Beaumont
CAPITAL MANAGEMENT

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BCM 4Q21 Market & Strategy Commentary: Decathlon Tactics

The Speculative Fever is Breaking

By the BCM Investment Team

It seems sentiment turned simultaneously from the most speculative areas of the market while major U.S. equity indices held strong near all-time highs. The last time we saw this was in the peak of the 2000 tech bubble.

The FOMC telegraphed a rate-hike campaign in 2022 along with a continued tapering QE. But the last time the Fed implemented a rate hike campaign, rate-sensitive economic activity slowed, and the yield curve flattened causing them to reverse course (lower rates) shortly after.

The future is uncertain, but market prices seem to project a certainty that most investors would deem imprudent. The markets almost seem balanced on the head of a pin, and nearly every statistical measure of market performance is at or near a historical extreme.

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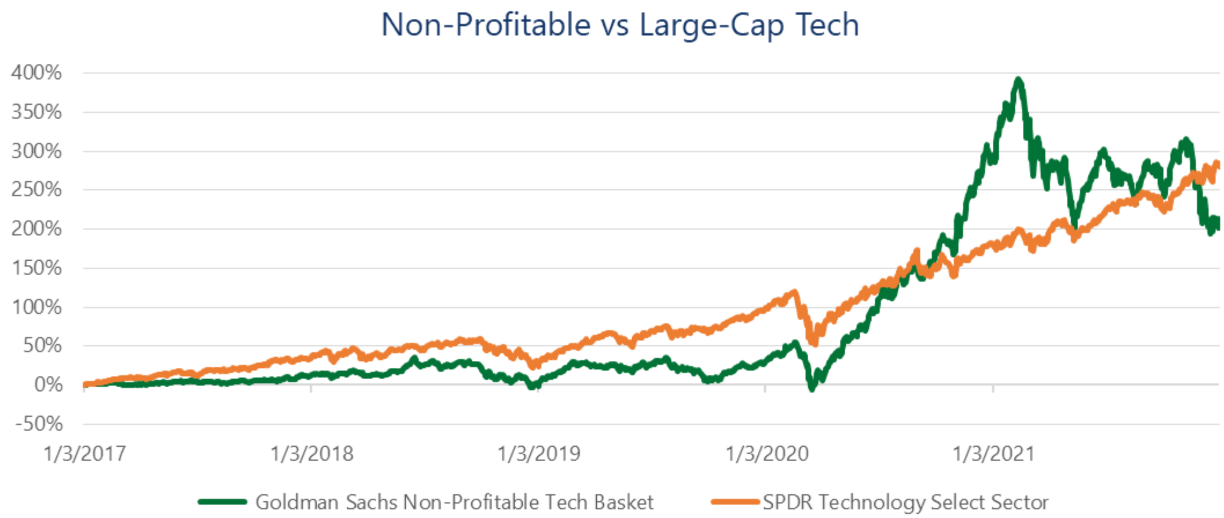
We'd like to start by wishing our readers a happy and healthy New Year. When we wrote our last quarterly letter the U.S. was in the midst of a wave in Covid-19 cases driven by the Delta variant. At the time, we had hoped it would be one of the last major waves as Covid-19 continued along the path to becoming an endemic disease. Then the Omicron variant emerged. Fortunately, the Omicron variant does seem to be milder than the Delta variant that came before it. Unfortunately, it is far more contagious and successfully evades acquired immunity from both vaccines and prior infection. Taken together, these attributes have led to an unprecedented number of cases and the ensuing societal disruptions but hopefully accelerated the virus' move towards endemic circulation. The emergence of the Omicron variant was certainly an unexpected development, but we remain optimistic that we are approaching the functional end of the pandemic.

