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Q2 & H1 2023 — STRATEGY & MARKET UPDATE

LESSONS FOR TODAY FROM THE EVOLUTION OF FINANCE

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Executive Summary

Q2 echoed the success of Q1 and produced a remarkably robust H1, much to the amazement of Wall Street pundits who were more bearish. In contrast, throughout 2023's first half, our strategies were positioned assertively and strongly benefited from the market's buoyancy. This contrast of perspectives has deeper roots. Our strategies espouse that markets are self-governing regimes with vast autonomy and powerful self-preservation mechanisms and that investing is, first and foremost, about adaptive, risk-controlled, and tax-aware navigation of market-regime shifts. In contrast, we believe that most of Wall Street still clings to the embryonic concepts of early Finance, especially the idea that the market is just an arena of prices that is passively shaped by exogenous economic, geopolitical, corporate, and monetary forces and that investing can succeed only by accurately forecasting the future.

2023 Q2 & H1

On the heels of a very strong Q1 (S&P 500 +7.5%), Q2 delivered an even stronger come-back quarter (+8.7%), which propelled the market to a blockbuster first year-half (+16.9%). This persistent buoyancy brought the S&P 500 to 4,450 by June 30th, a much higher level that eclipses by a whopping 9% the average annual 2023 target forecast given by the chief investment strategists of Wall Street's largest 23 firms. The Street's widespread bearishness has proven to be as unjustified as its pervasive bullishness was at the end of 2021.

Such inaccuracy won't get you far in Vegas and has, in our opinion, provided poor investment guidance to investors. Advising investors first to decrease portfolio exposure on the eve of 2021, then increase exposure on the eve of 2022, and recently lower exposure on the eve of 2023, has run counter to the market's direction, significantly increasing the ultimate investor risk—the risk of *shortfall*.

As a reminder, our research indicates that investors' cardinal risk is <u>not</u> interim portfolio volatility or drawdowns but shortfall, defined as the lack of sufficient portfolio growth to meet investors' financial goals. And shortfall comes from two sources—insufficient gains or persistent losses—both of which have been aggressively tapped since CoViD by the countercyclical mainstream Wall Street guidance.

As readers of this series know well (https://fa.wellsfargoadvisors.com/gnh-capital-group/publications.htm), throughout 2022 and YTD, our research has argued that the post-2021 decline is not a sign of a sick market that is falling apart. Instead, we have demonstrated that the market has purposely engineered a controlled pullback seeking to counter the Fed's interest rate crusade, which the market has considered from the start as unnecessary and harmful. Having initiated a stream of layoffs, paved the way for this year's bank defaults, and helped the bond yields top out, the market put in a bottom in October 2022 and has risen ever since to the

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amazement of some Wall Street pundits. Thankfully, our strategies have ignored the Wall Street sirens and assertively participated in the rally from its very beginning.

This contrast begs an interesting question: What is behind the systematic inaccuracy of Wall Street's guidance that has persisted over the years?

Forecasting vs. Tracking

Wall Street is obsessed with forecasting—from estimating companies' future sales to discounting upcoming cash flows and from projecting stock earnings to forecasting market levels.

Still, the record of this widespread practice has not been encouraging.

In contrast, our strategies have made it a point to **eschew all forecasting** and concentrate instead on **tracking the unfolding trends** registered in financial and economic data streams.

Using innovative data-patterning techniques, our research has been able to capture the market's evolving health and investment-worthiness and to position our strategies in what we believe to be a market-adaptive and risk-vigilant manner. In this way, without the noise accompanying forecasts, we believe our strategies have a better chance of navigating the shifts in the market regime.

For more about our strategies' data-patterning capability, please read our previous report, "Q1 – YTD (May) 2023 Strategy & Market Update," as well as the relevant sections (pp. 2-3) of "Our Offering – Click here to read our manifesto," both archived on our website, www.GNHCapitalGroup.com, under "Publications".

The passing of Harry Markowitz – Evolving Finance's original recipe

Q2 coincided with the passing of Harry Markowitz—the Nobel Prize laureate who co-founded Modern Finance.

Markowitz got modern Finance off the ground by formulating its first-generation model known as Modern Portfolio Theory (MPT). His contributions were seminal, especially for his era (1950s – 1970s). Chief amongst them was the quantification of portfolio diversification, a fertile idea that boils down to the admonition for investors to build more sustainable portfolios by **mixing and not matching holdings** (i.e., aiming to include low inter-correlated assets). Such portfolios tend to afford more comfortable rides without sacrificing much return. And one can directly trace to Markowitz's pioneering work much of what has dominated investing to this day, especially passive investing/indexing and the ubiquitous "pie-chart" portfolio constructions with fixed asset-class-based allocations that are either risk-rated (conservative, moderate, aggressive) or goal-oriented (income, income and growth, growth), to mention a few.

