GNH
CAPITAL GROUP
of Wells Fargo Advisors

SCALING THE INVESTMENT TREE – INSIGHTS FROM OUR PROCESS

Kostas Grigorakis, CFA®, Managing Director – Investments, Senior PIM Portfolio Manager

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Part 1 – What it Takes

Imitation is the sincerest form of flattery, which is why we feel compelled to thoroughly address the questions posed by our clients, prospective investors, and followers of our work.

How do you invest? How would you build and, over time, change my portfolio? With all that is going on, is it a good time to invest? How can portfolios be future-proofed? What sets you apart? Why do you believe your approach is more effective?

All these questions boil down to one overarching consideration: investors recognize the market as their adversary and inquire about strategies that can guide their portfolio's army to victory against it.

Our answer?

Yes, investing is akin to going to war (or at least to a grueling offroad race, as we have written). Because of that, for over a quarter of a century, we've employed rules-based strategies painstakingly engineered to be:

- Market-Adaptive (see Part 2)
- Risk-Controlled (Part 3)
- Tax-Aware (Part 4), and
- Active navigating market-regime shifts (Part 5),
- Focused on cultivating wealth sustainably in a stair-step fashion regardless of market gyrations and economic vagaries (Part 6).

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In the next five sections, we'll delve into the components of our approach and showcase the innovations we've introduced to help give our investors a competitive edge.

How we invest? We invite you to take a deeper look!

Part 2 – Market Adaptability

Market-adaptive portfolios can greatly benefit investors. In this post, we unveil our proprietary process for implementing that.

Why the quest for Market-Adaptive portfolios?

In previous posts, we have showcased the historical evidence *against* so-called 'client-centric' portfolios that are 'tailored' to investors' needs (income/growth/both) [1], horizon [2], risk appetite [2, 3], or benchmark preference [4]. History shows that such formulaic portfolios succeed only by chance—when investor profiles happen to align perfectly with current market dynamics—otherwise, they are vulnerable to diverging market conditions.

In contrast, market-adaptive portfolios hone in on minimizing shortfall risk and achieving stair-step sustainability in a wide variety of market environments.

Adaptive portfolios depend on continuous market surveillance. To achieve this, we leverage our indicators to monitor over 100 aspects of market activity, organized into six hierarchical categories: Overall Health and Investment-worthiness > Fronts > Factors > Sectors > Geographies > Commodities/Bonds/Interest Rates/Currencies. Monitoring occurs across five different intervals (1-, 15-, and 60-mins., daily, and weekly) and is refreshed several times daily. We then integrate this information using the decision matrix of each of our strategies to guide capital deployment.

Here, we highlight the first step in this process—deciphering the market's overall health and Investment-worthiness. It's a challenging task given the persistent gyrations and overwhelming noise that dominate market activity. In an effort to accomplish this, we rely in part on our QUAD strategy's assessment of market functioning and our CORE strategy's evaluation of the state of the economy (as outlined in our Manifesto [5]). These inputs are then complemented with the information gleaned from nine additional screens to give us a verdict on the nature of the market regime—Bullish or Bearish. Having determined that, we proceed to evaluate the remaining five categories.

While adaptive strategies emphasize market awareness, their goal is not to be reactive but to strike an insightful balance between ***accommodation***—heeding veritable signals of consequential market shifts—and ***assimilation***—filtering out noise and explaining away false positive and false negative signals. In our opinion, a well-tuned market-adaptive portfolio would have reduced its overall exposure in 2008's Global Financial Crisis but maintained its growth posture in 2020's CoViD crash.

Part 3 – Risk Control

Once portfolios become market-adaptive, it's time to focus on risk control, the most complex aspect of money management.

Fearful investors mistakenly prioritize risk control over market adaptability, which often backfires. Risk management is a double-edged sword: it benefits portfolios when executed well but increases failure when done improperly.

Here is our view as long-time risk managers:

Portfolio risk is a vertical continuum, with obscured upstream sources but vivid downstream manifestations. 20th-century finance focused on reducing downstream measures like Volatility, Drawdowns, and Cross-correlations, but this approach

often resulted in poor results—seen in the demise of pension plans and the underperformance of endowments and alternative funds [6].

Volatility is non-cumulative, tends to cluster, and is notoriously mean-reverting. Avoiding volatility's surges while embracing its drops exposes portfolios to costly whipsaws. Additionally, markets often rise on high and fall on low volatility.

Similarly, Drawdown control is fraught with problems. Despite the S&P 500 being in drawdown 93% of the time, with a median intra-year drawdown of -13%, the index has averaged nearly +10% per year since 1928 [7]. The index's frequent pullbacks (-5% nearly every year) and occasional corrections (up to -20% every 4 years), which have been brief compared to its rare, sustained declines, often trigger false positive risk signals that lead to costly traps.

