2Q21 Commentary

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"Once men turned their thinking over to machines in the hope that this would set them free. But that only permitted other men with machines to enslave them."

- Frank Herbert, *Dune*

"Most decisions are not binary, and there are usually better answers waiting to be found if you do the analysis and involve the right people."

-Jamie Dimon, CEO of JP Morgan

Welcome

What a difference a year makes. Just 12 months ago the pandemic went global and changed life as we know it. At the time, COVID-19 was poorly understood and the only tool to combat its spread was a total shutdown of society. Today, there are several highly effective vaccines available and herd immunity is closer than ever.

As of March, New York State has had 1.8 million confirmed cases of COVID-19, though the actual number is likely higher from under-reporting of cases earlier in the pandemic. Additionally, 5.3 million people have at least one dose of the vaccine and 2.8 mil people are fully vaccinated.[1] With these numbers, over 1/3 New Yorkers have some level of immunity against COVID-19. With approval of the Johnson & Johnson (JNJ) vaccine and additional production from Pfizer (PFE) and Moderna (MRNA) this will improve further. Unless the vaccine rollout stumbles, we think normal life returns as 2021 progresses.

As investors we ask, 'what comes next?' Did COVID-19 permanently alter certain behaviors? Will people return to gyms or will they continue exercising at home? Do we need all this office space, or can some employees work remotely? At a macro level, how will the US address the fiscal deficit? The answers to these questions will have far-reaching implications.

As we work to identify investments and allocate capital for a post-pandemic world, we will continue to monitor COVID's retreat as closely as we did its advance.

Stay safe and thank you for entrusting us with your investments.

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[1] https://covid19vaccine.health.ny.gov/covid-19-vaccine-tracker. Accessed 3.17.2021.

1Q21 Review

Inflation

As we reflect on 1Q21, one topic is bubbling to the surface after a long dormancy: inflation. Inflation is hard to pin down and slowly erodes the purchasing power of savings which is why it is known as 'the silent thief.' We will continue to discuss inflation in future publications but, for the scope of this piece, we look at why inflation concerns are arising now, whether inflation is good or bad, and how investors can position.

Inflation concerns are arising primarily because US government is running historic deficits at a time when the national debt is already at a record. Amidst this macroeconomic backdrop, there appears to be no political will to raise taxes, cut spending or otherwise manage the budget. Instead, to finance this debt, the US Federal Reserve (the Fed) is simply acquiring the debt from the US Treasury. This process stimulates the economy by increasing the money supply while keeping interest rates low. The short-term benefits are clear, but the long-term consequences are unknown. Of the potential long-term consequences, inflation concerns us the most.

Additionally, the US economy is reaccelerating strongly as it emerges from the COVID-related shut-down. Pent-up demand and high levels of consumer savings mean that consumers are ready to spend and can afford to pay more for what they want. The strong housing market, where prices astonishingly rose +10% last year, is an example of this.[2] A strengthening economy coupled with expansionary monetary policy increases the likelihood of rising inflation.

Inflation, like many things, is not binary. At its most extreme, like the Weimar Republic or modern-day Venezuela, it is economically devastating. Currency becomes worthless and economies revert to a barter system. In more moderate cases, like the US in the 1970's, inflation is disruptive. The value of certain asset classes, like long-term bonds, is severely impacted by even moderate inflation because the interest payments cannot adjust to changing market conditions. In more benign forms, such as the 2000's, low inflation helps provide stable, predictable prices and foster economic growth.

As investors, there are several ways to position for inflation. The first is to manage allocations and avoid the asset classes that are most challenged by inflation. For example, cash and long-term bonds will perform very poorly in an inflationary environment because they cannot adjust or reprice based on inflation. Assets such as real estate and equities are better able to preserve value through bouts of inflation. Some companies with strong pricing power can simply raise prices to adjust for inflation. For example, credit card companies like Visa (V) and Mastercard (MA) make their money by taking a percentage of each transaction. As prices rise, the revenue of these companies automatically rises in tandem. Outside of hyper-inflation, equities are a relatively sturdy investment in an inflationary environment.

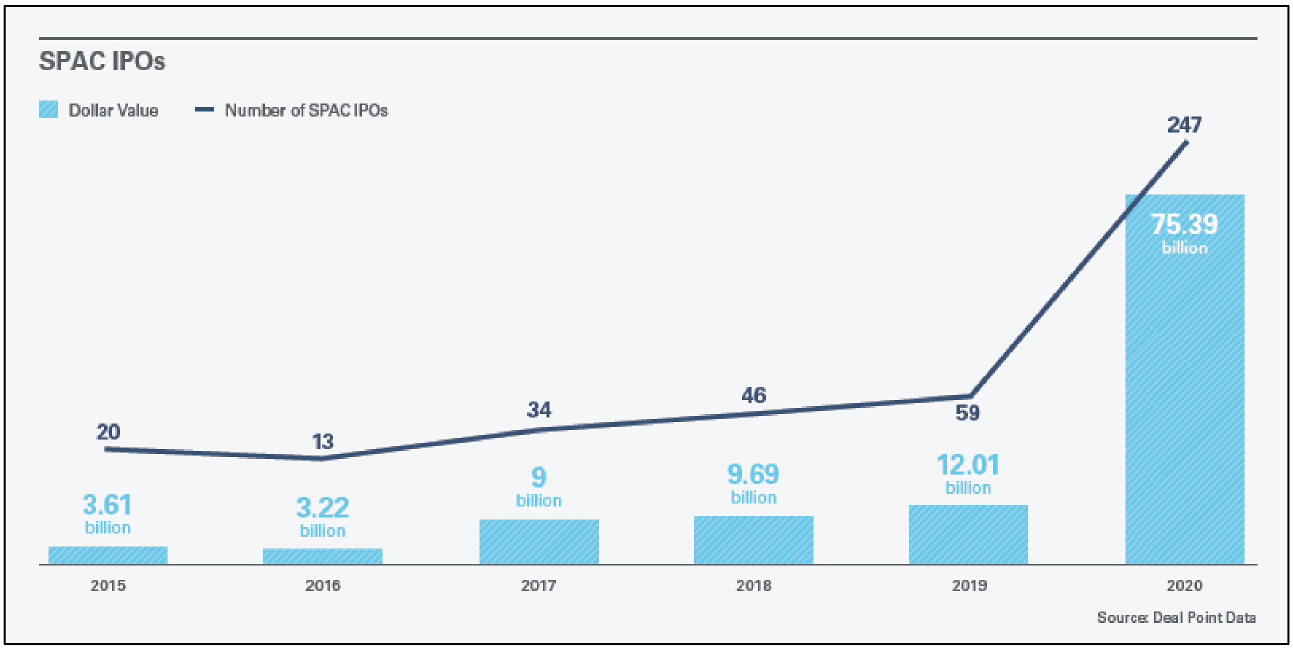
Finally, if investors are really worried about inflation, they can try to hedge their exposure with

