2Q22 Commentary

Content

"Doubt is not a pleasant condition. But certainty is absurd."

- Voltaire

"It is implicitly taken for granted, and often taken as unquestioned dogma, that as long as human beings remain inventive, we will stay ahead of any impending threat by continuous and ever more ingenious innovations."

- Geoffrey West, *Scale*

"Most things I worry about never happen anyway"

- Tom Petty

Welcome

With everything going on in the world, we wanted to open the Quarterly Outlook with a light-hearted lesson on expectations, preparedness, and life. We'll go back to the fourth quarter of 1994…

In November 1994, Newt Gingrich and the Republican Revolution took control of Congress and numerous governorships. At the center of this national campaign was the *Contact with America,* a set of policies the Republicans would seek to implement if elected. Chief among them was a commitment to a balanced federal budget. In 2022, the US has over $30 trillion in debt and the federal government is projected to run a deficit of $900 billion, neither amount captures additional entitlement liabilities like Medicare and Social Security. So much for balance.

In December 1994, during a diplomatic meeting in Budapest, Hungary, the newly independent nation of Ukraine agreed to forfeit its stockpile of nuclear weapons left over from the Cold War. As the USSR disintegrated, Ukraine found itself with the third largest stockpile of nuclear weapons in the world. In exchange for assurances from the US, UK, and Russia that its border and sovereignty would be respected, Ukraine forfeited its nuclear stockpile. Whoops.
As the Republican Revolution stormed Congress and Ukraine forfeited its nukes, Tom Petty and super-producer Rick Rubin released *Wildflowers*. On it, the track "Crawling Back to You" features the lyric
"Most things I worry about never happen anyway"

We agree. Most of the things we worry about never happen. But that doesn't mean we should throw caution to the wind! In both investing and life, it's best to prepare for the worst. We lock our doors at night. We insure our homes, cars, lives, and health. Volatile periods like we are now experiencing remind us to conduct our affairs prudently and responsibly.

So, listen to Tom Petty. Listening to politicians doesn't seem to work.

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Ukraine

We think a direct consequence of the Ukraine War is a reinvigorated NATO. The bonds between NATO countries, particularly European countries, are stronger because of this common threat. It is also possible that other countries like Sweden and Finland opt to join the alliance. Additionally, each NATO member is likely to take its own security more seriously. Already we have seen Germany commit to sharply increase its defense spending.[1] A stronger NATO, and in particular Europe, will significantly impact the balance of power in the world.

We also think this war is a rude awakening for Europe's energy policy. Prior to the invasion, Europe was pursuing green sources of energy such as solar and wind while also seeking to shutter nuclear power plants. These dual mandates left Europe heavily reliant on natural gas imports, particularly from Russian pipelines. This geopolitical deleverage left Europe reliant on an autocratic regime.

There is no easy substitute. Importing liquified natural gas (LNG) is helpful but expensive because it must be cooled to -260° F and shipped across the ocean! Europe will continue pursuing aspirational sources of green power, but necessity will drive energy policy in the short-term. Rising coal consumption, higher electricity costs, and a reexamination of nuclear are all likely scenarios.

Finally, we think this conflict might contribute to instability in Eastern Europe. Since he came to power 22 years ago, Vladimir Putin constructed and organized institutions around himself. Although weak economically and militarily, Russia is still a regional power with nuclear weapons. Given how poorly the invasion is going for Russia, it is difficult to envision Putin wielding the same power and influence he had prior to the invasion. For that reason, we think this is the beginning of the endgame for the Putin regime. What does Russia and its sphere of influence in Eastern Europe look like without Vladimir Putin? We have no idea and neither does anyone else. Instability in Eastern Europe is a risk worth considering.

[1] https://www.reuters.com/business/aerospace-defense/germany-hike-defense-spending-scholz-says-further-policy-shift-2022-02-27/

Monetary Policy

We think monetary policy is the stock market's primary driver in 2022. Energy prices and geopolitics generate headlines, but the epicenter of the financial markets is the Federal Reserve. The Fed is tasked with supporting maximum employment, keeping prices stable, and keeping long-term interest rates moderate.

