3Q22 Commentary

Content

"The best pitchers have a short-term memory and a bulletproof confidence."

- RA Dickey

"Our worst misfortunes never happen, and most miseries lie in anticipation."

- Honoré de Balzac

"Thinkin' back on my one-room shack
Now my mom pimps a Ac' with minks on her back
And she loves to show me off of course
Smiles every time my face is up in The Source
We used to fuss when the landlord dissed us
No heat, wonder why Christmas missed us
Birthdays was the worst days
Now we sip Champagne when we thirsty
Uh, damn right, I like the life I live
'Cause I went from negative to positive"

- The Notorious B.I.G.

Welcome

A traditional investment strategy combines stocks and bonds because these asset classes typically exhibit negative correlation. They are negatively correlated because of the way they respond to economic growth and interest rates. Strong economic growth pushes stock prices and interest rates higher. Bonds only pay a fixed coupon so when interest rates rise, bonds become less desirable, and prices fall. When the economy and stocks do poorly, interest rates usually fall so bonds perform well. The problem this year is that as the stock market declines, interest rates are rising and pushing bond prices down! So, with stocks and bonds declining in lockstep, traditional investment strategies everywhere are having a tough go.

Year to date, Novem's investment strategies are performing well on a relative basis. Novem Dividend Select and Novem Capital Appreciation in particular are off to a terrific start, strongly outpacing the S&P 500. Novem Strategic Fixed Income is also far ahead of its benchmark, the Bloomberg US Aggregate Bond Index. We attribute this to a key tenet of our investing philosophy: rather than focusing on making the single absolute best investment, like betting it all on the next Apple (AAPL), we focus on avoiding the worst decisions. This approach helps us avoid 2022's worst performers like unprofitable technology stocks and long duration bonds.

The Federal Reserve is hiking rates to bring inflation under control. There are concerns that this will tip the economy into a recession which is driving market volatility. The financial topic du-jour is whether the Fed's moves will result in a 'soft landing' i.e., a short, mild recession, or a 'hard landing' with a more severe recession.

The Fed must bring inflation under control. This likely causes turbulence in the short term but longer term this normalization of monetary policy is positive. We probably sound like a broken record, but we remain focused on the long-term. In our Novem investment strategies, we seek to own high quality companies with competitive fundamentals and clean balance sheets. These types of characteristics are not impacted if the Fed hikes 25, 50, 75, or even 150 bps.

Thank you for the trust you place in us.

- Your Novem Investment Team

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Update on Novem Investment Team

Despite the volatility in the financial markets the Novem Investment team is performing well, and we have several exciting changes to announce. First, our analyst, Thomas Lyons, accepted a higher position in Charlotte, North Carolina with another RIA firm. Thomas was a terrific employee and added a tremendous amount of value during his tenure with Novem. It's always hard when talented employees graduate on to the next level, but we are proud to watch his career move upwards. Thank you, Thomas!

We also have Daniel Williams joining us this summer as an intern. Dan is originally from Fairport, NY and is currently earning top marks in St John Fisher College's Financial Planning program. Our portfolio manager, Charlie Ruff, teaches investments as an adjunct professor and Dan earned the highest score in the class. We are very excited to have Dan this summer and we think he'll be a terrific addition to our team. Please join us in welcoming Dan!

The US Consumer

The US is the largest economy in the world and is 70% consumption. The US consumer is a key determinant in the direction of the global economy. The declining stock market and high inflation negatively impacts both consumers' wealth and confidence. With the Federal Reserve hiking interest rates in this environment, the financial press seizes any less-than-perfect data to conclude that a major recession is imminent.

Based on our analysis today, our view of the US consumer is relatively optimistic. The Federal Reserve has a dual mandate: to maintain price stability (control inflation) and promote full employment. If the Fed aggressively fights inflation by raising interest rates too high or too fast, it will likely cause employment to fall as companies lay off workers. The Fed must balance price stability with employment so a deep, protracted recession would amount to a policy failure. Inflation is hurting consumers. During the fall of 2021, inflation became a primary driver of negative consumer sentiment.[1] To help consumers (read: 70% of the US economy), it's imperative that the Fed tame inflation.