[2] https://www.huduser.gov/portal/sites/default/files/pdf/Housing-Market-Indicators-Report-February-2021.pdf

a more targeted investment. Commodities, TIPS or Treasury Inflation-Protected Securities, cryptocurrencies, and real estate are all held up as investments that can help hedge against inflation. Such investments can be highly speculative and are not suitable for all investors. It is important to note that if you own your home, your net-worth has a built-in inflation hedge. As inflation takes off, your house will likely increase in value. Positioning your investments for inflation does not necessarily have to be complicated and speculative.

Special Purpose Acquisition Companies: Caveat Emptor

SPACs, or Special Purpose Acquisition Companies are a recent investing phenomenon dominating the headlines. SPACs are also known as "blank check companies." As the below chart illustrates, SPACs skyrocketed in popularity. 2021 is still young but has already surpassed all of 2020 with over 370 SPAC initial public offerings raising about $181 billion![3] Should investors take the plunge? There could be a few diamonds in the rough but overall, our outlook on the space is highly skeptical. Like many things in finance, the idea is simple, but the investment is complicated and nuanced.



[4]

A SPAC begins with a sponsor team. At best, this team includes well-regarded investors, managers, and/or operators that add value by lending their knowledge and leadership to a young business. At worst, the sponsor team includes promotional individuals focused more on

[3] https://www.cnbc.com/2021/03/04/spacs-are-becoming-less-of-a-sure-thing-as-the-deals-get-stranger-shares-roll-over.html
[4] https://www.skadden.com/insights/publications/2021/01/2021-insights/corporate/the-year-of-the-spac#:~:text=In%202019%2C%20there%20were%2059,the%20prior%20five%20years%20combined.

themselves than shareholder value. Once assembled, the sponsor team goes to the public markets and raises capital from outside investors. This is why a SPAC is sometimes called a 'blank check company.' Once the sponsor team raises capital, the SPAC's next step is to search for an investment target.

At this point, the sponsor team has a general aim, but not a specific target investment. For example, a SPAC might target companies in the software industry. In making this investment, the alignment of incentives is questionable. Sponsor teams are incented to do *something* rather than nothing which increases the risk that the sponsor team makes a sub-optimal investment. For example, a sponsor team might make an investment outside of its realm of confidence just to complete a deal. A SPAC led by an ex-mining executive is unlikely to help a software startup.

Each SPAC is unique, but many sponsor teams incent themselves heavily with equity. The result is that if a SPAC is successful, an outsized share of the upside accrues to the sponsor team and the original outside investors are diluted. This creates a "heads I win, tails you lose" situation where the sponsor team has more to gain, and outside investors have more to lose. If you are a member of the sponsor team, SPACs are clearly a great investment structure!

For the target company, SPACs provide an opportunity to access resources and grow the business. A promising, privately held company can access the liquidity of public equity markets to fund growth. Partnering with the right sponsor team can also provide seasoned leadership and industry knowledge to further develop the business.