Coronavirus in the U.S.: Latest Map and Case Count

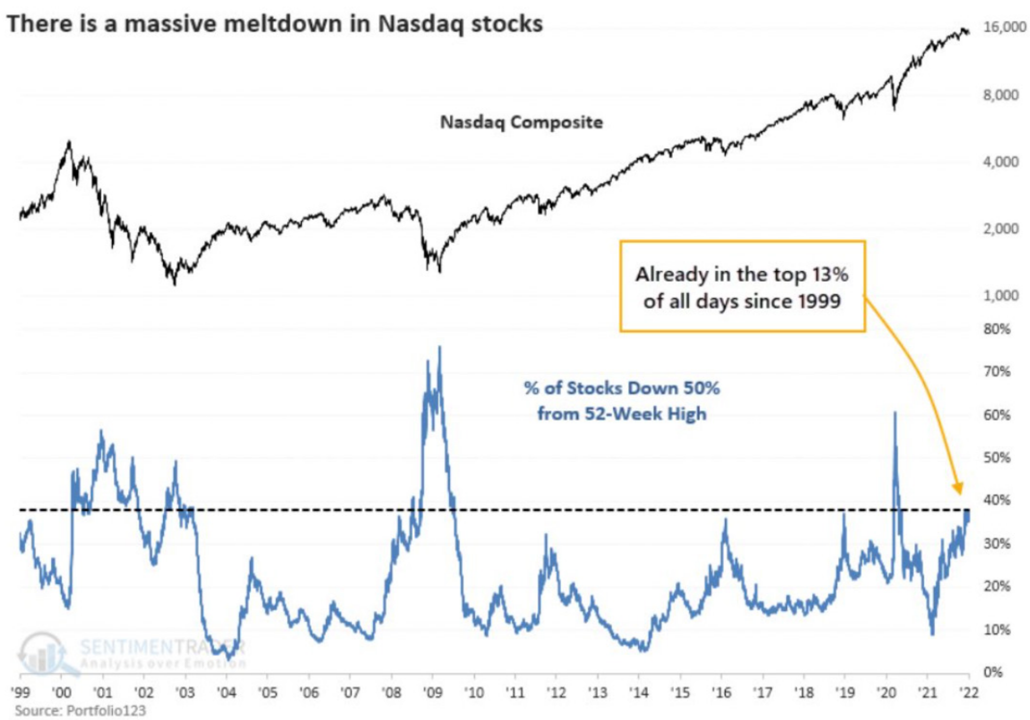
Source: The New York Times Coronavirus Map and Cases (U.S.), as of 1/1/2022.

Moving on to the markets, although it wasn't necessarily apparent in the major indices, there seemed to be a shift in sentiment during the quarter. Since March of 2020, speculation has been rampant in many corners of the market. We've touched on it in past letters, but only briefly because the speculative areas have little overlap with our investment universe. Meme stocks, SPACs, software-as-a-service (SAAS), electric cars, cryptocurrencies, and non-fungible tokens (NFTs) are but a few examples. While there is some overlap among these themes, there is only one commonality across all of them: *the expectation of making life changing sums of money in a short period of time.* This is fundamentally the basis of all speculation. As long as marginal investors believe they too can participate in potential life changing gains, the speculative fever continues.



Source: Goldman Sachs Marquee, Bloomberg for the period 1/1/2017 through 12/31/2021.

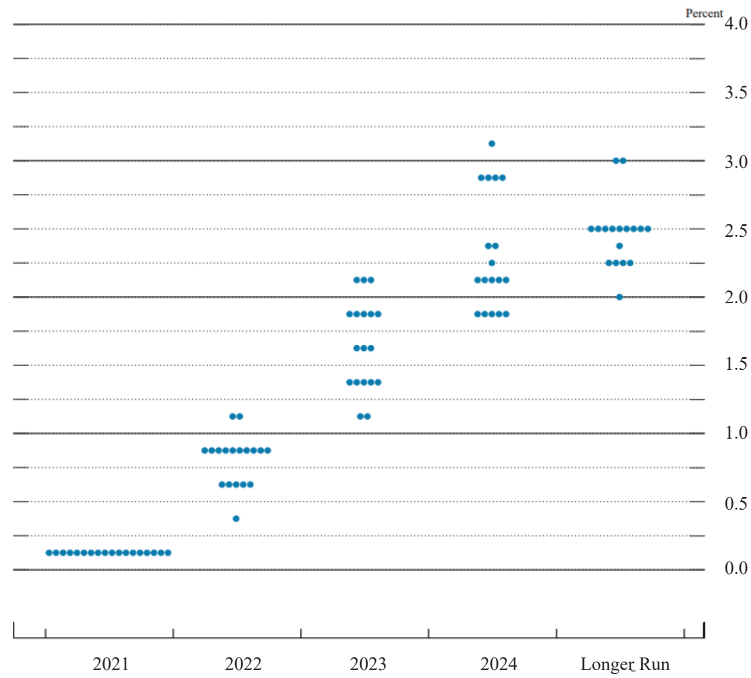
The speculative fever was most pronounced from March of 2020 to February of 2021. As an example, over that time frame the Goldman Sachs Non-Profitable Tech Basket returned over 400%. Since then, this particular basket has struggled, but other themes took up the mantle and continued to march higher. This brings us to the fourth quarter, when it seems that sentiment turned simultaneously on many of these speculative areas in the market. Companies with billions of dollars in market cap fell by 50-70% in a matter of weeks. As of the end of the year, 40% of the companies in the NASDAQ composite were down over 50% from their 52-week high. The last time this occurred with the composite remaining at an all-time-high was the peak of the tech bubble in 2000. This phenomenon occurs as investors sell their speculative stocks and pile into the largest companies which retain their positive momentum, giving us the phrase "the generals always get shot last."