The key difference in our more optimistic assessment is the strong labor market. As we've previously discussed, the labor market is tight and help-wanted signs are everywhere. Consumers are confident when they are employed so a strong labor market supports consumer confidence. Workers also have more negotiating power which helps wages keep pace with inflation. A strong labor market also helps the Fed balance employment and price stability thereby allowing the Fed to normalize monetary policy. The short term might not be smooth but long term the fundamentals are solid.

But will the Fed cause a recession? How bad will it be? For clues, watch the labor market. As long as the labor market remains strong, we don't see a high probability of a protracted, severe recession.

[1] https://data.sca.isr.umich.edu/fetchdoc.php?docid=68530

China's Housing Market

China's housing market, long an engine of economic growth, is turning. Many of us remember the damage of the 2008/2009 financial crisis and the dangers of excess in the US housing market. Unfortunately, the Communist Party often manipulates information to fit its narrative which heavily skews economic data. With reliable data hard to find, forecasting and quantifying these risks is especially difficult. Still, based on estimates and what solid data we can locate, there are three reasons why we think China's housing market could be a significant problem for China's economy.

1. ***Housing is an enormous part of China's economy.***

In a 2020, Kenneth Rogoff of Harvard University and Yuanchen Yang of the Tsinghua University conducted research on China's housing market and found that "China is even more dependent on housing construction than Ireland or Spain just prior to the financial crisis."[2] Currently, the economic impact of real estate in the US is about 17%. The all-time high in the US was about 19% in 2005 prior to the financial crisis. In China the impact is currently 30%. With so much of the Chinese economy dependent on real estate and housing, any turbulence in this sector will be especially impactful.

2. ***Housing is an enormous portion of Chinese consumers' wealth***

Many people have a significant amount of their wealth in their home so changes in housing prices can have a profound impact on consumer confidence. In the US, about 35% of consumer wealth is in real estate. In China, this figure is closer to 70%.[3] Chinese consumers will be very sensitive to any weakness in housing prices.

3. ***Housing and real estate are a substantial portion of municipal government revenues***

In China, many local governments finance their spending by selling land to developers. Sales of land account for about 1/3 of local government revenue.[4] A weaker housing market and declines in land sale revenue will stress the finances of local governments. Jonathan Cheng of the Wall Street Journal writes[5],

> *"Local governments collectively amassed the equivalent of more than $4 trillion in debt at the end of 2020, up 20% from a year earlier, show data from China's Finance Ministry. That debt is regarded by economists, and by Beijing itself, as a*

[2] Rogoff, Kenneth and Yuanchen Yang. "Peak China Housing." National Bureau of Economic Research. August 2020. Pg 33, 34.
[3] https://fortune.com/2021/12/02/chinese-real-estate-investing-home-ownership-evergrande/#:~:text=China%20is%20a%20nation%20of,estate%2C%20according%20to%20Loomis%20Sayles.
[4] Wong, Jacky. "China Risks Property Fallout. Wall Street Journal, New York City, 9 September 2021.
[5] Cheng, Jonathan. "China's Policy Squeezes Local Governments. Wall Street Journal, New York City, 26 January 2022.

threat to the country's financial stability.

The sum is widely believed to be a gross underestimate with considerable debt buried in financing vehicles and camouflaged in other forms"

