GREENROCK RESEARCH

223 West Jackson, Suite 850
Chicago, IL 60606
www.greenrockresearch.com

INVESTOR INSIGHTS – FIRST QUARTER 2022

2021: Surprisingly Good Performance

One year ago, it would have been hard to find analysts who were optimistic for the S&P 500 to be up 28.9% in 2021. The S&P 500 started 64 years ago and only 10 of those years have produced higher returns. Domestic small cap was also up significantly, 26.8%. The rest of the world did not fare as well, EAFE was up 11.8% and Emerging Markets were down 2.2%. Investors found a safe haven in the U.S.

We achieved similar returns in our equity markets. Dearborn slightly underperformed the S&P 500 up 25.2% while Henderson beat EAFE up 18.2%. North Star underperformed the S&P 600 but was up 17.9%. The weighted average of 42.5% to domestic large and international and 15% to domestic small showed our portfolio up 21.35% while the benchmark was up 21.24. The way we see it, this is a victory. Keeping pace with large rises is not an attribute we strive for, but we are happy when we get it.

Our alternatives managers 3EDGE and Forefront were up 6.94% and 9.63%. These were welcome returns while the bond market was down 1.5%.

Ark had a difficult year. Our concentrated portfolio was down 9.23% while the ETF was down 23.56%. This made for a difficult yet not surprising year as the ETF was up over 150% in 2020.

So, all of this was nice to see. Now on to the New Year!

2022: What Now?

This is the question of the hour because of the fabulous equity returns of 2021. Can it continue? Are stocks undervalued, fairly priced, or overpriced? Does it matter? What about bonds after the rate rise in 2021? These are the questions on our minds. We will answer them and provide some insights into what we think 2022 will bring and how we will maneuver it.

If one had bought the S&P 500 index and held it for the last three years, 2019, 2020 and 2021, the annualized return would have been over 25% and you would have doubled your investment. This is only the second period in history that returns were this high for three consecutive years. Ominously, the other period was a combination of consecutive years covering 1995-1999. For that 5-year period, $100 turned into $340 and any combination of a consecutive 3-year period produced a double. So we are in rarified air, what has just happened is far from common or normal. We can see with hindsight analysis what happened in the late 1999s, investors thought we had great companies that would continue to lead. But what happened over these past three years? Why are stock prices so high? Was it the same euphoria of the late 1990s?

The succinct answer is stocks are now the only perceived reasonable investment because interest rates are so low. On July 1, 2020, the yield on the 10-Year U.S. Treasury was 0.53%. It is astonishing that investors thought this yield when investing $100,000 with the U.S. Treasury for 10 years would get them a total of less than

Kevin Malone	Dave McGahay	Mark Knipfer	Bob Southard
312.463.1301	312.463.1303	312.463.1305	312.463.1304

$6,000 and that would be fine. Investors found cash to buy that yield, so that is the proof they were fine with the return. Today the yield on a similar investment of 10-year brings a yield of 1.67%. All of these yields are before taxes, so the net return to some investors could be just 1%. Even if you believe inflation will be very low or perhaps we will have deflation, a 1% net return is not something we should find interesting.

We all know the problem that brings for investors, they cannot achieve their clients' investment return needs with yield at these levels, not at 1.67% and certainly not when the yield was 0.53%. They need 5% or in many cases even 10% to accomplish their goals, so many investors increased their risk levels and allocated much higher levels to equities. Their thought was safety does not pay and they had no choice. We have seen similar logic historically, although for slightly different reasons. In the 1960s, the Nifty Fifty were called one decision investments, you just bought them and forgot about them. The problem was that their losses made investors wish they could forget them. The top five stocks created more than the whole return of the S&P 500 in 1999, and the largest company, Microsoft, peaked at the end of 1999 and took over 14 years to get back to break even. The logic of bonds does not work so put assets in investments with higher risk is a sure way to see your capital disappear: it did in the 1960s and in the 2000s, and it will again.

So, today, with a 10-Year Treasury yield of 1.67%, bonds are not attractive. They solve almost no investor's return needs. Stocks are almost as highly priced as they were in 1999. Now many analysts would say this time is different. There are great companies who are changing the world. We agree there are many great companies, but the "this time is different" idea has lost more fortunes than any other idea. This does not mean we could not have another year of high returns, there is a lot of cash chasing very few good ideas. At the beginning of 1999, we analyzed the returns of the S&P 500 index for 1998 and found the top 12 stocks produced the entire return. We told clients this could never happen again, but we underestimated the herd mentality as 1999 was a great year and five stocks produced the whole return. So, we must be careful, putting your money in a mattress or in cash yielding almost nothing is not the right answer. We have to take risk, but the risk has to be thoughtful risk given these stock and bond levels.