In many quarters Markowitz's work is uncritically hailed to this day as the perpetual bedrock of investing. But in a burgeoning field that relies on innovation to harness the dynamic world of money, we believe such a static view only does a disservice to the work of this pioneer who set the evolution of Finance theory and practice in motion.

Markowitz's work is far from the eternal investing gospel. Over time, subsequent discoveries in academia and across the industry have shown how his conceptualizations were groundbreaking but also embryonic—containing only kernels of truth, subject to numerous limitations, omitting crucial knowledge, and even

incorporating cardinal errors. This is a common characteristic of early scientific conceptualizations and a natural stage in every growing domain of systematic inquiry. Invariably, in every field, we see that new facts are noticed, and refinements, in theory, result in the evolution of domain knowledge.

So, what has changed in Finance since Markowitz and how those developments relate to our strategies?

Markowitz and early Finance models had simplistically postulated that investment returns were driven by the state of the overall market. Other drivers were initially omitted and later defensively labeled only as "anomalies," seen as threats to the elegant simplicity of Markowitz's theory.

Yet, in the following decades, we came to comprehend those forces not as aberrations but as systematic determinants of returns—today's celebrated **Factors** with first amongst them Value and Size (Fama, French, and Banz), Momentum (Jegadeesh, Titman, and Carhart), and Volatility (Ang).

This process of divergent discovery and conceptual integration allowed **Finance to evolve through three generations**: from Markowitz's single-factor model (**Gen 1**), through the three-factor models of **Gen. 2** (Market, Value, Size), to today's multi-factor **Gen. 3** theory (Market, Value, Size, Momentum, Volatility, Quality, etc.). Our strategies' engineering incorporates the entire three-generation progression of those nested theoretical and practical advancements.

And even more:

For some years now, the leading edge of the Factor research tradition has begun to cross into a new era—Finance's **Gen 4.** In it, the emphasis is not as much on identifying and leveraging a larger cohort of investment Factors but on the better organization, integration, and meta-analysis of the factor universe.

Our strategies are an offspring of the fourth generation of Factor research. Their crucial contribution to this wave has been their understanding that, although factors are the ultimate drivers of investment returns, the status of the market regime—the market's underlying health and orientation—dictates the productivity and expression of factors and its secular shifts. This innovative view has significant implications for the way we structure and manage our portfolios:

Factor productivity varies over time, with periodic ebbs and flows of relative outperformance and phases of dramatic instability. Investors are intuitively familiar with the instability phases of Factors, like the 'bear' stretches of the Market factor (e.g., 2000, 2008), the 'traps' that registered in Value (consider its continued underperformance for more than a decade!), and the 'crushes' that punctuate Momentum (e.g., Nasdaq's -78% decline in the dot-com collapse). As trackers of the market regime—its health and shifts—we believe our strategies are well-positioned to steer portfolios toward the strengthening factors and away from the weakening ones.

As inhabitants of the lofty Gen 4 level, our strategies simultaneously offer a tribute and a sweeping but constructive critique of Markowitz's contribution to investing. In our opinion, this sets us apart from the many offerings that are still clinging to the embryonic ideas of early Finance, especially the belief that the market is just an arena of prices that is passively shaped by exogenous economic, geopolitical, corporate, and monetary forces, and that investing can succeed only by accurately forecasting the future.

Our strategies beg to differ. We believe markets are self-governing regimes with vast autonomy and powerful self-preservation mechanisms. Investing is first and foremost about adaptive, risk-controlled, and tax-aware* navigation of market-regime shifts.

Last Word

We invite you to spread the word about your GNH Capital Group experience within your circles of influence. The last five years have been challenging for most investors. They have been battered by the historic bond market fall and whipsawed in the steep downdraft of 2018, the crash of 2020, and the turmoil of 2022. And throughout the last fourteen years, they have been torn between the Scylla of speculation and greed and the Charybdis of worry and indecision. We believe our strategies' adaptability and risk controls have been an excellent antidote to haphazard performance and a booster of investor confidence. Please assist us in spreading the word.

We remain grateful for your trust, loyalty, support, and friendship!

On behalf of GNH Capital Group's entire team with Henrik, Richard, Chad, and Isabel,

Kostas

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