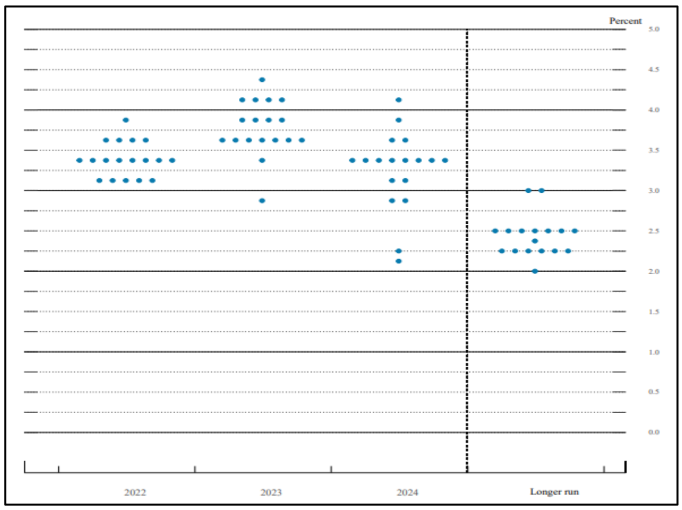
China's housing market is a significant issue not only for homeowners and property developers but for municipal governments as well!

This fall, Chairman Xi is widely expected to take an unprecedented third term as General Secretary of the Communist Party. To make this as smooth as possible the Chinese economy is being coddled along. There is a strong incentive for officials to delay addressing these imbalances in the Chinese economy. Sweeping problems under the rug hides them, but what happens after Xi gets his third term?

Quarterly Outlook

Fixed Income

The Fed continues to raise interest rates to combat inflation. At the most recent meeting the Federal Reserve increased rates 75bps moving the current target range to 150-175bps. Below, the Fed dot plot is a graphical representation of where Fed members believe the target rate policy should be. Based on the dispersion of the 'dots,' currently the minimum target rate in 2023 is 3% and the maximum is over 3.5%. This implies a minimum additional 100bps worth of hikes in 2022.



**FOMC participants' assessment of appropriate monetary policy. June 15, 2022.*

The valuation of any given bond is driven by three factors: the yield curve, credit quality, and duration. Our core fixed income strategy is focused on the two we can control: credit quality and duration. We continue to look for high credit quality and shorter duration versus the benchmark in this current Fed tightening cycle. We are actively monitoring rates will look to expand duration if we determine that rates increases are slowing due to economic weakness. At this point we believe rates will continue to rise. Against this backdrop, we find a favorable risk/reward in owning short duration, high quality bonds.

Equities

In equities, we believe defensive value stocks will continue to outperform growth stocks as interest rates continue to climb. Growth stocks pulled back from where they started the year at over 30x P/E to around 22x through May. This is slightly below the 10-year average of ~24x. However, given the current uncertainty through the myriad of global factors (Inflation, Ukraine War, China lockdowns to name a few) we continue to expect global markets to remain volatile. Going forward, we are emphasizing companies that can generate cash flows now. The present value of potential profits far in the future is discounted more heavily with higher interest rates. This is why growth stocks, who are expected to earn more profits later, are underperforming.

Value stocks, which tend to generate strong cash flows today, are outperforming on a relative basis. As long as interest rates continue to rise, we favor value stocks. Of course, there will be volatility too. We can't stress enough that a long-term focus is necessary, especially in times of volatility.

Alternatives

Alternatives are a broad sector covering a variety of investments from real estate to commodities to bank loans. It is difficult to have a general outlook on the category because it is a catch-all for anything that doesn't fit into traditional asset classes. Specific sub-sets of alternatives may be positioned well to take advantage of the current inflationary environment. Historically, real assets such as commodities and real estate performed well in inflationary environments. Commodities generally tend to be a leading indicator because their prices react quickly to underlying changes in the economy. Real estate also tends to have decent correlation to inflation because over the long-term, housing prices move in the same direction as wages.[6] The diversification benefits of select alternatives can make sense in traditional allocations. The Novem Investment team recently launched our latest strategy, Novem Liquid Alternatives. Using ETFs and mutual funds, we target select parts of alternative assets to provide additional diversification. Based on your individual needs, this strategy may or may not be a good fit. We recommend discussing this with your financial advisor.