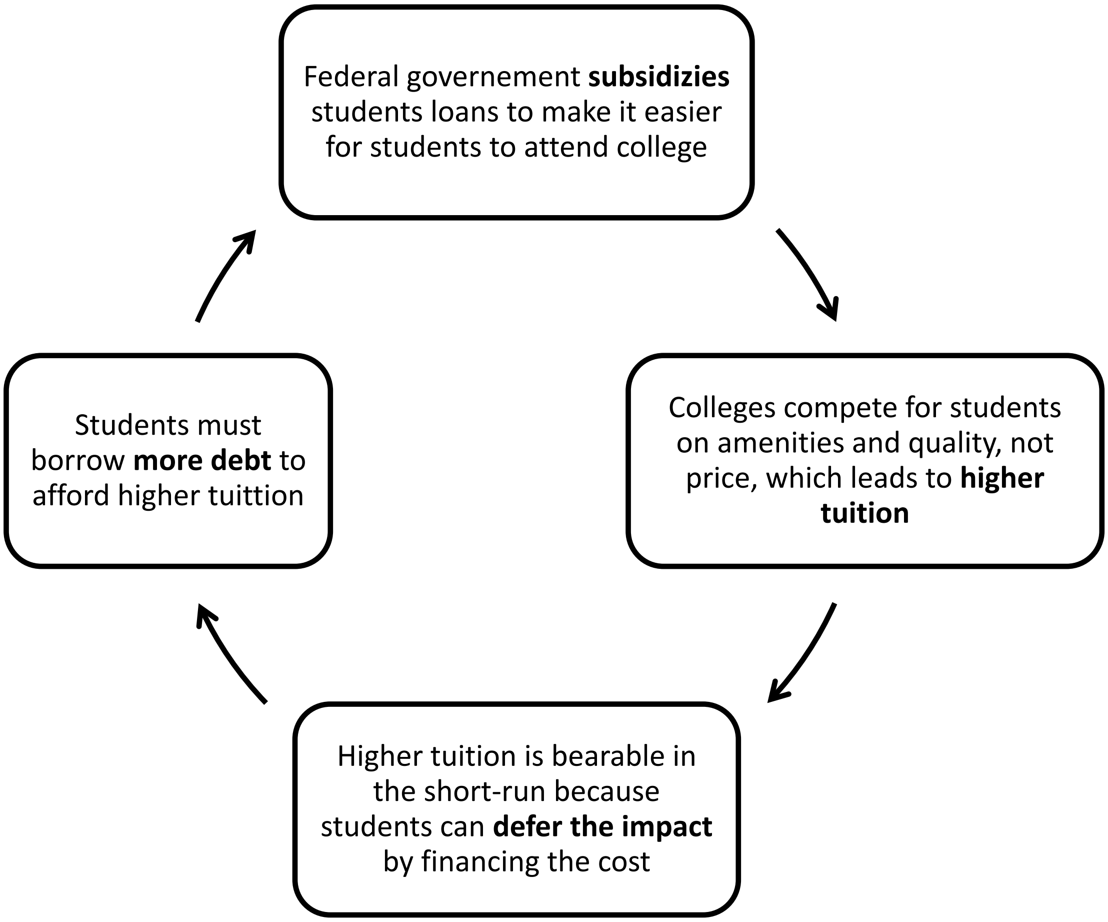
For outside investors, the advantages of SPACs are less certain. The ultimate promise is that the sponsor team finds a great investment and outside investors end up owning a portion of a young, promising company that develops into a successful business. But these young, promising companies often lack profits and sometimes even revenue. The investment by a SPAC is speculative- there is no guarantee the target company will succeed. On top of the issues regarding incentives and shareholder dilution, SPACs have a great amount of operational risk.

To conclude, SPACs are highly speculative investment vehicles fraught with complexity and poorly aligned incentives. They are not suitable for many investors. To any investor interested in a SPAC, we recommend reading and understanding the entire S-1 on file with the Securities and Exchange Commission before purchasing.

Student Loans: The Glacial Crisis Pt 2

Last quarter we began examining some of the causes and impacts of the $1.6 trillion student loan crisis. This issue hits close to home. We calculated that ***to replicate the college and post-graduate educations of the Novem Investment Team it would cost $1.52 million***.[5] Over time, student loans grew and developed a reinforcing cycle. To break this cycle likely requires politically unpopular decisions.

[5] Includes only accredited institutions. Does not include the School of Hard Knocks.



To address student debt, the latest policy from Washington is centered almost exclusively on debt forgiveness. Under such a policy, the government would simply cancel debts, immediately removing a burden for the borrowers. Unlike other forms of debt such as mortgages or credit cards, student loans are almost entirely held by the government which makes debt cancellation much easier operationally. Of the $1.6 trillion outstanding, the federal government owns $1.4 trillion.[6] Canceling some portion of student debt would expand the US government debt but not directly burden any single demographic which makes it a politically easy choice. But debt forgiveness does not address the underlying causes of the problem and leaves the above cycle intact.

We also think there should be a distinction between acceptable and unacceptable student debt. For example, the most indebted demographic is borrowers who are 35-49 years old. This demographic accounts for 31% of borrowers but owes over $600 million (38%) of total loans outstanding. Half of this debt burden is high-debt borrowers who owe over $80,000![7] We expect that medical school, law school and MBA programs are behind this high amount of debt

[6] Mitchell, Josh. "US Faces Big Student-Loan Loss." The Wall Street Journal. 21 November 2020. A1.
[7] https://studentaid.gov/data-center/student/portfolio

for this demographic. Forgiving $10,000 or $50,000 might be a popular policy, but does a high-earning doctor or lawyer need this help?

Loan forgiveness is a short-term stimulus, not a long-term solution. A long-term solution must address the cycle of higher tuition, easy credit, higher debt. Next quarter we'll dive into some more comprehensive reforms beyond simply canceling debt.

2021 Outlook: Where Do We Go from Here?

Conviction Level

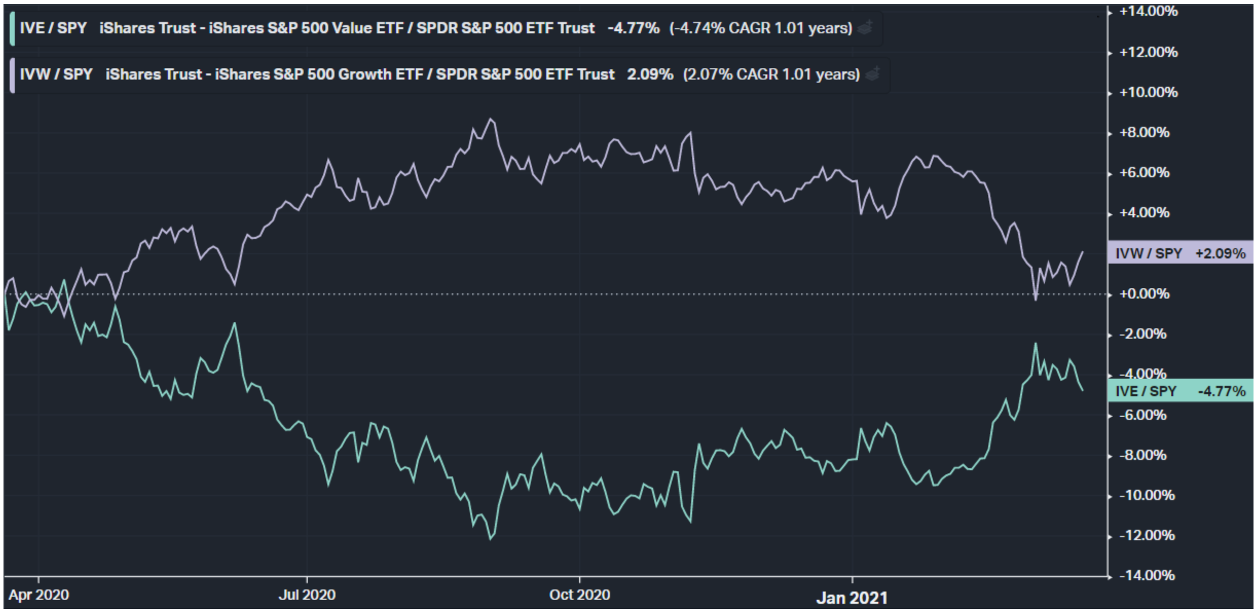
Our conviction indicates how we think asset classes will perform against the broader market.