Inflation is running in the high single digits, and it is the Fed's responsibility to tame it. To fight inflation, the primary tool is raising interest rates. Higher interest rates styme inflation primarily by destroying demand. This happens by increasing the rates and costs for instruments like mortgages and auto loans. Buyers that could afford payments on a $300,000 house and $30,000 car can only afford payments on a $250,000 house and a $25,000 car. Aggregated across the economy, this impact is significant. The same goes for companies who use debt to fund their business. When interest rates are low, a company might build a new factory. With higher rates, this expansion might be downsized, delayed, or completely canceled. In this way higher interest rates reduce the consumption of individuals and companies.

Higher interest rates also impact financial markets. Higher interest rates decrease the value of bonds, in particular long-dated bonds with a high duration. For a 30-year US treasury bond, a 1% increase in interest rates will lower the price of the bond by over 20%! Given our view of inflation and interest rates, it should not come as a surprise that the duration of Novem's fixed income strategies is extremely low.

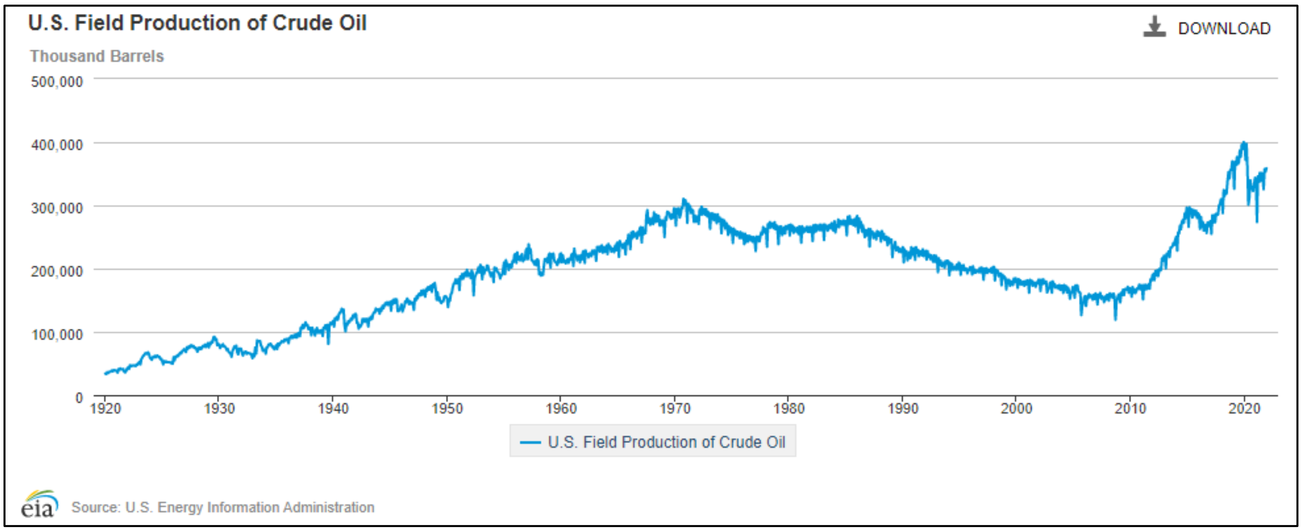
Like long duration bonds, higher rates also impact growth stocks. As opposed to value stocks, which are typically profitable today, the worth of growth stocks is predicated upon *future* profits. A promising yet unprofitable technology or pharmaceutical company is valuable because it will earn profits years from now. Rising interest rates diminish the present value of these future profits. We are already seeing this take place as the tech-heavy Nasdaq entered a bear-market (denoting a 20% decline from its highs).

There is an adage that bull markets do not die of old age, they are killed by the Federal Reserve. We are not calling for a steep or protracted recession, but we think higher rates will not only slow economic growth but also put downward pressure on financial markets. We recommend working closely with your financial advisor to examine and understand how the various assets in your portfolio might perform through such a scenario.