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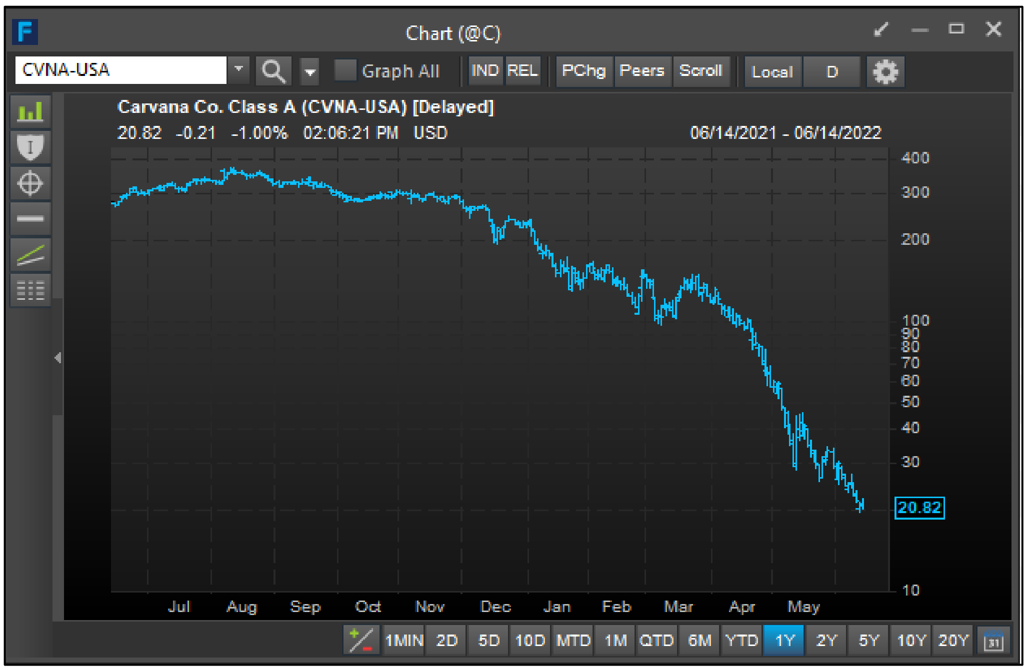
[6] https://www.bloomberg.com/news/articles/2022-01-24/is-real-estate-a-good-investment-hedge-against-inflation-what-the-experts-say

Deep Dive: Carvana (CVNA)

This summer, you might see this company's license plate frames during a road trip. Carvana (CVNA) is an e-commerce-oriented used car dealership. From its founding 2012, the concept for CVNA was to be the Amazon of used cars.

By leveraging technology CVNA would purchase, recondition, sell, and deliver used cars better and more efficiently than incumbent dealerships. Instead of owning dealerships, CVNA would pass these savings in the form of lower pricing. By letting people shop online, CVNA would also provide a better experience with more inventory and no notoriously pushy salespeople. As a disruptive, fast-growing business CVNA's story resonated with investors. After going public in 2017, CVNA was a Wall Street darling, eventually peaking at a value of $30 billion in the fall of 2021. That is not the case today.



What went wrong? How could a stock that was worth $375/share decline 95%? Is CVNA's experience indicative of what can happen to *any* stock?

The Novem investment team conducted a great amount of research which drove our decision not to invest in the stock over the past few years. Perhaps at some point we will find the risk/reward relationship of CVNA shares attractive. What follows is a sampling of our historical research to provide a view into our investment process. This research is backward looking and summarizes why we previously made an investment decision. It is not necessarily relevant today and does not constitute a recommendation.

To understand the profit potential of CVNA, we first dove into the financials of traditional dealerships like Asbury Automotive (ABG), Lithia Motors (LAD), and Penske Automotive

Group (PAG). Most dealerships generate revenue through four operations: new vehicle sales, used vehicle sales, parts & service, finance & insurance. The most profitable segment is parts & service.

About half of a dealership's gross profitability comes from servicing cars, not selling them. Used car sales are only about 10-15% of a dealership's profit. Since CVNA only sells used cars it does not have these lucrative other businesses. To succeed, CVNA must lower its costs enough to make selling used cars highly profitable.

We saw two significant issues preventing CVNA from rationalizing costs- its real estate and the cost of acquiring a consumer. Instead of forgoing customer-facing real estate to save costs, CVNA began building car vending machines. Consumers would be able to insert a special coin and 'order' their car. It's a cute marketing gimmick, but we aren't sure how this cuts costs.