	High Conviction	Moderate Conviction	Neutral	Low Conviction	Very Low Conviction
Large Cap Equities		◆			
Small Cap Equities			◆		
Short-Term Fixed Income			◆		
Long-Term Fixed Income					◆
High Yield		◆			
Municipals			◆		

Conviction levels are for illustrative purposes only and should not be relied upon as investment advice, research, or a recommendation by Novem Group regarding (i) the asset class, (ii) the use or suitability of the model portfolios or (iii) any investment in particular. Only an investor and their financial advisor know enough about their circumstances to make an investment decision.

Large Cap Equities – Moderate

We continue to maintain our moderate conviction for Large Cap Equities. We favor value companies with healthy balance sheets that will benefit from reopening. Speculative growth stocks have seen a choppy start to 2021 paring back some of their 2020 outperformance, but they are still valued at forward P/E levels that haven't been seen since 2000/2001. Large Cap Value has recovered to start the year, returning 4.21% compared to -3.85% for Growth.



Small Cap Equities - Moderate

We continue to maintain a moderate conviction on small cap equities. The Russell 2000 has continued its tear and is up 11.44% YTD and 31.18% 1-year trailing vs. the S&P 500. The run-up of popular retail stocks pushed the index to an all-time high in its forward P/E ratio. Much like our positioning in large cap equities, we prefer higher quality value names in the small cap space that will continue benefitting from reopening.

Short-Term Fixed Income - Neutral

Short term fixed income prospects remain the same due to the Federal Reserve's monetary policy. The yield on short term fixed income remains suppressed. With low rates expected to prevail for the next few years, investors seeking safety and liquidity are better served keeping their money in cash.

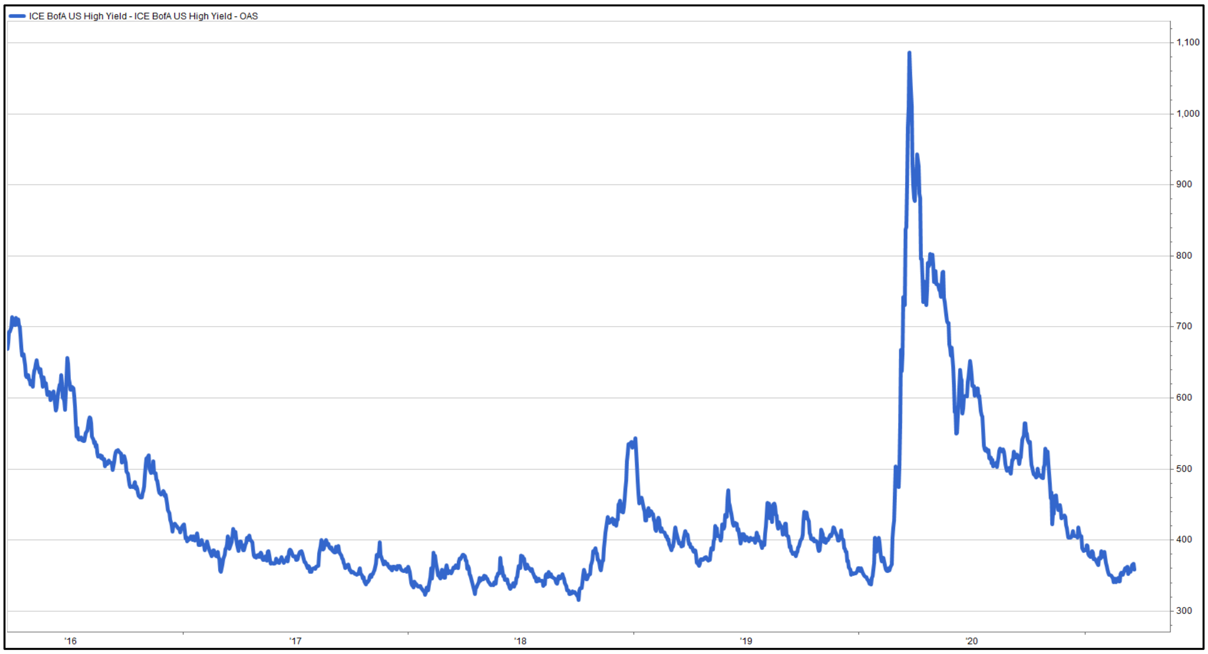
Long-Term Fixed Income – Very Low

Over the past year we have stressed the importance of avoiding fixed income instruments with duration risk. In the past quarter, we have seen rising rates in the long-term fixed income market. Rising rates are detrimental to investors with duration risk – iShares 20+ Year Treasury ETF (TLT) is down 15% YTD. Novem's Strategic Fixed Income Strategy maintained very limited duration exposure and outperformed as interest rates increased. Investors seeking yield should continue looking towards alternative asset classes while investors looking for safety are best off maintaining cash or low-yielding short duration treasuries.

