1Q22 Commentary

Content

"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."

- Amos Tversky

"Somebody told us Wall Street fell, but we were so poor that we couldn't tell."

- Alabama, *Song of the South*

"Thirty spokes share the hub of a wheel; yet it is its center that makes it useful.
You can mold clay into a vessel; yet it is its emptiness that makes it useful.
Cut doors and windows from the walls of a house; but the ultimate use of the house will depend on that part where nothing exists.
Therefore, something is shaped into what is; but its usefulness comes from what is not."

-Tao Te Ching

Welcome

We hope your holiday season was enjoyable. As we went to press, rising COVID-19 cases means indoor masking is again mandatory in New York State. This backward slide is unfortunate but does not scare us. This is now the third 'wave' to hit New York. Total cases are elevated but hospitalizations and deaths remain well-below prior peaks.[1] The vaccines are greatly reducing the severity of illness. The threat the virus poses, specifically to high-risk individuals, is meaningful but the terrifying uncertainty of early 2020 is gone. We're vaccinated and have plenty of toilet paper.

One data point we are watching closely is the Federal Reserve's messaging around monetary policy. Since the pandemic began, the Federal Reserve provided economic and financial support by keeping interest rates low and engaging in quantitative easing. Through its actions and messaging, the Fed signaled that short-term economic support was more important than the risk of generating inflation. The reasoning was that if inflation showed up, the Fed would have time to react by reducing quantitative easing and raising interest rates.

In August, the Federal Reserve held the opinion that inflation was temporary. At the time, inflation was seen as narrow, rather than broad-based, with prices in many categories beginning to moderate. There was less evidence of a "wage-price spiral" where rising wages feed higher prices in a vicious inflationary cycle.[2] Within four months, the Fed's tone shifted from keeping rates lower for a long time to reducing monetary stimulus and raising rates faster than expected. Things can change quickly! This is one reason why you hired Novem to monitor these developments in real time!

Like the Federal Reserve, we remain optimistic about the prospects for the US economy. We don't make market timing calls but given the strong performance of the equity markets over the past few years we think now is a good time to have a conversation with your advisor to reevaluate your allocation. With such strong price appreciation in equities, it could be a prudent time to rebalance your investments.

Thank you for your business and trust. We are excited for 2022.

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[1] https://coronavirus.health.ny.gov/daily-hospitalization-summary
[2] https://www.federalreserve.gov/newsevents/speech/files/powell20210827a.pdf

4Q21 Review

Inflation, Market Valuations, ESG pt3

Market Valuations: Where to Turn?

As professional investors, we are constantly wrestling with the valuation of the stock market. In previous outlooks, we presented various analytical techniques to help frame the discussion. One of our favorites is valuing the market relative to its earnings power, also known as a Price to Earnings or P/E ratio. On this metric, the stock market looks fully valued relative to its history. Currently, the S&P 500 is trading at 21x projected earnings, higher than its 10-year average of 16.6x.

On other metrics, the stock market could continue to perform. Strong economic growth and rising corporate profits can drive stock market performance. Exactly one year ago, the S&P 500 was *more expensive* on a P/E basis. Despite the seemingly high valuation in December 2020, strong earnings growth propelled the S&P 500 over 25% higher in 2021!

Another frank observation about the stock market's valuation is now a popular acronym in the financial press: TINA, or, There Is No Alternative. With interest rates so low, there are no straightforward investments where investors have a chance of earning a return above inflation. For those seeking reasonable risk-adjusted returns, the stock market is the only show in town.

One asset class that we find attractive on a relative basis is international equities. Compared to US stocks, international stocks are trading at just 14x projected earnings.[3] Divergences in valuation such as this are often a sign of an investment opportunity. Should this gap in valuation continue? One reason why this divergence might continue is that the US economy is incredibly strong and dynamic. With US companies growing faster than European or Japanese counterparts, it's appropriate for the US stock market to trade at a premium. But what is stopping European and Japanese companies from closing this performance gap? Could these other economies catch up? We are continuing to research and analyze non-US equities to better understand this opportunity.