Neither has the use of 'low-correlated' blends and Conservative/Moderate allocations proven effective. Shifting correlations and prolonged underperformance in income assets, especially in this century, have depressed portfolio returns more than they have curtailed risk [8].

Why do we believe these risk control measures have proven counterproductive?

There are two main reasons for that.

First, downstream risk measures are merely derivative of investors' cardinal risk, which is *shortfall*—falling short of paying bills or meeting funding goals. Shortfall has *2* sources—cumulative losses and inadequate returns—a dual objective that traditional risk management overlooks due to its single-minded focus on loss avoidance.

Second, modern analysis [5] reveals that downstream risk measures are contingent on the status of the market regime! Bullish regimes reward elevated volatility, drawdowns, cross-correlations, and market exposure, while Bearish regimes punish these traits and reward restraint.

So, where is the cutting edge of risk management today?

Investors should begin by accurately assessing the current market regime to decide whether to relax or tighten their management of downstream measures. Failing to do so can paradoxically increase risk. They should then monitor the effectiveness of their risk management by ensuring the likelihood of shortfall remains within a narrow, low range.

Simple—but not easy.

How do we go about controlling your portfolio risk? Take a deeper look at our strategies!

Part 4 – Tax Awareness (Without Interference!)

After ensuring market adaptability and properly aligning the portfolio's risk controls with the market regime, the next step is to focus on tax efficiency—in that precise order. Prioritizing taxes may appear enticing on marketing brochures, but it can be self-defeating—nothing good comes from putting the tax cart before the investment horse.

Investors should be alert: While the Do's of portfolio tax management are few, straightforward, limited in impact, and well known, they are often lionized. There is no good reason for that. In contrast, the Do-Not's of portfolio tax

management are numerous, obscure, highly impactful, and poorly understood. Savvy investors are well advised to focus on them!

In short, here are the Do's:

All other things being equal (like access to effective strategies), investors can maximize funding for tax-free and tax-deferred accounts (such as Roths, IRAs/401Ks, CRTs, etc.) and house the most tax-intensive strategies and highest-growth assets within them. Tax-loss-harvesting should also be continuously pursued as a deliberate and thoughtful objective.

Now, the more critical Do-Not's:

First, investors should not be blinded or immobilized by taxes—taxes are merely the tail of the investment dog, and they should not be allowed to wag it.

Second, investors should remember that the unrealized gains of taxable portfolios are merely *dormant*. There is no way to hide them permanently; they will scale with the portfolio's success and are bound to be triggered by sales as investors raise cash to distribute income or reposition the portfolio. Accumulated capital gains that are not triggered today will be larger tomorrow if the portfolio continues to grow. They can only be smaller if the portfolio falters, which is undesirable.

Given that death and taxes are inevitable in our lives, once proper tax location has taken place, tax awareness, first and foremost, should mean…no tax interference. The key objective should be to prevent taxes from interfering with advancing the two primary goals of asset management—market adaptability and risk control. In other words, tax awareness should not become tax interference, as illustrated below:

We believe portfolios must shift adaptively as market leadership changes. Hesitating or neglecting to do so for tax considerations often backfires.

Also, markets are cyclical and eventually transition to a bearish regime, delivering significant losses. Managing this transition by reducing exposure through across-the-board sales is crucial for robust risk management. This may initially trigger substantial tax liabilities but opens the strategic opportunity to rebuy early in the subsequent bullish regime, potentially capturing gains that exceed the tax outlay triggered by the initial defensive repositioning. This is known as "slingshot opportunity."

How can you best build a tax-aware but not tax-interfering portfolio?

Take a closer look at our strategies!

Part 5 – Market Regime Navigation

Parts 2-4 briefly referred to market-regime awareness as a prerequisite for well-honed portfolio adaptability, effective risk control, and savvy tax management. But how does a 'market regime' manifest?

Veteran investors intuitively recognize that market activity unfolds in large-scale waves, expansive in both time and scope, exhibiting a sustained directional orientation either up/bullish or down/bearish. These waves reflect the workings of market regimes.

Bearish *market regimes* should not be confused with Wall Street's "bear markets," which are primarily defined as drawdowns deeper than -20%. Bearish market regimes are broadly and sustainably capital-destructive and have fueled the most severe bear markets, such as those during the Great Depression and the grizzly bears of 1973-1974 and 2007-2009. In contrast, most of Wall Street's bear markets have occurred during *bullish* market regimes, resulting in shorter durations and robust rebounds that have significantly mitigated the capital destructiveness of their drawdowns. Examples include the Wall Street-postulated bear markets of 1987, 2020, and 2022—flashy events without widespread virulence.

Our studies have shown that Wall Street's bear market alerts are not very actionable—they often produce false-positive signals, resulting in whipsaws and increased shortfall risk. After all, drawdowns tend to build up erratically, usually appearing ominous but rarely exceeding -20 %, provide late confirmation while remaining subject to reversals, and frequently do not warrant portfolio repositioning.