Source: @GavinSBaker from 1/7/2022

The big unanswered question is whether this disruption will spill over to the broader market—"will the generals get shot?". So far that has yet to occur, and perhaps this is just a healthy rotation away from the most overvalued companies and into some of the best businesses in the world. We've been careful to avoid the word "bubble" when describing this phenomenon because it's truly difficult to determine a bubble without the benefit of hindsight. In 2000, Microsoft traded at nearly 80x forward earnings while the 10-year treasury rate was around 6%. Fast forward to today and Microsoft trades at 35x forward earnings with the 10-year treasury rate just under 2%. We know that the first price is wrong[1] because we have the benefit of hindsight, but only time will tell for the second.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source: The Federal Reserve Summary of Economic Projections, 12/15/2021.

Whether the price is right or wrong, there's no denying that interest rates are low and market multiples are high. The Atlanta Fed's GDPNow estimate for real GDP in the fourth quarter is currently 6.8% annualized, year-over-year Consumer Price Index (CPI) growth in December was 7.0% annualized, and wages are growing at an annualized rate of nearly 5%. Does a sub-2% 10-year treasury rate make sense long-term given this macroeconomic backdrop? The Federal Open Market Committee (FOMC) certainly believes that a 0% federal funds rate is too low, and they've telegraphed four rate hikes in 2022 along with a continued tapering of Quantitative Easing (QE). The markets almost seem balanced on the head of a pin. The expectation is that higher growth and inflation in the short-term will force the Federal Reserve (Fed) to adopt more restrictive monetary policy, restricting long-term growth and inflation which justifies lower interest rates. That may seem like an unstable equilibrium of sorts, but this was the prevailing regime from 2009 up until about 2017. Between 2017 and 2019, the last time the Fed embarked on a serious rate hike campaign, rate-sensitive economic activity—such as home-buying—slowed, long-term rates didn't budge, and the yield curve flattened. Shortly after, the Fed responded by lowering rates back in line with market expectations.

If the last paragraph seems somewhat confusing, it's because the current market environment **is** extremely confusing. The future is uncertain, but market prices seem to project a certainty that most investors would deem imprudent. It's important for us to convey that we do not know what the future will bring, but as quantitative managers we benefit from insights generated by the statistical analysis of decades of market data. Nearly every statistical measure of market performance is at or near a historical extreme. Our forward-looking systems believe that caution is warranted, and the fundamental investor in us tends to agree. This is far from a pronouncement of gloom and doom, simply a call for caution. We believe that our quantitative systems give us the best chance of successfully navigating the uncertain market environment that lays ahead.

As always, we thank you for your business and trust, and we look forward to navigating these ever-shifting market environments.

[1] Interest rates are important context for comparing these two valuations and make it clear that there is a larger relative difference than even the price-to-earnings (PE) ratio would indicate. You can convert a PE ratio to an "earnings-yield" for better comparison. Microsoft's 80x PE ratio is a 1.25% earnings yield, producing an "equity risk premium" of -4.75% vs a 6% treasury yield. Microsoft's equity risk premium today is 0.8%. From here the logic may be somewhat convoluted but converting the spread between the two equity risk premiums back into a ratio suggests an 18x difference in relative valuation.

