifters who operate hedge funds. These folks all love their lavish compensation, which in turn is supported and driven by their fee structures. Sure, we want to keep a roof over our head and keep the lights on but we have taken a very different approach to our business.

Mind the structure of your investment program and things strongly tend to work out. No guarantees, just better odds.

Structure IS the Strategy.

Clothier Springs Capital Partners Update

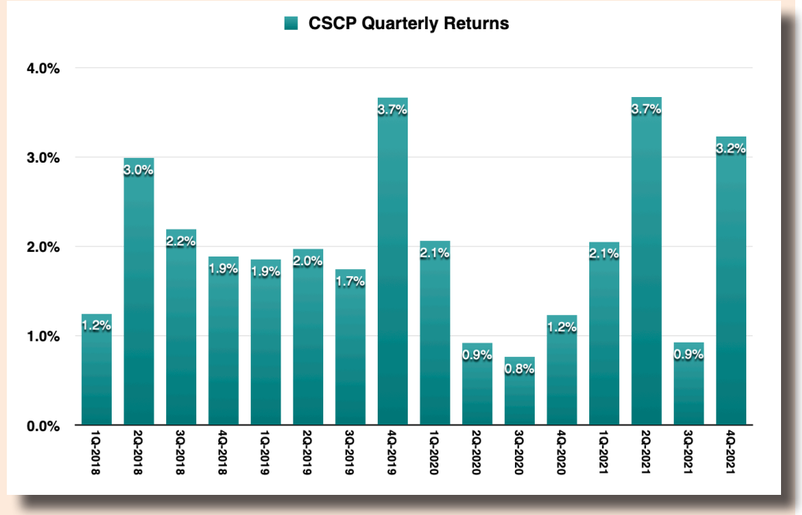
The partnership ended the year on a strong note as we had two capital events. Deal sponsor Penn Capital sold the Mustang 101 project in suburban Houston and 85% of the Madison Grove project in Huntsville, Alabama. The Mustang 101 project delivered us a 13% annualized total (gains + income) return and the Madison Grove project delivered a 25% annualized total return.

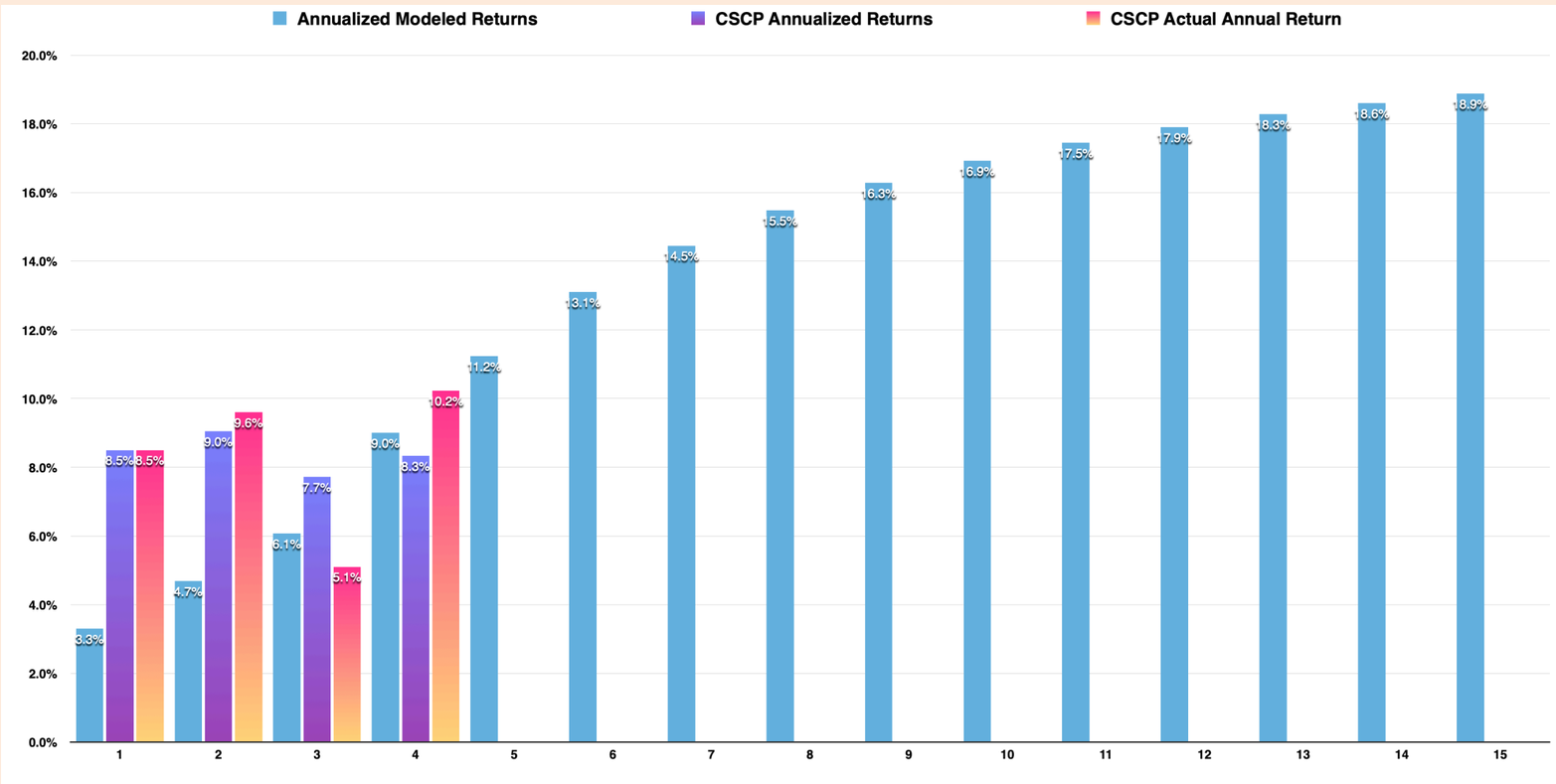
We have now had five capital events and the weighted average annualized return so far is 29%. That may be more than we should expect going forward.