Energy Prices

The prices we pay for energy depend on a complicated, nuanced, and global balance of supply, demand, and logistics. Before the Ukraine War, oil and natural gas prices were already rising. In 2021, the spot price of West Texas Intermediate (WTI) rose 63%. In 2022, before Russia invaded Ukraine, spot WTI rose another 31%! The Ukraine War is a catalyst but the key driver behind high energy prices is years of underinvestment. Additionally, the current state of the US shale industry is a key datapoint in the balance of global energy markets.

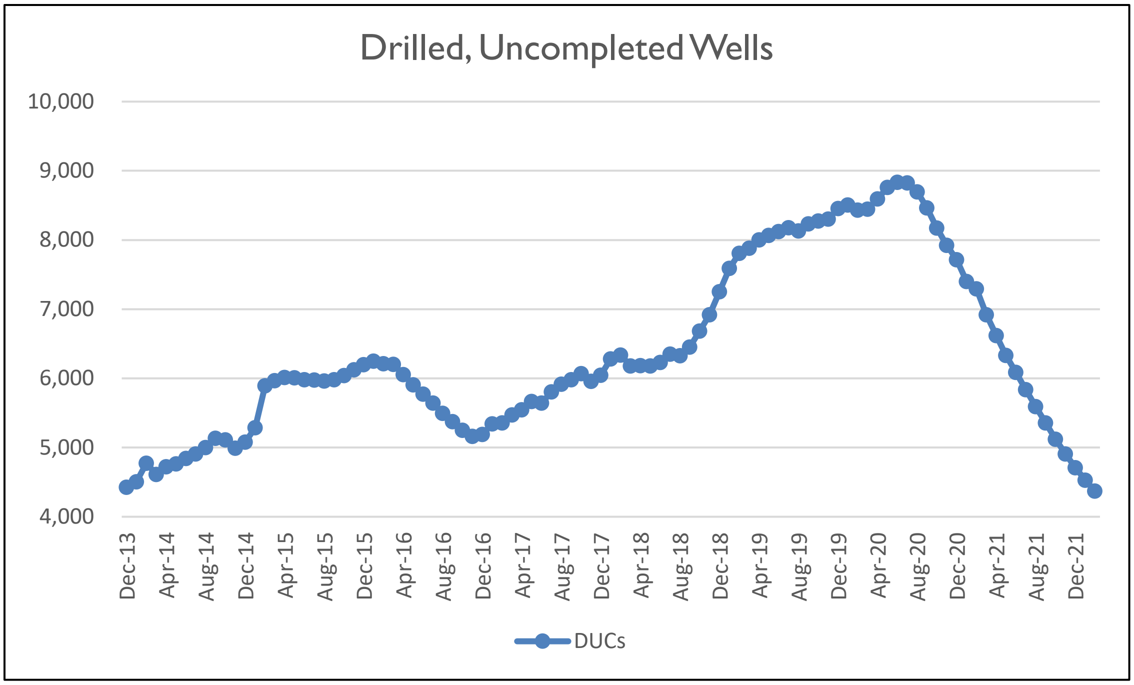
After record-high oil and natural gas prices in the mid-2000's, the US energy industry



responded with investment and innovation. By applying capital and new technology to older or more complicated fields, the Shale Revolution drove US production to new highs. For a while, equity markets rewarded companies that grew production fastest. Short-term growth was favored over profitability and long-term shareholder value. By 2014, a dearth of supply from US shale caused oil prices to drop about 50%.

Low prices forced the industry to adjust from a philosophy of 'growth at all costs' to a more measured 'growing within profitability.' As part of this shift, exploration budgets were cut sharply, and companies stopped looking for new discoveries. The energy industry's restraint is positive for long-term shareholder value but acts as a governor on shale supply growth. Now facing nearly, a decade of underinvestment, the energy industry is hard-pressed to grow supply.

Compounding this problem, the industry has no inventory of excess drilled but uncompleted wells. Known within the industry as DUCs, these wells are already drilled but not fracked or producing hydrocarbons. DUCs are the easiest and fastest way to grow production.



As demand recovered in the wake of the COVID-19 pandemic energy companies tapped these excess DUCs. Now this low-hanging fruit is gone, and energy companies must find and develop new resources. It will take time for this industry to respond.