Beaumont Capital Management (BCM) Strategy Commentary

BCM Decathlon Tactics Strategies

The Decathlon system continues to approach the market cautiously. Decathlon seeks to invest for growth when the odds are “in our favor” and avoid risk assets when the system deems the risk and/or volatility to be too high. All three portfolios are overweight fixed income, while equity exposures—where held—are diversified. As we detailed in the market commentary, there were many disruptions below the surface which supported the decision to cautiously allocate, but the U.S. market indices remained invincible. As U.S. investors, we often use these indices as our reference point, but it’s important to remember that they have been major outliers for much of recent history. This brings us back to the chart that we showed in our last quarterly letter. Unfortunately, not much has changed, although we do have new context to add.

Source: Bloomberg, Beaumont Capital Management (BCM). Data for the period 2/28/1992 through 12/31/2021.

The 1-year trailing return differential of the S&P 500® Index and 20+ Year U.S. Treasuries remains extremely elevated. This is just one of the many measures of equity performance that are elevated to extremes. Historically, these metrics tend to normalize, and there are a few ways that can happen. Equities can decline, bonds can rally, or the market can move sideways for an extended period. Our system likely views the safest approach to be reducing exposure to the far more volatile of the two asset classes.

Obviously economic situations are different throughout past periods of history and history certainly doesn’t always repeat, but it is interesting to compare 2010 in the chart above to our current situation. In both cases the economy was coming out of a recession that drove bonds yields initially much lower during a massive equity drawdown, followed by a massive recovery in equity performance. Shortly after that peak in relative performance in March of 2010, stocks suffered a >10% drawdown and treasuries rallied even further than that before equities resumed their longer-term recovery.[2]

While our strategies don't rely on such simple "patterns" directly, it’s certainly plausible we might see a similar situation occur, and if that were the case, we might expect our systems to increase their equity exposure. Over the course of recent months, we haven't seen much deviation in the day-to-day rankings as the general conditions leading to our conservative asset allocation haven’t changed. Looking at the current trends in the rankings, the system remains overweight fixed income across the board with diverse equity selection on the margin. Intermediate- and long-duration bonds remain highly ranked. We expect the portfolios to remain overweight fixed income until better opportunities present themselves, or the risk of downward mean reversion in equities falls.

[2] Between 3/31/2010 and 7/2/2010 the S&P 500 Total Return Index returned -12.12% while the Bloomberg U.S. Long Treasury Total Return Index returned 11.73%

Before detailing the attribution for each portfolio, we would like to quickly explain how to read the different attribution effects. We break down strategy attribution into three effects: allocation effects, timing effects, and selection effects. We first start with the benchmark, which represents the "neutral" asset allocation of each strategy. We expect each strategy to average this asset allocation over time, with significant variation over shorter periods of time due to the strategy's opportunistic nature. Over the course of the quarter, we calculate the portfolio's average asset allocation; any differences between the benchmark and a portfolio statically allocated to the portfolio's average asset allocation is referred to as ***allocation effects****. Next, we look at the portfolio's actual asset allocation on a day-to-day basis to see how well the system shifted its asset allocation and refer to this as* ***timing effects****. Lastly, we look at the actual performance of the portfolio and refer to any difference from picking individual securities within asset classes as* ***selection effects****.*

BCM Decathlon Growth Tactics – Prior Quarter Attribution

The portfolio returned 3.89% gross of fees (3.76% net) during the quarter, compared to a return of 4.74% for a blended benchmark of 70% MSCI ACWI / 30% Bloomberg Barclays U.S. Aggregate Bond Index. The portfolio's average asset allocation during the quarter was roughly 52.8% fixed income, 43.3% equity, and 1.8% currency. Allocation effects detracted ~1.78% from performance as equities outperformed fixed income. Both timing and selection effects were positive, contributing ~0.32% and ~0.61% respectively. In total, the portfolio underperformed its benchmark by 0.85% gross of fees (0.98% net). The portfolio ended the quarter allocated to 60% fixed income, 20% U.S. equity, and 20% developed international equity.