No cost savings in sight

Second, CVNA's cost of acquiring a consumer is incredibly high. CVNA spends about $1,100 for each car sold *just on advertising*.[7] Facing expenses like this, CVNA loses money on every car it sells.

One thing Carvana did get right was utilizing technology and streamlining the sales process. Customers enjoy browsing inventory from the comfort of their home and appreciate a straightforward sales process. Unfortunately for CVNA, this early advantage was competed away.

Companies with a similar value proposition, like Vroom (VRM), entered the market. Also, traditional dealerships responded by investing in technology and emphasizing customer-friendly features like delivery and no-haggle pricing. In this way, CVNA improved the car-buying experience by forcing an entrenched industry to evolve and offer better service. Unfortunately, this disruption alone did not help generate profits.

In the Novem investment strategies, we emphasize high quality companies with strong fundamentals and attractive valuations. This means we want to buy companies with defensible profit margins, clean balance sheets, and the potential to appreciate. In the past, CVNA did not make the cut.

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[7] 2022 10K. pg. 26.

Advisor Spotlight: Tom Burke

Tom is a graduate of Cornell University with a bachelor's degree in Applied Economics. He is a 30-year veteran of the financial services industry working with financial advisers, businesses, organizations, and individuals. Over the years, Tom has developed and managed employee benefit and retirement plans, and through hard work, brand development, and practice acquisitions, he successfully built his own financial services practice. In 2014 Tom rejoined Novem and has worked with the company ever since.

What are your thoughts on the market for 2022?

With over 30 years in the financial services business, one thing I'm sure of with the market. Advances are "permanent", and setbacks are "temporary." Stay on course and don't bailout at the bottom.

What common financial mistakes do you see people make?

People are emotional beings, which is why they make poor decisions in investments. If you have a solid rational and buy stock XYZ at $20/share…. when it goes down to $10/share you should absolutely LOVE IT!

Time to buy more at a 50% discount. What a deal! Oh no no…. people sell XYZ, take their tidy loss and move on to their next "great" idea. Generally speaking, people lack discipline and freak out at the first sign of any trouble. That necessary discipline is here at Novem Group comes in the form of professional advisors and a professional portfolio management team, which will "save" clients from their emotions and possible knee jerk reactions that will compromise attaining long term goals.

At a broad level, what is your investment approach?

I am generally a buy and hold guy with certain protections and hedges available today through the use of options and other strategic investments. We have a very talented professional investment team here at Novem, which I depend on to make the buy/sell decisions for the model portfolios. I might augment their efforts with some more tactical buys that run outside the models.

How does Novem Group benefit you as an advisor?

Novem Group supports me in the areas of customer service, technical support, comprehensive technology platform, and professional wealth management strategies. With Jennifer Price leading our customer service efforts, Rob Hayes handling B/D sales and recommendations, Kaeri managing the technology platform, and Charlie Ruff's team overseeing our wealth management strategies…. I can focus on the "Client, our single greatest asset." The team I work with here are very dedicated and talented. I feel like the General manager of the team and liaison to the clients. Jennifer is clearly the captain where everything flows through her. Rob is the highly skilled specialist who helps us with the more challenging cases. Kaeri is our Special Teams Coordinator keeping the information platform flowing. Charlie our Offensive Coordinator manages our overall strategies…… his team matriculates the ball down the field and oversees our performance. Our team concept allows me to specialize in an area that suits my skill set: client acquisition and development.

What is your favorite part of being a financial advisor?

It's helping people achieve their goals and objectives. It's a ton of fun to solve the puzzle by helping clients get from A to Z. I am a "boots on the ground" kind of guy. Client face to face meetings are the best.

I love the diversity of people with different situations that require different solutions. I really enjoy working with like-minded people in Jennifer, Rob, Kaeri, and Charlie's team. I believe Financial Advisors tend to isolate themselves on an island from time to time. It's much better and rewarding to be part of a coordinated team effort.