Investors can analogize market regime shifts to tectonic movements, likening bull and bear markets to surface erosion.

In the 20th century, finance theory struggled to analyze market regimes beyond identifying bull/bear markets of a large, 'secular' scale. However, in this century, significant progress has been made in understanding regimes, particularly in interest rates, while research on equity regimes remains largely proprietary.

How do we track market regime shifts?

Our strategies have pioneered two methodologies for tracking and navigating regime shifts based on the functioning of the capital markets (QUAD strategy) and the economy's condition (CORE and FOCAL strategy). This awareness helps us over time to calibrate the level and focus of the strategies' exposure, modulate their risk posture based on the readings of upstream (shortfall) and downstream (drawdowns, volatility, correlations) measures, and optimize their tax efficiency.

Market regime navigation in 2008 necessitated moving to cash, temporarily sacrificing tax efficiency while minimizing shortfall risk. Conversely, holding steady amid record downstream risk readings in 2020 preserved tax efficiency and minimized shortfall risk.

Are you inspired to navigate market regime shifts? Take a look at our strategies!

Part 6 – All-Weather Stair-Step Wealth Cultivation

Let's put the explorations of all the previous parts together.

Capital markets have been, and will likely remain, the largest source of wealth creation in history. However, their activity is turbulent, much like a gushing river, and not easily converted into a robust and sustainable stream of economic benefits. It's like standing next to a raging torrent—furiously surging, boiling, and cascading—trying to ensure a steady water supply.

Is this analogy accurate? More than one can imagine:

We all invest to pay bills and meet funding aspirations, keeping up with modernization. Given inflation + Lifeflation [9], investing in T-Bills or bonds can be inadequate, so we turn to equity markets. The shocking reality is that, since 1926, nearly 60% of stocks have failed to beat, and 40% has barely beaten, T-Bill returns. All of the wealth above Treasury Bills was produced by just 4% of all 25,000 stocks, with merely 86 companies responsible for half of that—a needle in the haystack [10]. Talk about turbulence and creative destruction!

How about the much-advertised solution of simply buying an index fund?

Unfortunately, this does not work outside of random luck, a truth that index evangelists obscure. The compounding of the overall market seems relentlessly constructive only if one does not take out money—a fiction not applicable to real-life portfolios. Once portfolios make distributions, their performance decouples from the index. It becomes subject to the sequence of returns, with early stretches of negative and volatile returns and inflation spikes having disproportionately more damaging and potentially derailing consequences than later-occurring ones, a random factor.

Indexing was ineffective during the Great Depression (1929-1942, -86%), the Great Stagflation (1966-1982, -64% inflation-adjusted), and the early 2000s, when the S&P 500 delivered negative 10-yr. returns traversing two major bear markets. Now, we believe the index is careening toward the next bear market. Our studies reveal that the S&P 500 has a 13% shortfall rate in meeting a standard 5% disbursement schedule over all sliding 30-year periods since 1900, well below the ideal 5% threshold.

So far from simple, cultivating wealth sustainably in a stair-step fashion regardless of market gyrations and economic vagaries is an engineering challenge. It parallels the conversion of AC current (turbulent market returns)—to DC (the smooth, steady growth that must power our lives). As detailed in previous parts, such a conversion requires a 'transformer' (market regime navigation), a 'bridge rectifier' (market adaptability), a 'filter capacitor' (risk control), and a 'voltage regulator' (tax awareness)—the components that define our approach.

What sets apart the way we invest? Take a closer look at our strategies!

[1] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_are-conventional-conservative-portfolios-activity-7132412660934963200-eT3w?utm_source=share&utm_medium=member_desktop

[2] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_ask-not-what-your-horizon-ispt-1-ask-activity-7158576157594968064-xqem?utm_source=share&utm_medium=member_desktop

[3] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_gnh-capital-group-of-wells-fargo-advisors-activity-7099842905841827841-QzIc?utm_source=share&utm_medium=member_desktop

[4] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_to-index-or-not-to-index-part-1-index-activity-7182055769830309888-PPs1?utm_source=share&utm_medium=member_desktop

[5] Microsoft Word - GNH Capital Group - Our Offering (June 2023) (CAR-0523-03954).docx (wellsfargoadvisors.com)

[6] University endowments fail when compared with the stock market. Here's one reason. | Morningstar

[7] YCharts

[8] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_are-conventional-conservative-portfolios-activity-7132412660934963200-eT3w?utm_source=share&utm_medium=member_desktop

[8] https://www.linkedin.com/posts/konstantinos-kostas-grigorakis-cfa-754264103_economy-markets-inflation-activity-7188522243662966785-GtUK?utm_source=share&utm_medium=member_desktop

[9] Bessembinder, Hendrik. Wealth Creation in the U.S. Public Stock Markets 1926 to 2019 (February 13, 2020). Available at: https://ssrn.com/abstract=3537838

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