High Yield – Moderate

High yield may be the only reliable fixed income asset class for yield seeking investors. However, we continue to stress that not all high yield debt is created equal. Current high yield spreads to treasuries are trending towards the bottom of their 20-year range. This spread represents the extra yield investors obtain by investing in high yield bonds relative to treasuries. Since high yield bonds are inherently riskier than treasuries, investors are compensated for the excess risk. When spreads are high, there's more room for appreciation. Conversely, low spreads imply less potential upside. In the current environment, Novem High Yield is centered around the higher quality credits in the high yield space.

Chart: spread between High Yield Bond Index and US Treasuries near historic lows



[8]

Municipals – Neutral

As our illustration in last quarters outlook suggests, municipal debt is an attractive investment for the highest tax investor (ex: $2.5M income in NYC). Otherwise, the current low rates on municipal debt make them unattractive to investors in lower tax brackets. The recent passage of the $1.9T relief bill has provided some assistance to municipalities, many of whom have struggled due to depressed economic activity. We prompted the question "will these municipalities be able to meet their future obligations?" and the bill has provided some clarity. States and municipalities will be made whole from their revenue lost during the pandemic. As a result, Moody's has raised their credit outlook for state and local governments. The plan will significantly boost near term revenues, benefitting the municipal bond market. With more of the country getting vaccinated and re-opening on the horizon, it will be interesting to see if additional federal support is required. Municipal investors should continue to be cautious and selective in their investments.

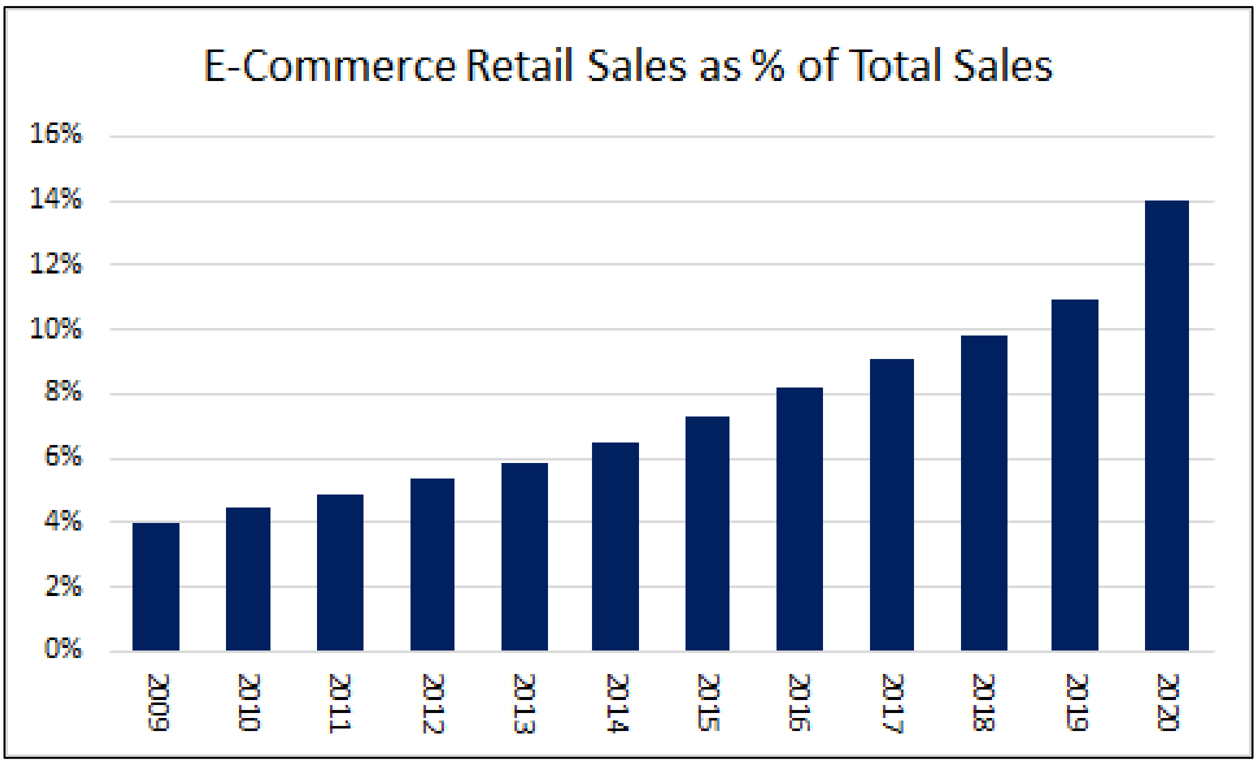
[8] Source: FactSet Charting.

Deep Dive of the Quarter: COVID's Impact on Commercial Real Estate

Commercial real estate provides an alternative to traditional asset classes and can serve as a hedge against inflation. The commercial real estate sector covers a wide range of sub-sectors each with their own unique challenges and opportunities. For this deep dive we wanted to highlight three of these sub-sectors and how the pandemic has accelerated secular trends in these markets.