We have several other investments that are under agreement of sale. We have no particulars on the eventual returns we will book, but indications from the deal sponsors are encouraging.

We have done some basic modeling of what future returns could look like given the following assumptions: the partnership maintains a 70% equity to 30% debt ratio, and one-fifth of our equity investments have a successful capital event every year, providing a 20% annualized return. The light blue bars in the exhibit below are the modeled returns using those assumptions.

Most deals take a few years to get up to speed, improve Net Operating Income (NOI), commence preferred return payments and have a liquidity event. As we now enter that time when several of our deals have matured, the aim is to have a regular turnover of deals (with their projected returns) and to reinvest in more deals that provide the required returns. All indications are that both single family and multi-family housing is in short supply. —>





We believe this is a reality that will persist for some time and our partnership can benefit from the business of lending to builders and developers and providing equity capital to developers and re-habbers of multi-family homes. The debt returns are a straight interest rate for providing capital. The equity deal returns are a function of the value-added activities of developers enhanced by the typical leverage (traditional bank financing) on top of our equity capital in the standard capital stack.

With the expected pending capital events in 1Q-2022, we will receive something close to $800,000 in return of capital and our anticipated profit participation. This will have to be turned around and invested in more deals that can provide our required return for equity investments of 16% to 20% annual total return.

We have committed to a project in Brooklyn, NY to build a 30 unit multi-family structure in the desirable Williamsburg neighborhood. We continue to build a pipeline of potential deals that provide economic, geographic and target resident diversity.

Our audit (EisnerAmper) has already commenced and we will have partnership K-1's as soon as reasonably possible.

Democratization a Two-Edged Sword

Not too long ago, the commission for buying 100 shares of stock at a local brokerage firm was $400. Last week—investing a new account—we bought 1,000 shares of a $20 stock at our custodian—Interactive Brokers. The commission was $5.

Technology and competitive pressures have made accessing the markets very inexpensive. However, access to the markets is nothing without an understanding of how to operate in the markets, what drives returns and importantly, what activities to avoid.

Day Trading For Kids?

As a perfect example, we see ads now for apps to "teach your kids how to day trade." Day trading is an activity with a negative expected return. Sure some trades will win, but in aggregate and over time, it is a money losing proposition. Access to the markets without an understanding of how to operate in the markets is dangerous and will ultimately prove to be very expensive. And many strategies have market structure working against them.

The simple truth is that any action in the markets will have a result. With the right capital and account permissions an investor could do almost anything in the markets, from buying soybeans to selling Tesla short to "day-trading" cryptocurrencies, to using leverage to...the list goes on.

What makes a prudent, fiduciary quality investment program is that the collective actions and trades to implement portfolio decisions result in a program with a positive expected return—informed by market return history and current capital market conditions—and at a reasonable total cost.

Markets Not a Place to Play

We have been risking personal, corporate and client capital in the markets for more than four decades now. While the "markets" are effectively the collective actions, opinions and trades of millions of people, they prove time and time again to be very, very good at separating the novice, naive, misinformed and overeager investors from their money.

The Wall Street complex is now full of entities whose business model is extraction: market making, high-frequency trading, index arbitrage, proprietary trading, front-running, paying for order-flow (RobinHood), market manipulation and other types of fomenting investor behavior (think March 2020).

Our investment advisory services are built to avoid all of that predatory extraction. We limit trading to necessary initial investment and periodic rebalancing. We know how to execute in the markets. We use ultra-low-cost ETF vehicles. We rely on Investment Policy structure to build globally allocated portfolios and hope to manage client behavior to eliminate the impulse to abandon the markets when the going gets tough.

Structure IS the Strategy

Why We Are an Independent RIA

As we hope you know, Clothier Springs Capital Management, LLC is a Registered Investment Advisor (RIA). We are registered with and regulated by the Pennsylvania Department of Securities with the same regulatory requirements as promulgated by the Securities and Exchange Commission (SEC). Once we reach a size threshold, we will be regulated directly by the SEC.