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

Start young, embrace risk/reward concepts, live within your means and a prosperous happy life will follow.

Given recent market volatility is there any specific advice you have been giving to clients?

Turn off your computer, TV, and PHONE… go outside and enjoy beautiful Upstate New York. Walk, hike, bike, boat, swim, golf, fish - great public parks and beaches. It's the best time of the year with Great Lakes and Finger Lakes fun for all ages. Hug your kids and grandkids. Be thankful for your blessings. Maintain your long-term perspective on the markets and on life. Do a random act of kindness for a stranger. Stay positive…your investments will be positive too. Keep smiling - it's very attractive. Choose Love. GO BILLS.

What is your favorite restaurant in Rochester?

Ristorante Lucano. Chuck and JoAnn Formoso are the husband-and-wife team that run this elegant Italian restaurant using the freshest imported Italian ingredients. Fabulous Italian wine list. It is a wonderful place for family and friends to enjoy an amazing meal prepared with heart and genuine Italian class. Foodies delight and service with a smile.

What is one trip you are looking forward to this year?

Super Bowl LVII in Phoenix AZ. GO BILLS!

What We're Drinking: McGregor Vineyard

A few summers ago, when unseasonably bad weather spoiled our plans to water-ski, we ventured out to some of the local Finger Lakes wineries. Nestled in the hills above Keuka Lake, McGregor Vineyard became one of our favorites. Offering a balanced collection of both reds and whites, their Cabernets and Rieslings are the main attraction.

If you're looking for something different, we recommend trying the Cabernet Franc. Typically used as a blending grape, Finger Lakes vintners (and McGregor in particular!) have had luck bottling Cabernet Franc on its own.

Our favorite is probably the Cabernet Sauvignon. We've found that it pairs nicely with a s'more and a bonfire after a long day on the lake. Cheers to summer!

Update:

Last quarter, we highlighted Hollerhorn Distillery in Naples, NY. This picturesque and unique operation also featured a terrific restaurant with an extensive beer list. Unfortunately, shortly after our feature, Hollerhorn caught fire and was severely damaged.

The good news is that the owners, Karl and Melissa Neubauer, are planning to rebuild. Raise a glass to the perseverance of small business owners like Karl and Melissa. We're looking forward to supporting them when they reopen.

Historical Perspective: Economic Forecasting in Japan's Darkest Hour

From *The Psychology of Money* by Morgan Housel (pgs. 177-179) **Emphasis our own.**
"Optimism is the best bet for most people because the world tends to get better for most people most of the time.

But pessimism holds a special place in our hearts. Pessimism isn't just more common than optimism. It also sounds smarter. It's intellectually captivating, and it's paid more attention than optimism, which is often viewed as being oblivious to risk.

Before we go further, we should define what optimism is. Real optimists don't believe that everything will be great. That's complacency. **Optimism is a belief that the odds of a good outcome are in your favor over time, even when there will be setbacks along the way.** The simple idea that most people wake up in the morning trying to make things a little better and more productive than wake up looking to cause trouble is the foundation of optimism. **It's not complicated. It's not guaranteed, either. It's just the most reasonable bet for most people, most of the time.**

…

Take Japan in the late 1940s. The nation was gutted by defeat from World War II in every way – economically, industrially, culturally, socially. A brutal winter in 1946 caused a famine that limited food to less than **800 calories per person per day.**

Imagine if a Japanese academic had written a newspaper article during this time that said:

> *Chin up everyone. Within our lifetimes our economy will grow to almost 15 times the size it was before the end of the war. Our life expectancy will nearly double. Our stock market will produce returns like any country in history has rarely seen. We will go more than 40 years without ever seeing unemployment top 6%. We will become the world leaders in electronic innovation and corporate managerial systems. Before long we will be so rich, we will own some of the most prized real estate in the United States. Americans, by the way, will be our closest ally and will try to copy our economic insights.*

They would have been summarily laughed out of the room and asked to seek a medical valuation.

Keep in mind the description above is *what actually happened.*

Disclosures

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