Retail

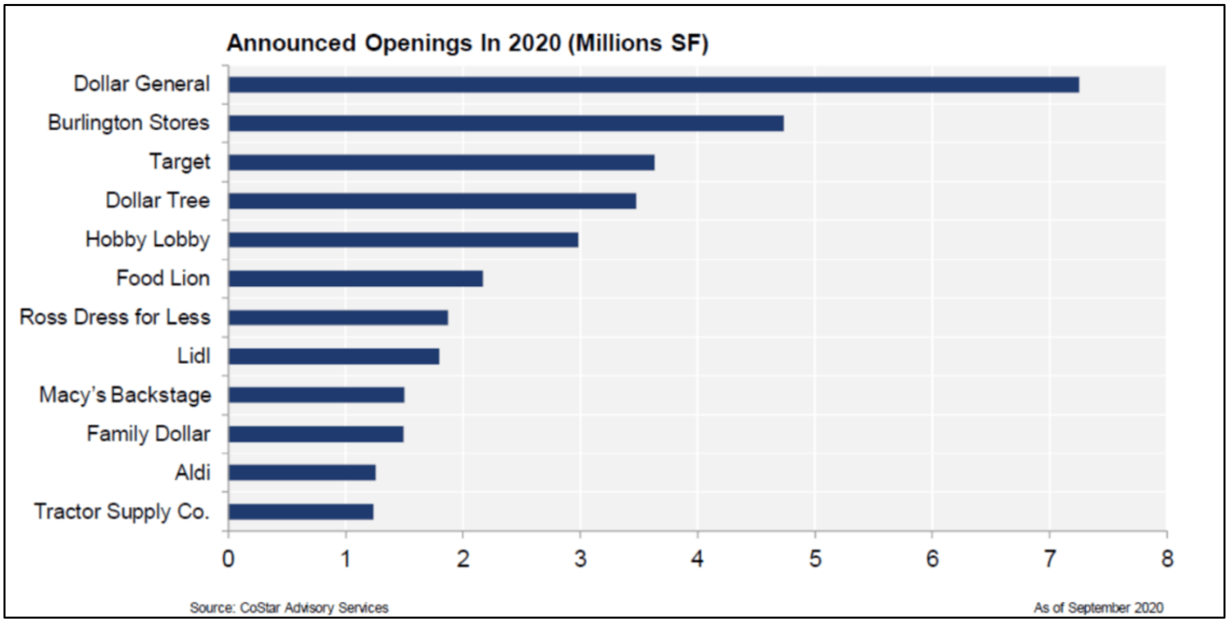
Over the last 10 years, retail sales have slowly moved online. COVID greatly accelerated this secular trend. As seen in the chart below e-commerce took market-share from brick & mortar stores at a rate of about 1% per year. However, from 2019 to 2020 this percentage leapt from 11 to 14%! It is critical for owners of retail-focused real estate to navigate this trend.



Source: FRED Economic data

One consequence of this move to online shopping means companies need less traditional brick-and-mortar locations. One research firm, CBRE, predicts that by 2025 total retail space will be reduced by 20%. This means that retail commercial real estate may struggle soon as downsizing occurs. This is further evidenced by the forecast that retail store closures in 2020 and 2021 each will exceed the record closures in 2019 of 9,800 locations.[9] The companies that will be most affected by these closures are likely to be concentrated in department stores and apparel shops. For example, at peak, Sears and Kmart operated 3,500 and 2,500 stores, respectively. Both brands are now liquidating completely and have, between them, fewer than 200 stores still open.[10]

Not all traditional brick and mortar retail is 'dying'. Some companies actually opened additional stores during the pandemic which highlights one underlying trend that people still value an in-store shopping experience.



Companies that can embrace the new retail concept that is more experience driven should be able to absorb some of the losses of traditional department stores. The future of retail will likely involve some form of a hybrid store that is able to efficiently accommodate the physical shopping experience with the buy online and pick up in-store consumers as well. This hybrid approach should help benefit both the retail as well as the industrial sub-sector of commercial real estate.

Industrial

As part of the growing e-commerce trend Industrial commercial real estate should continue to benefit. Industrial real estate continued to thrive during COVID because it includes the warehouses and shipping logistics. More e-commerce means more distribution centers and connected warehouses. Each additional $1 billion in e-commerce sales requires an additional 1.25 million sqft of warehouse space. With e-commerce sales projected to grow from $861

[9] International Council of Shopping Centers (ICSC)
[10] https://www.forbes.com/sites/warrenshoulberg/2021/01/05/how-many-sears-and-kmarts-will-be-left-by-2021s-end/?sh=6c151bd46bcc

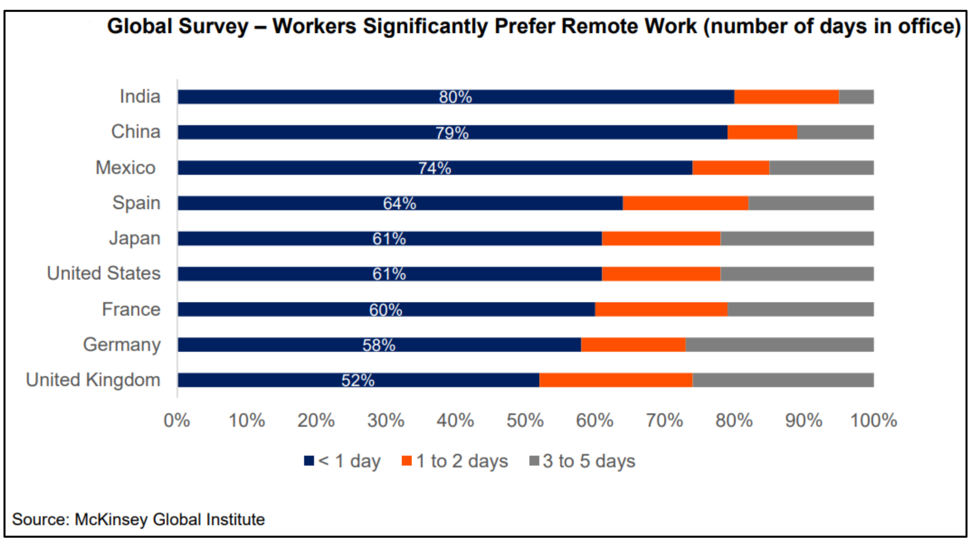
billion in 2020, to $3.4 trillion by 2025, an additional 3 billion sqft of warehouse space is needed to meet demand.[11] This additional space is equivalent to 17,000 Walmart super centers or an area 1.6x as large as Washington DC!