Financial professionals who wish to serve individual investors must register either as an RIA or as a (stock) broker. Professionals who wish to earn commissions from the sale of products like funds, syndications and other packaged products, or from transactions must be registered as brokers. Their regulatory obligation to clients is to recommend what is "suitable"...a gray area with lots of wiggle room if ever there was one.

RIA's are only permitted to earn compensation for advisory services directly from their clients in the form of asset-based fees, consulting fees or retainers. We chose to be an RIA because we want to serve only one master—our clients. Our loyalty is exclusively to our clients. Our regulatory obligation as a fiduciary is to put client interests first. Our business model ensures it—we have no incentive to do otherwise.

Ample evidence exists—and common sense informs us—that brokers are conflicted—always balancing client needs with their own choices and recommendations and the compensation each recommendation will generate. It's a conflict that won't always be resolved in the client's favor. It is simply human nature.

So we are a Registered Investment Advisor by choice, to operate under the structure that best enables and requires competence and ethics. We are an independent by choice to operate with the lowest possible overhead which directly leads to lower fees and better outcomes for our clients. We answer to and are solely beholden to our clients.

Data Drives Everything

We have always had a bias towards data and analytics. Even as a stock-picking portfolio manager in a former business I always wanted to know the metrics: earnings, Price/Earnings ratios, price to book value, valuations, projected growth, Return on Equity (ROE), dividend yield and payout ratio, etc to name but a few. Knowing the metrics was a way to compare apples to apples and to provide support for any investment decisions. As we live in a data-rich and data driven world, this approach makes complete sense in literally every arena: business, medicine, engineering, even sports.

Michael Lewis wrote "Moneyball" which was published in 2004. It was about how the manager of the Oakland Athletics baseball club—with the lowest payroll in major league baseball—in 2002 decided to abandon the old school methods of player evaluation—and go all in on measuring what activities contributed to wins and what players were good at them, even if overlooked by the rest of the league and traditional ways of evaluation, and acquire them.

This resulted in a season of more than 100 wins and caught the attention of some ball club owners—most notably the owner of the Boston Red Sox—a hedge fund operator with an appreciation for data and analytics. He soon hired a young analytical manager and the Sox proceeded shortly to break the "Curse of the Bambino" by winning the World Series after a near 100 year drought.

We immediately recognized Moneyball as a metaphor for stock picking as both endeavors seek to find overlooked players (stocks) with potential and acquire them as cheaply as possible. The rest of Wall Street also understood this and all Street research that year referenced Moneyball endlessly.

What is interesting to us is how some still reject analytics. One of our favorite examples is a well-know ESPN sports journalist who rails against any professional coach or team using analytics to decide how to select athletes or even worse, how to manage a game. The incentives to use data are powerful. Professional sports is a multi-billion dollar business and coach salaries are quite large. Winning games keeps coaches employed. They would be fools not to use data.

Of course, analytics can be over-worked—paralysis by analysis—and one of our favorite authors—Malcolm Gladwell—wrote about this in one of his books. The anecdote is about a doctor who came to work in the emergency room of a busy Chicago hospital. They had an evaluation protocol for patients who arrived in the ER. The protocol had more than 100 data points. The doctor instantly realized that 100 was too many, difficult to obtain and impossible to do in a timely fashion. He whittled the protocol down to just 3 data points. Patient outcomes improved immensely. Time and lives were saved.

This is not rocket surgery as they say. I would not want a doctor to diagnose and treat me without the relevant data in hand nor should a coach put a player in the game without quantitatively understanding the player's abilities, tendencies and percentages. Analytics will also help him make better game decisions. Full stop. No guarantees, just the best chances and odds.

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

One of our favorites--Bruce Hornsby--Playing the song that put him on the map: That's Just the Way It Is, Live at the Town Hall in NYC in 2004. Check out the musicianship and the competence of the band and the fun they have.

Closing Thoughts

After an outstanding year in the U.S. equity markets in 2021, things have become a little unsettled in early 2022. Inflation has been running hot and it is expected that the Federal Reserve will raise rates to tamp it down. Fully priced equities have responded as might be expected, with a 10% sell-off already in the books. More to come? Your guess as good as ours. Probably safe to assume that falling rates are no longer a tailwind for long dated assets like stocks...and they may deliver anemic returns for a while. Global equities--emerging markets especially--now have the best short-term expected returns.

All of us are looking forward to resuming a life as normal as possible, given prevailing pandemic and health concerns and realities. When will that be? No one can really know but there are some indications that we may be moving towards the endemic stage, where COVID exists rather like the flu, and people with vaccine and previous exposure immunity have little to fear.

Our article in this issue about data can be reduced to this simple concept relative to sports:

What matters (hits, steals, walks, etc.), who can do it, and what is the price for acquiring and keeping them?

Replace sports with, medicine, business or investing and a fundamental algorithm for maximizing success, however one defines it is clear. We live in a data rich world. It makes sense for us to know what matters as we advise clients and build portfolios.

Thomas F. McKeon, CFA | January 25, 2022