Inflation

Last quarter we covered the current debate of Transitory versus Enduring inflation. There are intriguing datapoints on both sides of this debate, but our view is to prepare for the worst and maintain a margin of safety. Currently, market prices suggest an annual inflation rate of about 2.7%/year over the next five years.[4] Our strategies are positioned with the expectation that inflation will be higher than consensus.

A recent development in this story was a shift in narrative from the Federal Reserve. In response to rising inflation Chairman Powell suggested to Congress that "it's probably a good

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[3] MSCI ACWI ex US. Data from FactSet.

[4] https://fred.stlouisfed.org/series/T5YIE

time to retire that word (transitory)."[5] As we went to press, Powell indicated that the Fed would reduce quantitative easing and start raising rates earlier than expected. We view this step towards more normal monetary policy as a long-term positive, but there are still two very large inflationary drivers that we are monitoring.

The first is housing. Housing is the largest expense consumers face, accounting for 32% of the Consumer Price Index (CPI).[6] With such a heavy weighting, moderate changes have profound effects on inflation numbers. When calculating shelter costs, however, the Bureau of Labor Statistics (BLS) doesn't look at home prices per se but looks instead at the rent-equivalent cost of shelter. This nuance is slight but currently, this difference means that the roughly 20% increase in home prices has not impacted inflation numbers. Instead, when computing CPI, BLS considers rent. Over the past year, rent costs increased just 3.5%.[7] Rents typically follow housing prices because it takes time for leases to expire and landlords to raise rent. This means that the 'shelter' portion of CPI, weighted at 32%, is poised to increase strongly.

The second key inflationary driver is the labor market. The cost of labor is rising at its fastest rate since the early 2000's.[8] Despite raising wages, business continue to face a headwind of labor shortages. No Economics PhD is needed to notice the *Help Wanted* signs in every business window. Labor is unique because of its potential drive inflation's feedback loop- the wage-price spiral mentioned in our Welcome section. This idea holds that when faced with higher labor costs, businesses raise prices. Faced with higher prices, workers demand more pay and inflation cycles higher.

To perform well and earn strong returns, a portfolio must avoid the damaging erosion of inflation. Even without additional shocks (higher energy prices, rising food costs, etc.) shelter and labor costs are positioned to put upward pressure on inflation over the next few years. This could certainly change but we are maintaining a margin of safety.

ESG Investing Pt 3

During the third and fourth quarters of 2021 we covered the rise of ESG or Environmental, Social, and Governance-oriented investing and spoke about its pros and cons. For our third installment on this topic, we will cover our current view of ESG investing and offer recommendations for investors interested in this part of the market.

On the surface, ESG investing appears comprehensive and effectual. Incorporating alternative data on unique and important trends can give investors a unique 'edge' that might not be apparent in a firm's financial filings. Exploiting this 'edge' drives outperformance all the while contributing positively to the environment, social justice, and corporate governance: a win-win!

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[5] https://www.cnbc.com/2021/12/02/powell-time-to-retire-transitory-what-it-means-for-the-ecb.html
[6] https://www.bls.gov/news.release/archives/cpi_11102021.htm
[7] https://www.bls.gov/news.release/archives/cpi_11102021.htm
[8] https://www.washingtonpost.com/business/economy/us-labor-cost-increases-reach-20-year-high-amid-worker-shortage/2021/10/29/bb8d6c6c-38a8-11ec-8be3-e14aaacfa8ac_story.html

Unfortunately, we don't see practice and theory lining up. Limited and non-standardized environmental data makes ranking companies difficult. Evaluating companies on social metrics is also qualitative and highly subjective. Governance, while meaningful is mostly captured by regular, fundamental equity analysis and is not unique to ESG. So, does ESG investing work?

It's our view that, as it stands today, ESG investment products fundamentally benefit neither the investor nor the causes that ESG investing seeks to advance. Most recently, the case of Activision (ATVI), the maker of popular videogames like *Call of Duty*, serves as a reminder of ESG's shortcomings. ATVI faced numerous complaints and even lawsuits regarding sexual harassment in the workplace.[9] Despite this documented information, ATVI was included in ESG strategies at Vanguard, Blackrock, and State Street. We have not seen data that convinces us that ESG investment products contribute positively to environmental, social, or governance issues.