There is strong demand for new construction to meet the very specific criteria of modern logistics. Some of these criteria are +40ft ceilings, multiple mezzanine floors, and minimum size of 3 million sqft. These specifications help suppliers increase the amount and efficiency of inventories which is necessary not just for supporting e-commerce but for supporting modern, flexible supply chains as a whole.

Last, COVID served as a catalyst for companies in developing flexible 'China-plus-one' product sourcing. We first touched on this idea of more flexible supply chains in our 2Q20 outlook during the depths of the COVID bear market. To better handle disruptions, suppliers are looking to increase their inventory on hand from 15 to 60 days.[12] More flexible supply chains mean more demand for warehouses and manufacturing sites. For example, industrial rents in El Paso are forecast to increase by 28.5% over the next 5 years.[13] All of these factors combined should create a strong environment for industrial real estate to continue to thrive in the foreseeable future.

Office

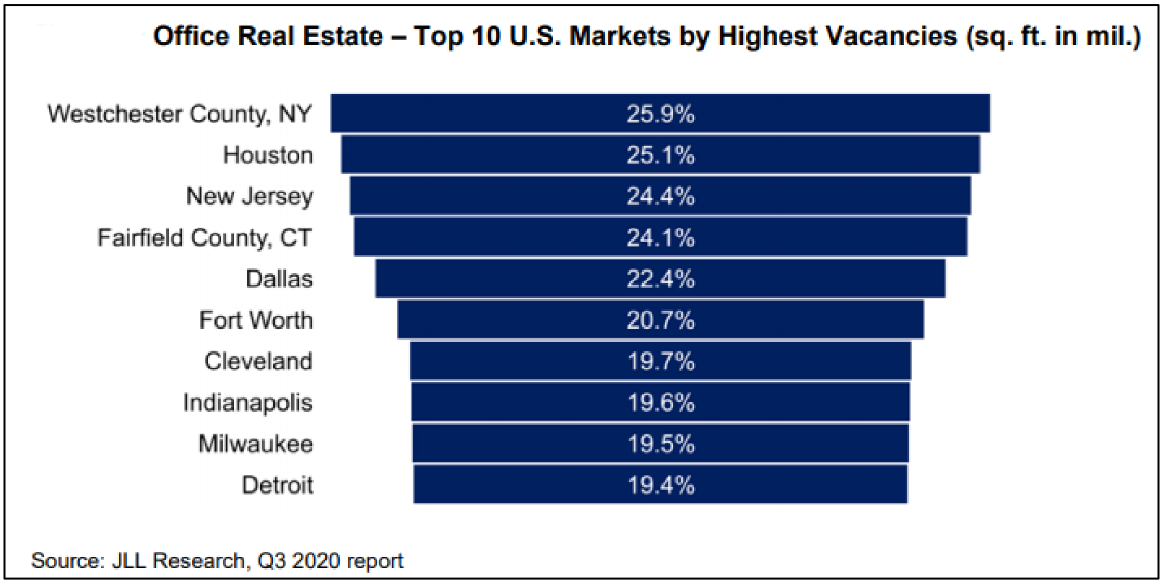
The last sub-sector to highlight in this deep dive is office real estate. In the face of COVID, many businesses shifted to work-from-home out of necessity and are now questioning the necessity of their pre-COVID leases. Many businesses will still need a physical presence for certain in-person tasks and meetings, but work is becoming much more flexible. Going forward,



[11] https://chainstoreage.com/study-e-commerce-market-will-continue-strong-growth-2021#:~:text=By%202025%2C%20Finaria%20forecasts%20the,to%20%242.43%20trillion%20in%202020
[12] CBRE
[13] CBRE economic advisors

this approach could develop into work-from-anywhere as employees could log-in from any location with a reliable internet connection. Both employers and employees expect this flexible approach to continue. With fewer employees in the office at any given time, companies will need less office space.

This has two major implications for office real estate. First, the outlook for future rent increases is pressured if businesses need less office space. In central business districts where rents were highest before the pandemic, rising vacancies are early evidence of this trend.



Second, owners might modify and renovate buildings to create flexible workspaces that better fit the changing habits of tenants. Office modifications and renovations represent a significant expense when the market is already under pressure. Going forward, the office sub-sector of commercial real estate is facing many challenges and uncertainty.

Overall commercial real estate could be a strong investment, but it is important to understand the specific nuanced risks. If you are interested in better understanding the real estate market and its role in your investment strategy, please work with your advisor and the Novem Investment team.

Advisor Spotlight: Mackenzi Springer

Mackenzi Springer is a rising star in the Rochester office. She works closely with the team and is constantly leveraging the Investment Team's expertise and technological resources. Mackenzi is constantly bringing in new business and is actively prospecting for new clients. Whether you're a young professional seeking financial advice, a retiree rolling over your 401k, or a company looking to set up a retirement plan, Mackenzi is able to help.

What are your thoughts on 2021?

The start of 2021 has been shaky in my opinion with the change in administration and the overall uncertainty of what the economy will look like going forward. Change in the political landscape and the ongoing confusion with the pandemic has made investors weary thus far. I think the lack of public communication from our new president hasn't helped the situation and investors would be more inclined to buy if we had further clarity on COVID-19 and the reopening process. Overall, I have high hopes for 2021 and think that at some point in this calendar year we will see further reduction in COVID-19 restrictions, continued increase in vaccinations and eventually some sense of normalcy.

How has Novem benefited you as an advisor?