Many of the headlines we see regarding energy prices are short term in their focus and discuss either the Ukraine War or inflation. Neither issue is helping lower the price of energy, but the main reason for today's high energy prices are years of underinvestment in exploration.

Quarterly Outlook

- ***Favor high credit quality and short duration in fixed income markets***
- ***Continue to favor Value stocks over Growth stocks***
- ***International equities favorable versus US because of valuation dispersion***

Fixed Income Outlook

To combat high inflation the Fed raised interest rates by 25bps- the first step in a rate-hike cycle. With inflation expected to continue additional rate hikes are expected. Currently the market expects the target rate to comb from 25bps to 175-200bps by year end. These projections should be taken with a grain of salt due to the macroeconomic factors at play, but it's worth noting that prior projections have anticipated less aggressive rate hikes in previous cycles. Over the past four tightening cycles, futures underestimated the overall policy move by 75-175bps.[2]

Fixed income is very sensitive to changes of interest rates – as rates rise, bond prices fall. Modified duration measures the price change in a bond given a 1% change in interest rates and it's an important component in fixed income portfolio construction. Novem's core fixed income portfolio has a short duration relative to the benchmark which could help us outperform as rates climb. This relationship is easier to understand across investment-grade credit, but it becomes more nuanced in the high yield space.

High yield bonds are more economically sensitive than investment grade bonds. Rising interest rates generally signal economic strength. As economic outlook improves, credit spreads (the difference in yield between investment-grade and high yield bonds) tend to tighten. High yield spreads are near the bottom of their 15-year range. With quantitative easing winding down, it's unclear whether economic strength will continue. While high yield bonds are investable in the current market, we continue to caution investors from taking unnecessary credit risks. We carefully maintain exposure to high-quality high yield debt in our core fixed income strategy and lean towards capital preservation rather than chasing yield.

Growth vs. Value

What will outperform: growth or value? Tech-heavy Growth exhibited dominant performance in recent years, but Value is outperforming so far in 2022. Higher interest rates are generally positive for Value, partially because financial companies are a large component.

For Growth, it's important to consider the impact of rising rates on P/E multiples. Higher interest rates mean higher discount rates applied to future earnings which lowers a company's intrinsic value. This has a greater impact on high growth companies where most of their value is based on future earnings. For example, an unprofitable biotechnology company developing a

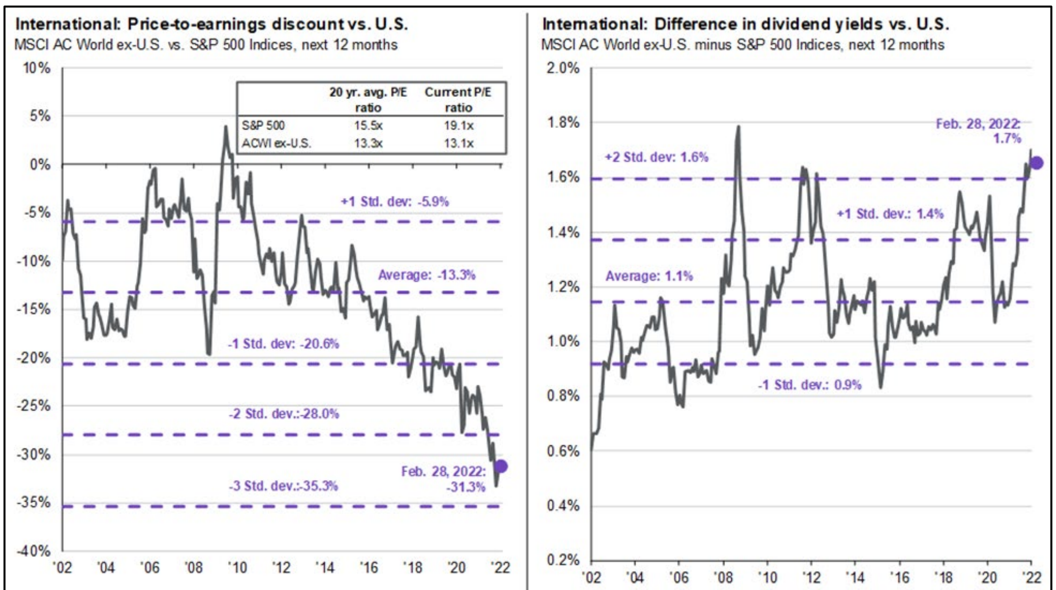
[2] https://www.cmegroup.com/insights/economic-research/2022/fed-rate-hikes-expectations-and-reality.html

blockbuster drug might be valued higher than a mature slow-growth company like a bank. But as interest rates go up, the future profits of the biotechnology company are discounted heavily, and the earnings of the slow-growth bank expand.