We do think that dedicated investors focused on specific issues can create change, though this takes place outside of ESG-wrapped products. Positive changes are driven by social investing with a very specific aim. The best example is boutique investment manager Engine No. 1 which engaged in a successful activist campaign to pressure Exxon Mobil (XOM) to develop a clean energy strategy. One key detail is that Engine No. 1 bought XOM stock and worked with management to make these changes happen. Many ESG-dedicated strategies would screen-out and simply not buy XOM which would not yield the same environmentally friendly result.

There are also other issues regarding weighting and prioritization of issues. In many situations, we think the difference is in the eye of the investor. One investor might care deeply about gender and racial diversity while another investor might prioritize human rights in China. One investor might prefer nuclear energy as a solution to carbon emissions while another might consider wind energy more environmentally sound. Investment products managed in a centralized fashion simply cannot fit the eclectic views of different investors.

With better data, we believe incorporating environmental analysis could become an important component of regular equity analysis. As it stands today, however, data is lacking. It makes sense that investors should avoid companies that are exposed to key social and governance issues but as we have seen, the devil is in the details. Although we see these ESG issues as incredibly important, current ESG-focused investment products are not a reasonable solution.

[9] https://www.wsj.com/articles/activision-esg-vanguard-blackrock-fidelity-woke-gaming-investing-sexual-misconduct-11637794901

2022 Outlook: Where Do We Go from Here?

Conviction Level

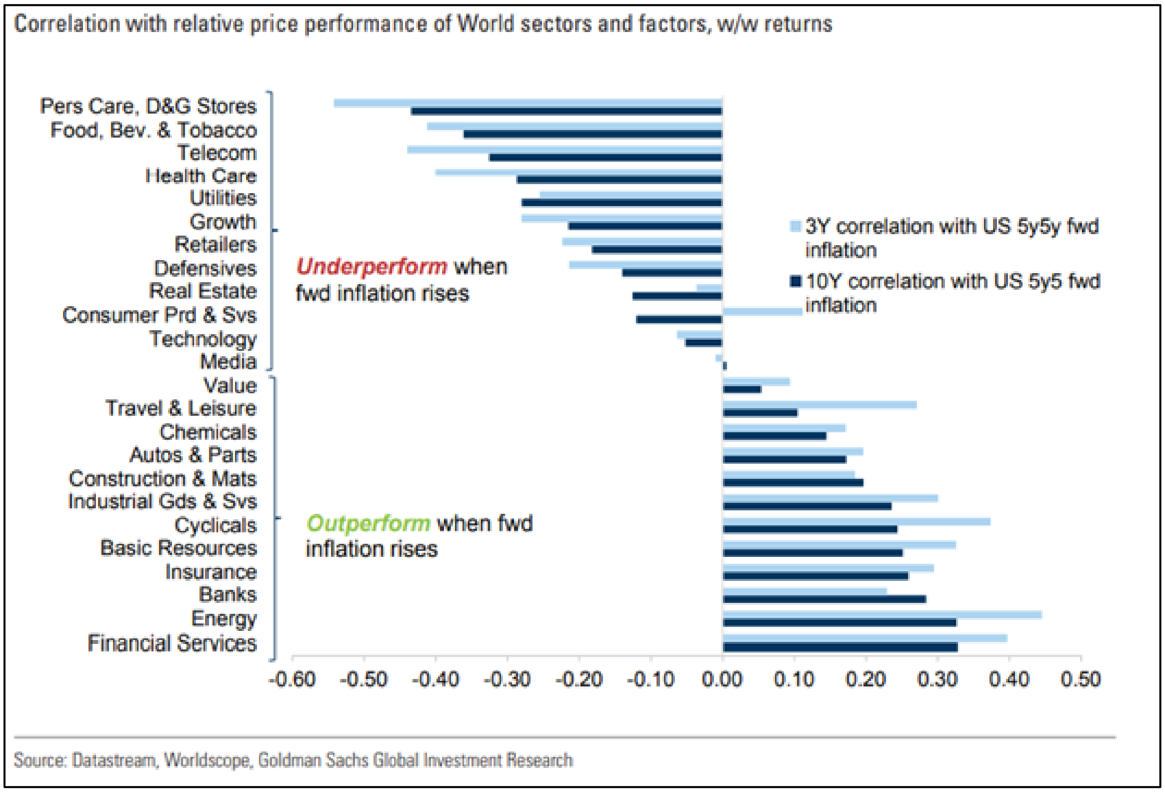
Our conviction indicates how we think asset classes will perform against the broader market.