Being an advisor at Novem is great because of our team-based environment. Our experience as advisors is diverse so there will always be someone to reach out to when an unfamiliar situation arises. It's not an "every man for himself" kind of workplace which I really appreciate, especially being early on in my career. I am also given ample resources for information and technology that I use to make my clients' experience at Novem seamless from the beginning and enjoyable going forward.

What financial mistakes do you see people your age making?

I frequently see a lot of people my age trying to day-trade stocks for a quick profit rather than buying and holding a well-diversified portfolio. I am all for taking on risk and being an aggressive investor, but social media is heavily influencing their short-term investment decisions (i.e., buying "meme stocks") and causing some folks to buy stock at a high price and sell it low when things get volatile, resulting in a loss. It's important to educate yourself before buying and selling positions and it never hurts to ask a professional for their opinion before doing so. One piece of advice I try to give to all younger investors is that time in the market is more important and will benefit you more in the long run than trying to time the market.

Apart from that, I often see younger people not prioritizing retirement savings. Even though retirement seems so far away, we all know time flies and that you can't get it back. Starting a retirement fund, whether that be an employer sponsored plan or an IRA and saving early and often is what will set you up for a successful retirement down the road. Increasing your contributions whenever you can and compounding interest over time are the keys to retirement success.

At a broad level, what is your investment approach?

Long-term investing for capital appreciation in a diversified portfolio, setting a target asset allocation based on risk tolerance and rebalancing the portfolio to keep on target.

How do you spend your time outside the office?

In my spare time I love DIY projects around the house, and I am on a first name basis with the paint department at my local hardware store. I am a new homeowner, so the projects never end! On the weekends that I don't have paint all over my hands, I spend a lot of time with my friends going out to eat at our favorite restaurants like Good Luck and The Revelry and I have officially been deemed "a regular" at The Winfield.

What's your favorite restaurant in Rochester?

Without a doubt, Good Luck. The service is fantastic, drinks are amazing, and I've never had a bite of food that I didn't love. They keep their staples on the menu year-round and rotate the rest seasonally to keep things fresh and exciting along with nightly specials. If you haven't had the Good Luck burger… run, don't walk, to Anderson Avenue and get your hands on one!

What is one trip you're looking forward to?

I just booked a trip to Charlotte, NC which is one of my favorite cities I've ever visited. This will be my fourth time in CLT and I've only fallen in love more with each visit. There is so much to do and the people there are awesome, an abundance of upstate New Yorkers have been relocating there so it almost feels like home. If you ever find yourself in CLT during football season, Tavern on the Tracks is a Buffalo Bills bar, and it feels like you're right in Buffalo during a game.

In a post COVID world, I'd like to go overseas to Europe and travel around the countries there. Italy, Spain, Greece and France to name a few. It would likely take a few trips to see everything I'd like to, but it's definitely a bucket list item to go overseas and see more of the world.

What We're Drinking

Other Half Brewing in Bloomfield, NY is what we're drinking this quarter. Located on 5&20, Other Half is conveniently on your way to and from the Finger Lakes. They have an expansive rotating draft list and offer plenty of outdoor seating. With an abundance of Double and Triple IPAs, it's easy to overlook their dessert like stouts. Their beers are phenomenal, high octane, and dangerously smooth, so be careful!

If you aren't local, Other Half is actively expanding so be on the lookout for them. Their flagship location is in Brooklyn and they most recently expanded to Washington, D.C, right around the corner from our D.C. office.

Historical Perspective

From Warren Buffett's annual letter in 1999 after a string of historically terrible investing performance. Despite the disappointing results, Buffett remains focused and does not waver from his long-term oriented, fundamental investment process. Emphasis is our own.

The fallout from our weak results in 1999 was a more-than-commensurate drop in our stock price. In 1998, to go back a bit, the stock outperformed the business. Last year the business did much better than the stock, a divergence that has continued to the date of this letter. Over time, of course, the performance of the stock must roughly match the performance of the business.

Despite our poor showing last year, Charlie Munger, Berkshire's Vice Chairman and my partner, and ***I expect that the gain in Berkshire's intrinsic value over the next decade will modestly exceed the gain from owning the S&P****. We can't guarantee that, of course. But we are willing to back our conviction with our own money. To repeat a fact you've heard before, well over 99% of my net worth resides in Berkshire. Neither my wife nor I have ever sold a share of Berkshire and -- unless our checks stop clearing -- we have no intention of doing so.*

Please note that I spoke of hoping to beat the S&P "modestly." For Berkshire, truly large superiorities over that index are a thing of the past. They existed then because we could buy both businesses and stocks at far more attractive prices than we can now, and also because we then had a much smaller capital base, a situation that allowed us to consider a much wider range of investment opportunities than are available to us today.

Our optimism about Berkshire's performance is also tempered by the expectation -- indeed, in our minds, the virtual certainty -- that the S&P will do far less well in the next decade or two than it has done since 1982. A recent article in Fortune expressed my views as to why this is inevitable, and I'm enclosing a copy with this report.

Our goal is to run our present businesses well -- a task made easy because of the outstanding managers we have in place -- and to acquire additional businesses having economic characteristics and managers comparable to those we already own. We made important progress in this respect during 1999 by acquiring Jordan's Furniture and contracting to buy a major portion of MidAmerican Energy. We will talk more about these companies later in the report but let me emphasize one point here: We bought both for cash, issuing no Berkshire shares. Deals of that kind aren't always possible, but that is the method of acquisition that Charlie and I vastly prefer.

While many investors chase the hottest investing trend and take dramatic actions to try to maximize returns, Warren Buffet lets the value of Berkshire Hathaway's businesses quietly compound. After a spate of underperformance in the 1990's, in the following decade Berkshire Hathaway went on to return 77% while the S&P 500 lost 9%.[14]

[14] https://www.berkshirehathaway.com/letters/1999htm.html

Disclosures

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