Our Dividend Select and Capital Appreciation strategies both lean into Value and favor companies we believe can respond to inflation. Both strategies outperformed the S&P 500 last year and have continued to outperform so far in 2022!

International Equities

Since the 2008 financial crisis, US equities strongly outperformed international equities. US grew earnings, but multiple expansion was the driving factor. In other words, US companies didn't grow earnings much faster than international companies, but US stocks outperformed because *more people bought US equities.*[3] As it stands, international companies are trading at a P/E discount relative to US companies that's over 2 standard deviations below the historical average. Additionally, international equities offer attractive dividends relative to the US. Adding



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of February 28, 2022.

exposure to non-US equities is one of our top-conviction ideas for 2022.

Domestic and international equities both face risks and we continue monitoring ongoing developments in Russia/Ukraine and China/Taiwan. Investing involves uncertainty but we believe the divergence in valuations creates an attractive opportunity.

[3] https://www.aqr.com/Insights/Perspectives/The-Long-Run-Is-Lying-to-You

Advisor Spotlight: Patrick Manuel

Pat joined Novem Group as a financial advisor in 2014 after leading a successful sales leadership position for a large manufacturing company. He spent the better part of the past decade both growing his practice and learning the operational side of the business, providing him with the experience required to take on his new role. A graduate of the University of Rochester, earning a B.A. in Economics, Pat holds the Accredited Investment Fiduciary (AIF©) designation and Series 66 and 7 securities licenses. In 2021, Pat was promoted to President of the firm, and his integrity, work ethic, and vision will continue to support the growth of Novem Group for years to come.

What common financial mistakes do you see people make?

The most common financial mistake that I see is when people are too intimidated to start their financial plan. It can be a complex and daunting task to map out how to save for a wedding, college, retirement, or any big life events. What people don't realize is that hitting a savings goal is typically not linear. No matter how small a contribution you may feel like you're making in the beginning, the power of compounding interest is a remarkable force, and will get you to your goal faster than you think!

What is your favorite restaurant in Rochester?

Our favorite restaurant here in Rochester is Perlo's, in East Rochester. My wife and I are not originally from the area, so we weren't familiar with the restaurant scene. When we purchased our first house, we found the closest Italian food restaurant and gave it a shot-and thank God we did! Over a decade later we've moved to another suburb, but still regularly make the drive to get to Perlo's.

How does Novem Group benefit you as an advisor?

Novem Group is the most dynamic financial services firm I've come across. As an advisor, I've found that we're provided with world-class technology to better serve our customers. Our business is changing rapidly, and our clients demand a "high tech, high touch" service model. Without those cutting-edge tools that allow us to discuss and set goals, measure risk, research positions and create unique portfolios, we would be doing our clients a major disservice.

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

Ireland! In 2019, my brother, brother-in-law and I planned a trip to southwest Ireland for my father's birthday. Two years and a global pandemic later, we are finally able to go. We are going to spend a week golfing at a few world-class golf clubs, and just enjoy a great country.

What is the simplest thing a client can do to improve their financial situation?

In my eyes, the simplest thing that a client can do to help themselves financially is to pay themselves first. Whether it be via a 401(k), savings account, or investment account, having the discipline to adhere to a budget that saves money will put you on a great path to financial freedom. Also, no matter how much you may earn if you're carrying "bad debt" like credit cards and high interest loan payments. You are going to end up spinning your financial wheels if you don't get that taken care of as quickly as possible.

What We're Reading

We recently finished James Clear's bestseller ***Atomic Habits****: An Easy and Proven Way to Build Good Habits & Break Bad Ones.* We highly recommend this interesting, accessible, and quick read.