	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

Even with the recent volatility in equity markets. Valuations remain elevated. The S&P 500's P/E ratio is at the higher end of its historical range. Given that the CPI rose to 6.8% in November (a 30-year high) it looks increasingly likely that rate hikes will occur in the coming year. Higher rates signal robust economic strength but can also put downward pressure on the equity market. Investors should continue to be cautious going forward and consider established companies with pricing power.



Small Cap Equities

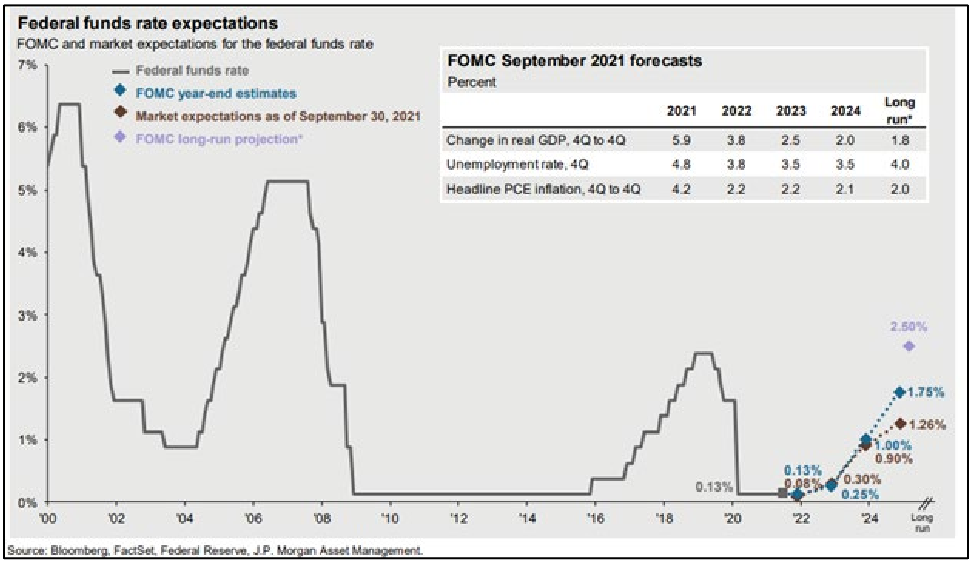
Small caps continued to lag through Q4, down slightly versus the S&P 500 which increased single digits. Over the long term, small cap stocks typically exhibit greater volatility but also generate a higher return. In 2021, small cap performance varied significantly between value and growth. Value was up over 20% while Growth was down slightly. For years, growth compounded strongly and outpaced value by a wide margin, so this is a definite change of pace (and one we were happy to see!). Looking forward to 2022, we continue to favor small cap value because of its exposure to the financial sector which benefits from rising interest rates.

Short Term Fixed

Short term fixed issues continue to offer extremely low rates that offers nominal value to investors given the rising inflation rates. Although short term fixed provides little to nothing in terms of yield it does provide investors with dry powder if volatility in equity markets continues. With the prospect of rate hikes in 2022 we are hopeful that this sector could soon provide a better return.