The fixed income exposure remained relatively static, primarily consisting of intermediate- and long-duration bonds of investment grade credit quality. Notably a long-term Treasury Inflation-Protected Securities (TIPS) ETF was held for the entire quarter. The portfolio's weighted-average duration was unchanged, starting and ending the quarter at 9.9 years. The portfolio's fixed income exposure outperformed the Bloomberg Barclays U.S. Aggregate Bond Index, due to its longer duration and TIPS exposure.

The equity exposure was a relatively diversified mix of sectors, with a constant allocation to the technology sector complemented by various value-oriented positions. In addition to the technology sector, the portfolio held positions in home construction, energy, utilities, and financials. Additionally, the exposure was allocated primarily to U.S. equities for most of the quarter before adding international positions near the end. The portfolio's equity exposure outperformed the MSCI ACWI during the quarter due to generally positive sector selection, which offset a negative contribution from energy sector positions.

There were two alternative positions held during the quarter. A real estate position focused on the residential, healthcare and self-storage subsectors was held from the beginning of the quarter until mid-December and a currency position, the Japanese Yen, was briefly held in October. The real estate position was a positive contributor to performance, while the currency position was a negative contributor.

BCM Decathlon Moderate Tactics – Prior Quarter Attribution

The portfolio returned 1.43% gross of fees (1.30% net) during the quarter, compared to a return of 3.39% for a blended benchmark of 50% MSCI ACWI / 50% Bloomberg Barclays U.S. Aggregate Bond Index. The portfolio's average asset allocation during the quarter was roughly 68.6% fixed income, 19.6% equity, and 9.8% currency. Allocation effects were negative, detracting ~1.99%, as equities outperformed fixed income. Timing and selection effects were negligible during the quarter. In total, the portfolio underperformed its benchmark by 1.96% gross of fees (2.09% net). The portfolio ended the quarter allocated to 70% fixed income, 20% developed international equity, and 10% currency.

The fixed income exposure was primarily allocated to a mix of intermediate- and long- duration bonds of investment grade credit quality with the notable inclusion of Treasury Inflation-Protected Securities (TIPS). Due entirely to market movement, as the portfolio's fixed income positions did not trade during the quarter, the weighted-average duration fell to 6.6 years at the end of the quarter, compared to 6.7 years at the beginning. The portfolio's fixed income exposure slightly outperformed the Bloomberg Barclays U.S. Aggregate Bond Index due to its longer duration and the TIPS position.

The equity exposure began the quarter allocated to the Software & Services and Canada ETFs. The portfolio's only trade was swapping the Software & Services ETF for the All-World ex. U.S. ETF in early-November. The portfolio's equity exposure slightly underperformed the MSCI ACWI during the quarter due to its overweight exposure to international equities.

BCM Decathlon Conservative Tactics – Prior Quarter Attribution

The portfolio returned -0.05% gross of fees (-0.18% net) during the quarter, compared to a return of 1.37% for a blended benchmark of 20% MSCI ACWI / 80% Bloomberg Barclays U.S. Aggregate Bond Index. The portfolio's average asset allocation during the quarter was roughly 88.2% fixed income, and 9.8% currencies. Allocation and selection effects were negative, detracting ~1.29% and ~0.13% respectively, as equities outperformed fixed income and mortgage rates rose. There were no timing effects as the strategy did not trade during the quarter. In total, the portfolio underperformed its benchmark by 1.42% gross of fees (1.55% net). The portfolio ended the quarter allocated to 90% fixed income and 10% currencies.

The fixed income exposure was primarily allocated to intermediate-duration bonds of investment grade credit quality. Due entirely to market movement, as the portfolio's fixed income positions did not trade during the quarter, the weighted-average duration fell to 6.6 years at the end of the quarter, compared to 6.7 years at the beginning. The portfolio's fixed income exposure performed in-line with the Bloomberg Barclays U.S. Aggregate Bond Index. The portfolio did not hold any equity positions during the quarter. It's one currency position, the U.S. Dollar, was held for the entire quarter and was a positive contributor to performance.

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Sources and Disclosures

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As with all investments, there are associated inherent risks including loss of principal. Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Sector and factor investments concentrate in a particular industry or investment attribute, and the investments' performance could depend heavily on the performance of that industry or attribute and be more volatile than the performance of less concentrated investment options and the market as a whole. Securities of companies with smaller market capitalizations tend to be more volatile and less liquid than larger company stocks. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments have exposure to credit, interest rate, market, and inflation risk. Diversification does not ensure a profit or guarantee against a loss.