The premise is that success is not the result of a single event. A Hall-of-Fame career is not the result of a single game-winning homerun. In business, millionaires don't magically appear overnight. Instead, these successes are the result of compounding. As time passes, small improvements on top of small improvements on top of more small improvements compound into exceptional results.

One of the anecdotes covered is the British Cycling team. Despite a national interest in competitive cycling, Great Britain underperformed pathetically for years. The team was so bad that bike manufacturers didn't want them using their bikes because the manufacturers considered it bad publicity. In 2003, a new coach, Dave Brailsford, implemented a new strategy that relentlessly focused on "the aggregation of marginal gains."[4] "The whole principle came from the idea that if you broke down everything you could think of that goes into riding a bike, and then improve it by 1 percent, you will get a significant increase when you put them all together."[5]

The team started making small changes on every detail including monitoring workouts, testing fabrics in a wind tunnel, and determining the optimal type of pillow and mattress to maximize sleep. The team even hired a surgeon to show the team how best to wash hands thereby reducing the risk of catching a cold. As these small improvements compounded, the team's success improved markedly.

We found numerous parallels between this thought process and finance & investment management. It reminded us of an old axiom.

Would you rather have $1,000,000 or a magic penny that doubles every day for 30 days?

$1,000,000 is hard to turn down but the truth is that the doubling penny will turn into over $5 million by the end of the month! Investing success is not the result of a single windfall but many small successes that compound over time.

We checked our pockets, piggy banks, and the cupholders in our cars but none of our change appears to magically compound. So how can we, as investors, create good habits that will compound over time and allow us to improve our probability of success?

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[4] Clear, James. Atomic Habits. Pg 13. New York, NY, Avery Publishing, 2018. Pg 13.
[5] Ibid.

The author, Clear, lays out a framework to help form good habits and break bad ones.

Form a Good Habit	**Break a Bad Habit**
Make it obvious	Make it invisible
Make it attractive	Make it unattractive
Make it easy	Make it hard
Make it satisfying	Make it unsatisfying

The good news is investing has never been more obvious, easier, or attractive. Working with Novem's client service team is a straightforward process and technologies like DocuSign mean you can open an account from just about anywhere in the world.

To further ways to make good financial habits obvious, attractive, easy, and satisfying. If you have bad habits, try to make them invisible, unattractive, hard, or unsatisfying.

Perhaps it is hard to save for retirement every month. Make it invisible by enrolling in a 401k or having IRA contributions automatically withdrawn. If you get a raise, automatically dedicate a portion of the raise towards your savings. You won't notice the money missing and won't have to decide every month how much to save or whether to save at all. When you receive your tax return, automatically apply a portion of it to your IRA or your children's 529 account.

On the other side, find ways to break bad financial habits. Spending too much on Amazon? Make it more difficult to make impulse purchases by removing the app from your phone.

Any other good ideas or tricks for forming/breaking financial habits? Send them our way!

What We're Drinking: Hollerhorn Distilling

Hollerhorn is MUCH more than a distillery- it's a great restaurant with excellent food and cocktails. There is also a beautiful outdoor space too where they host musicians all summer. Situated in the heart of Finger Lakes wine country Hollerhorn is close to some fantastic hiking and great wine.

The distillery specializes in tree spirits distilled from local maple syrup- truly unique and something we didn't even know existed. The taste is closer to a whiskey, but the distillation process is similar to rum. They offer tasting flights so you can easily sample the different varieties. We highly recommend the Flamed Maple spirit.

If innovative tree spirits aren't your thing, they also have a wide selection of beer, wine, and other refreshments.

We'll definitely head back to Hollerhorn this summer to enjoy the views and music. Let us know if you'd like to tag along! First round is on us…

Historical Perspective

We thought we would look at one of the most polarizing etfs over the past few years, the ARK Innovation ETF. This ETF has been around since 2014 but really began to make a name for itself as we rebounded from the March 2020 lows and saw tech companies take off!