Long Term Fixed

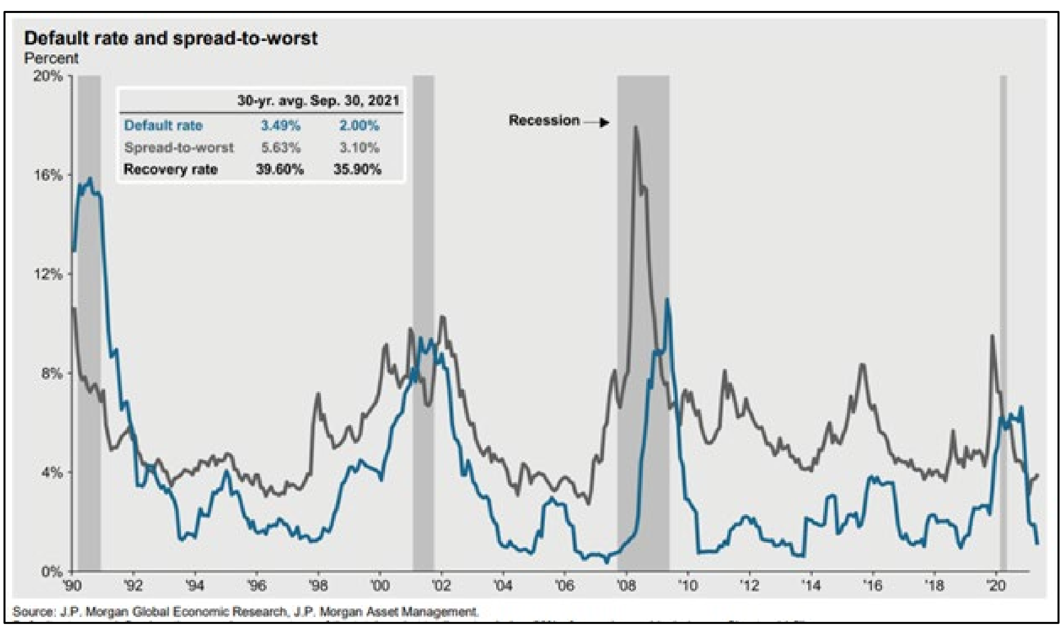
Yields in 30-year treasuries continue to remain near all-time lows. Duration risk in this space is even more prevalent now with high inflation and the Federal Reserve signaling 2-3 rate hikes next year. As we have stressed for multiple quarters the potential duration risk does not justify the additional yield. Buying long term fixed income is a bet that the Fed will reverse course and resume quantitative easing, perhaps even pushing interest rates negative! Based on current datapoints, we don't think the odds are in favor of investors in long term fixed income.



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

High Yield

High yield bonds are an area where one must remain focused on risk/reward - finding a perfect balance is difficult. Default rates in HY bonds are near 30-year lows. However, effective yields are at 30-year lows as well. Even if the economy continues to accelerate- gains will accrue to equity, not bond holders. Given this confluence of factors it is an extremely challenged sector currently. For example, the recovery rate on issues that do default is significantly below the 30-year average. If investors choose to use this space for additional yield it is important to focus on credit quality of the underlying companies.



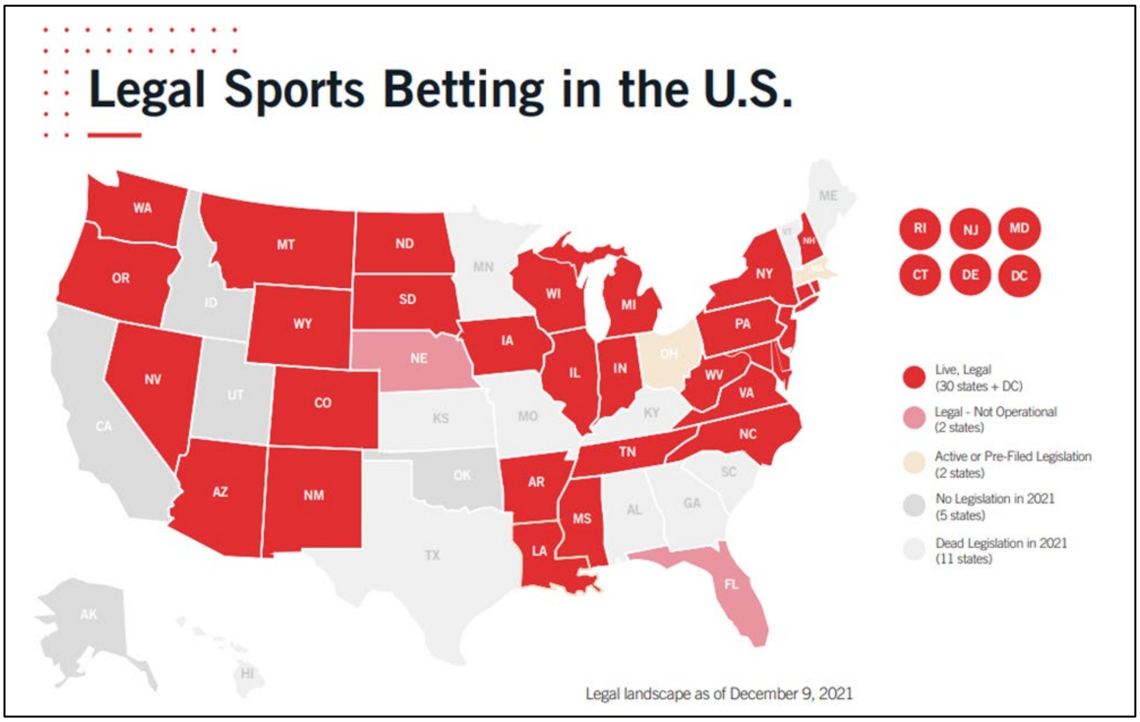
Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management.