The BCM investment strategies may not be appropriate for everyone. Due to the periodic rebalancing nature of our strategies, they are not appropriate for those investors who need or desire frequent withdrawals or deposits. The portfolio manager maintains full discretion over the portfolio.

The BCM Decathlon Tactics strategies are predictive, algorithm driven and use pattern recognition technology (PRT) to rank a population of ~130 handpicked ETFs in which it will "invest" in the 10 most promising based on upward price movement and defined volatility levels. BCM Decathlon Growth Tactics targets volatility and maximum drawdown at 16%, BCM Decathlon Moderate Tactics targets volatility and maximum drawdown at 12% and BCM Decathlon Conservative targets volatility and maximum drawdown at 7% with an 80% maximum equity allocation. The algorithm re-evaluates the population of ETFs and 'rebalances' once a sufficient number of securities have fallen far enough in the rankings to justify the resulting trades.

The benchmark for BCM Decathlon Conservative Tactics is 20% MSCI ACWI / 80% Bloomberg Barclays U.S. Aggregate Bond Index; the benchmark for BCM Decathlon Moderate Tactics is 50% MSCI ACWI / 50% Bloomberg Barclays U.S. Aggregate Bond Index; and the benchmark for BCM Decathlon Growth Tactics is 70% MSCI ACWI / 30% Bloomberg Barclays U.S. Aggregate Bond Index. The benchmark represents the "neutral" asset allocation of each strategy. We expect each strategy to average this asset allocation over time, with significant variation over shorter periods due to the strategy's opportunistic nature. We calculate the portfolio's average asset allocation over the quarter; any variation between the benchmark and a portfolio statically allocated to the portfolio's average asset allocation is the allocation effects. Next, we look at the portfolio's actual asset allocation on a day-to-day basis to see how the asset allocation shifted and refer to this as timing effects. Lastly, we look at the performance of the portfolio and refer to any difference from picking individual securities within asset classes as selection effects.

Index performance is shown on a gross basis. Estimated model returns were calculated using actual holdings may be provided (as indicated) gross or net of the maximum applicable BCM management fee of 0.50%. Security returns provided by Bloomberg include the reinvestment of any dividends. ETF performance shown, as contributors or detractors to the strategies, is gross of fees. Actual composite net performance will vary due to the additional fees and expenses charged by the TAMP and Broker/dealer used, and other factors. For complete performance information, including fees and other expenses, investment minimums, etc. please contact your Regional Consultant or BCM at the number below.

The Standard & Poor's (S&P) 500® Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. Indices are not managed and do not incur fees or expenses. The S&P Small Cap 600® Index is an unmanaged index that tracks the performance of 600 widely held, small-capitalization U.S. stocks. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World ex-U.S. Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets, excluding the United States. The MSCI ACWI Index captures large and mid-cap representation across 23 Developed Markets and 26 Emerging Markets countries. The MSCI ACWI Index ex-U.S. captures large and mid-cap representation across 22 Developed Markets and 26 Emerging Markets countries, excluding the United States. The Bloomberg Barclay's U.S. Aggregate Bond Index is a broad base index and is often used to represent investment grade bonds being traded in the United States. The Bloomberg Barclay's U.S. Aggregate Bond Index is a broad base index and is often used to represent investment grade bonds being traded in the United States. Goldman Sachs Non-Profitable Technology Index consists of non-profitable U.S. listed companies in innovative industries. Tech is defined quite broadly to include new economy companies across GICS industry groupings. The basket is optimized for liquidity with no name initially weighted greater than 4.65%. The Technology Select Sector SPDR® Fund seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the Technology Select Sector Index (the "Index"). The Index seeks to provide an effective representation of the technology sector of the S&P 500 Index.

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Beaumont Capital Management was originally created in 2009 as a separate division of Beaumont Financial Partners, LLC. Beaumont Capital Management LLC spun off as its own entity as of 1/2/2020. Beaumont Financial Partners, LLC was originally registered as Beaumont Trust Associates in 1981 and was reorganized into Beaumont Financial Partners, LLC in 1999.

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