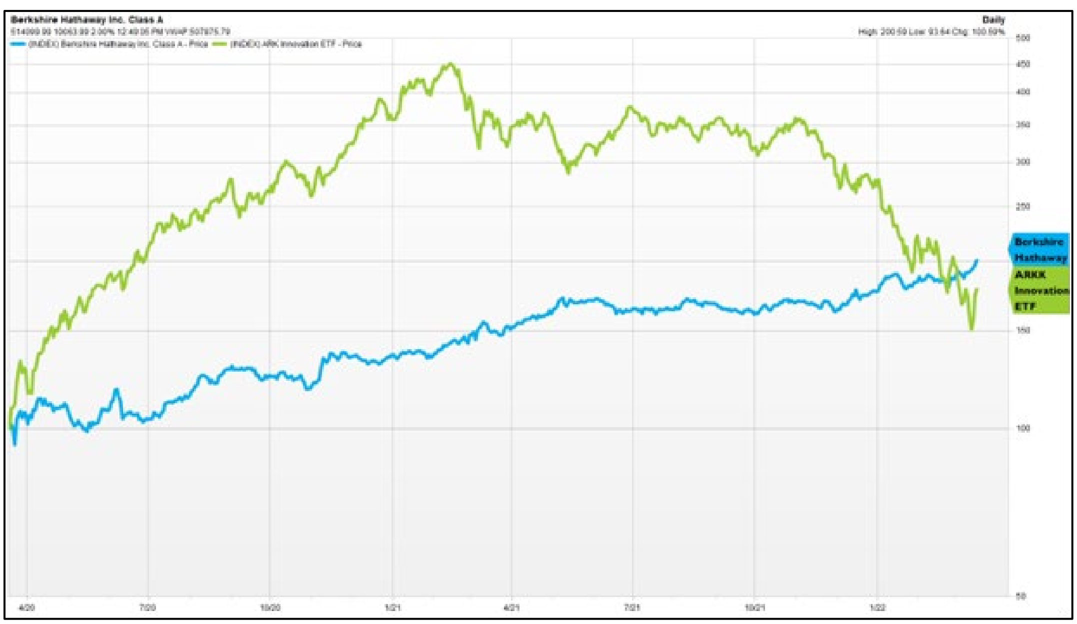
After the pandemic, the ARK fund performed very well and the portfolio manager, Cathie Wood, began receiving immense praise from the investment community.

- ETF News: Diversity Is the Secret Behind Ark's Success - Bloomberg
- As ARK soars (and spars), competitors line up rival ETFs | Citywire (citywireusa.com)
- Cathie Wood, the Best Investor You've Never Heard Of - BNN Bloomberg
- Cathie Wood: Secrets of the World's Best Innovation Investor (yahoo.com)

Akin to the hare in the adage her fund quickly reached astronomical return levels. From the March 23, 2020, market-low their ETF, ARKK was up over 300% less than a year later!

All the while old, value investments like Berkshire-Hathaway kept quietly plugging along like the tortoise. Never gaining flashy or headline grabbing returns. Berkshire continued along the way making slow gains day over day that compound over time (just like atomic habits!). As ARKK was peaking at its all-time high, Berkshire was only up around 47% from its March 23, 2020, low. During this time, Berkshire returned just 1/6th the performance of ARKK!

As you probably have guessed by now this story ends in a very similar way as the old tale! After reaching its all-time high in February 2021 ARKK began a relatively rapid decline. As the decline continued the dispersion between the tortoise and hare returns grew smaller and smaller. Until sure enough, earlier this year Berkshire's return from the March 2020 low surpassed ARKK. As we went to press in mid-March 2022, BRK/B has returned more than



double ARKK's return since the March 2020 lows. This helps drive home the point that having a longer-term horizon and achieving small incremental gains over time can compound into a fantastic return. Trying to chase the latest headline-grabbing investment typically ends poorly!

Additional Disclosure:

There are risks involved with investing in any such products, including the possible loss of principal. Investors should be willing to accept a high degree of volatility and the possibility of significant losses. Consider the Funds' investment objectives, risks, charges and expenses carefully before investing. ETFs are subject to market fluctuation and the risks of their underlying investments. ETFs have a unique risk profile, detailed in its prospectus, offering circular, or similar material, which should be considered carefully when making investment decisions.

Disclosures

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