Municipals

Investors in high individual tax brackets could benefit from municipal exposure in their portfolios but this is more of a financial planning topic. Municipalities should still have strong cash positions from the large amounts of federal aid deployed through the pandemic. Additionally, the low correlation to other asset classes could provide a ballast should the economy struggle in a rising rate environment. Ultimately it is important to focus on bonds with identifiable revenue streams and not just general-obligation pledges.

Deep Dive of the Quarter: US Sports Betting

A 2018 Supreme Court ruling overturned the *Professional and Amateur Sports Protection Act* (PASPA) and ended Nevada's sports betting monopoly. This allowed legal sports betting to go mainstream. The legal charge was led by New Jersey lawmakers and other states are now in the process of establishing sports betting laws. Sports betting offers not only tax revenue to states but also advertising/partnership deals for major sports leagues. Leagues benefit further from more engagement with fans. US legalization offers opportunities to both sportsbook operators and investors. With a glossary of terminology and books of "house rules," sports betting can be nuanced and overwhelming. As such, we spent this quarter researching the current landscape, industry players, and challenges the industry faces going forward.



Current Landscape

Prior to 2018, Americans wagered an estimated $150 billion on sports annually but only $5 billion occurred legally! Since the PASPA victory through October '21, $82 billion has been legally wagered on sports.[10] With more states legalizing sports betting, the share of legal betting should only grow. The image above helps illustrate the current market: [11]

The above map's depiction of "Live, Legal" does not mean sports betting is approved in those states without limitations. Online Sports Betting/Mobile Wagering isn't approved everywhere

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[10] https://sportshandle.com/sports-betting-revenue/

[11] https://www.americangaming.org/research/state-gaming-map/

but represents 84% of wagers in the US. As the regulatory environment matures, particularly around online sports betting, legal betting could grow further.
New Jersey is a great example of how a legal betting market can benefit the state. A study found that New Yorker's wagered $837 million in NJ in 2019, accounting for 20% of the states $4.6 billion handle- the total amount of money bet.[12] Bettors from NY can cross into NJ and once geographically located in NJ, are eligible to place bets. During 2019, 44% of wagers were placed within 2 miles of the NJ/NY border. In October '21 alone, NJ generated over $84 million in sportsbook revenue and over $10 million in taxes.

This trend should reverse a bit, as online sports betting in NY clears regulatory hurdles (expected to go live in early 2022) and New Yorkers don't need to cross the border. Rules and regulations vary state to state though the nationwide median is that states tax 11% of revenue. In a surprise to nobody, New York State will tax 51% of all gross gambling revenues. Some operators believe the tax eliminates any chance of profitability, while others view the NYC market as a crown jewel. Regardless, 9 operators have licenses, and the state expects online sports betting to generate $493 million annually by 2025.[13]

Key industry players:

Flutter Entertainment (OTC: PDYPF), Entain/BetMGM (NYSE: MGM), and DraftKings (NAS: DKNG) are currently the dominant players in the US. Flutter and Entain (OTC: GMVHF) are global giants that took different paths establishing US roots. Flutter which owns Paddy Power and Betfair, bought daily fantasy sports provider FanDuel. Flutter now leads the US market today with about 45% market share of the US online sportsbook. Entain was in M&A talks to be acquired by MGM, but this proved unsuccessful. Instead, a 50/50 joint venture was formed between BetMGM and Entain that combines MGM's physical casino properties with Entain's proprietary technology. Lastly, DraftKings established roots as a daily fantasy provider and has since expanded to sports betting. DraftKings is considered a pure play on US sports betting and as such, it commands the highest valuation of the three players.

Company	Market Cap ($bn)	Enterprise Value ($bn)	EV/Sales (NTM)	Price/Sales (NTM)	YTD Price Change
Flutter Entertainment (FanDuel)	25.4	27.5	3.2x	3.0x	-30.0%
DraftKings	21.6	10.6	5.6x	11.5x	-42.0%
Entain (BetMGM)	12.3	15.1	2.6x	2.1x	34.8%

Data from Factset 12/15/21

[12] https://www.si.com/betting/2021/08/09/gamblers-crossing-state-lines
[13] https://www.forbes.com/sites/willyakowicz/2021/11/08/new-york-picks-draftkings-fanduel-and-others-to-launch-states-mobile-sports-betting-program/?sh=3836cf2b1a08

CFRA estimates long-run revenue between $25-42 billion per year, meaning there could be room for each of these competitors.[14] But the path to profitability is likely to be challenging. Competition is intense and each firm is losing money as they spend heavily on advertising and promotions. Upfront costs to achieve competitive scale favors established companies like Flutter and Entain that have mature operations abroad to fund customer acquisition costs.

In DraftKings most recent quarter, they spent over $303 million on sales & marketing and over $219 million on general & administrative expenses. With over $500 mil of expenses, DKNG only generated revenue of $213 million. Through the third quarter, DKNG earned $823 million in revenue but lost almost $1.2 billion.[15] The company's cash burn has been concerning for investors and it will be important to monitor going forward. With little to no switching costs, it's incredibly easy for consumers to move from one sportsbook to another.

The big three also face competition from offshore sportsbooks. Offshore sportsbooks, like Pinnacle, have terrific reputations and are legal in other locations but illegal for US customers. Nearly instant cryptocurrency deposit/withdrawal options are an added perk. Most US bettors would prefer to keep things above the table and work with fully legal onshore providers with better transparency and safety. But with onshore sportsbooks facing high expenses and exorbitant taxes, it is easy to imagine a scenario where offshore competitors can offer more competitive odds and perhaps take market share.

Competition aside, a sportsbook must also establish a solid reputation for fair-dealing with its bettors. The latest scandal involves DraftKings targeting unprofitable (read: successful) bettors.

"This is an entertainment activity. People who are doing this for profit are not the players we want."[16]

Jason Robins, DraftKings CEO

Robins since clarified this statement to say that DraftKings does not want professional bettors, but the damage was done. Many frustrated bettors publicly broadcast their complaints on social media. In some cases, successful bettors saw their limits lowered to $1/game (effectively, a ban). The ultimate impact of this scandal remains to be seen, but this is a reputational blow for an already ethically unbalanced industry.

For sports leagues, the primary concern is integrity. Originally, before recognizing the revenue opportunity, the NFL opposed gambling. Commissioner Roger Goodell pointed out:

"If gambling is permitted freely on sporting events, normal incidents of the game

[14] https://advisor.marketscope.com/#/marketscope/thematicResearch/details/1002693821
[15] DraftKings 10-Q 3Q21
[16] Canaccord Genuity Digital Gaming Summit, 30 Nov 2021

such as bad snaps, dropped passes, turnovers, penalties, and play calling inevitably will fuel speculation, distrust and accusations of point-shaving or game-fixing."[17]

Goodell is correct that previously meaningless plays and calls will be heavily scrutinized. The NFL's concern should be centered at the officiating level. The NFL is unique to other leagues because many calls are highly subjective and incredibly impactful to the outcome of the game and season. Penalties can be called on practically every play and can sharply impact an outcome by extending or ending a drive. There are inconsistencies game-to-game, and every fan can recall at least one blown call that cost their team. The only exception, of course, is the Patriots who get every single call handed to them. With money on the line, it is important that the league begins better reviewing decisions and offering greater consistency.

A questionable play or call doesn't necessarily equate to illegal activity. Analysis of betting activity can also help detect outliers and likely nefarious activity. Data analysis helped identify match fixing in lower leagues, including Challenger Tennis. The problem is particularly acute in lower leagues because players can make significantly more money throwing a match than they earn by winning it. Similar concerns can be raised about college sports. ESPN's 30-for-30 *Playing for the Mob* highlights the 1978-1979 Boston College Men's Basketball Team, where mobster Henry Hill (*Goodfellas*) paid players to shave points.[18] Players today are eligible to get paid by sponsors, potentially muddying the waters in the future. As the industry continues to mature, some of these problems will sort themselves out while others may require more thought and league intervention.

Sports betting is already changing sports, for better or for worse. Advertisements, talk shows, and even commentary during the game will mention betting in one way or another. As sports betting operators like FanDuel, BetMGM, and DraftKings fight for market share, and state governments collect their tax revenues, US consumers can sit back and enjoy the entertainment of watching their favorite live sports with a couple bucks on the line.

[17] https://nypost.com/2021/10/07/how-does-roger-goodell-live-with-nfls-sports-betting-flip-flop/
[18] http://www.espn.com/30for30/film/_/page/playingforthemob

Advisor Spotlight: Jeremy Raco

What are your thoughts on the market for 2022?

The markets seem as though they are poised for some rough waters ahead. Having said that, as many headwinds as there are, there are many positive signs for the economy as well. I would expect choppy markets due to inflation, lots of political fighting and of course ongoing uncertainty and Covid concerns.

What is your favorite part of being a financial advisor?

I love to learn about people's lives. Where they have been and where they would like to go personally and financially. It is a very satisfying experience when a client sees their goals come to fruition.

At a broad level, what is your investment approach?

Buy and hold during short term events but be willing to reduce and ramp up risk based on longer term trends.

What common financial mistakes do you see people make?

The age-old mistake, of course, is not staying disciplined within one's investment allocation while the markets "do their thing." Jumping in and out of the markets and trying to time during short term volatility can be unproductive.

How does Novem Group benefit you as an advisor?

Novem gives me the autonomy and flexibility to service my clients. Novem also provides the tools, resources, and research to stay current with the economy and markets which translates to a better experience for clients.

How do you like to spend your time outside of the office?

Most of the time I am with my family and friends making wine, golfing, and cooking.

What is your favorite restaurant in Rochester?

So many great restaurants in Rochester… Probably Grinnell's, on Monroe Ave. I worked there as a kid and have spent many birthdays and other celebrations there. It is a bit of an institution.

What is one trip you are looking forward to in 2022?

I plan on driving West for a week and seeing where my car takes me… No itinerary or plans… Just see some more of our beautiful country.

What We're Drinking: Genesee Cream Ale

In prior Quarterly Outlooks, we tried our best to go up-market and appeal to the posh craft-beer crowd. We never received any feedback so we're going back to our roots.

Rochester's Finest makes the cut this quarter. Genesee Cream Ale or "Genny Screamer" is a local beer named after Western NY's river. Originating in Pennsylvania, the Genesee runs through Letchworth State Park, through the City of Rochester and empties into Lake Ontario. Its swift current provided hydropower to grain mills and helped drive the region's settlement. Genny Cream Ale is a smooth, crisp, and refreshing beverage that quenches your thirst, not your budget.

And don't forget, the annual Genny Keg Tree during the holidays is a sight to behold!

Historical Perspective

Technology and high-growth stocks dominated the headlines for the past few years. As 2021 concludes, we thought it would be interesting to look back to a somewhat similar time in financial history, the Dot-Com bubble.

Through the year of 1999 the Nasdaq compounded at almost 30% for a decade and many pundits were calling it a bubble.

From Barron's "Up and Down Wall Street, part 2" published August 30, 1999."

'…Any speech that makes mention of Dutch tulip bulbs can't be considered entirely favorably disposed toward the stock market. And when that phrase trips off the lips of the chairman of the Federal Reserve, it's a tad unnerving. All the more so when it's coupled with the expletive "bubble".'

After such a strong decade, perhaps this was finally the end of the Nasdaq's run. However, the market, true to form, acted irrationally. From the end of August 1999 (red arrow) into March 2000 the Nasdaq doubled!

Then finally the bubble actually burst in March 2000 and the Nasdaq would not reach the August 1999 level until 2007!

Just as we see now, calling the Nasdaq a bubble is a popular headline of the day. 1999 is an important reminder that timing the market is impossible. We don't know what comes next and neither does anyone else!

Disclosures

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