These are the investment ideas for the beginning of 2022.

We have five ideas for today, which is as small a group as we have ever had:

- Global High and Growing Dividend Portfolios
- Diversified ETF Portfolios
- Private High Cash Flow Investments
- A Small Allocation to the Ark concentrated portfolio or Kingsland
- A Small Allocation to Bitcoin

Our life is easiest when we find potentially robust future investments that will solve clients' investment return needs, and our life is most difficult when we are in periods like we are today with overpriced stocks and overpriced bonds. We obviously run the risk of calling a potential stock correction that does not materialize. We urged caution at the end of 1998 only to see stock prices climb over 20% in 1999. The following year started a decline over three years that saw stocks decline by 37%. So, no one has certainty about when stock price peaks, which is why moving to cash is not prudent. We think our strategies will provide a reasonable return, but we know if our caution on a correction turns out to be correct, we will find new opportunities that will provide outsized returns. After the 2008 correction, we were able to buy the preferred stocks of the best of the TARP companies at 12% yields. No one could have imagined that in January of 2008, yet they produced cash flow of 12% per year for four years and a double in our valuation. Today, no one has a crystal ball on opportunities. We will see if there is a market correction in our near future or not. With that perspective, let's look at our ideas.

Global High and Growing Dividend Portfolios

Today our domestic dividend portfolio has a yield of 3.28% while our international portfolio has a yield of 3.75%. Our small cap portfolio has a yield of 3.74%. We would contrast these yields with those of the S&P 500 at 1.35%%, EAFE at 2.68% and the S&P 600 of 1.25%. The weighted yield on our portfolio is 3.56% while the weighted yield of the three indices is 1.86%. Stated another way, our portfolio has a dividend yield just under twice the yield of the weighted indices.

There have been two times in the last 21 years when the S&P 500 declined 37%, 2000-2002 and 2008. During the first period, our dividend portfolio rose 15% while it declined 23% in the second period. So, our question is if we have a correction, will our dividend strategy perform like 2000-2002 and rise or like 2008 and fall. While we have no way of being precise, the two periods represented declines for dramatically different reasons. The 2000-2002 period saw a decline because stocks had risen beyond their fair value, while 2008 was because we were facing a banking crisis. So, this gives us some comfort that we will not participate if stocks prices decline 25% or 30%, but this period will be different so we do not take comfort that this period will be exactly like the 2000-2002 period. So, this is our perspective going into what we think will be a difficult investing period.

We think growing dividend strategies will be the best equity place to be this year and over the next decade. We think over both periods, the dividend differential between our portfolio with a weighted yield of 3.56% and the blended index of 1.86% will give us both protection and reasonable returns.

Compounding cash flow has been discussed as one of the great wonders of the investment world. If our dividends grow at just 5% annually, and they have grown between 7% and 8% historically, our compounded cash flow over the next decade will be over 5% and the final dividend yield will be over 6% if stock prices remain static.

It is worth noting that during the decade of the 2000s, the S&P 500 compounded at -0.95%, so one had fewer dollars at the end of the decade than at the beginning. Our portfolios compounded at 7.7% annually during this decade. Will the same thing happen over the next 10 years? Well, the answer is no one knows, but we like our position.

Rob Arnott of Research Affiliates projects all asset returns and volatility ten years from now. Oddly, he is projecting a repeat of the 2000s. He suggests the return of the S&P 500 will be -0.90% with a standard deviation of 15%. Now no one at Research Affiliates is clairvoyant, including Rob, but it is worth noting that today's stock prices remind them of the level of stock prices at the end of 1999.

Diversified ETF Portfolios

There are two strategies we use in our diversified ETF portfolios: one earmarks a standard deviation slightly higher than the Aggregate Bond Index and one earmarks a standard deviation of a combination of stocks and bonds. The key ingredient of these portfolios is their risk on/risk off nature. While they do not go fully to cash, they can make dramatic swings between a portfolio taking risk in the equity market and one that is very defensive. They have been an integral part of our portfolios for over 20 years, but they are critical today because bonds are no longer a viable investment option. Bonds were the investment of choice for defensive strategies, but today their yields project very low, perhaps even negative, bonds cannot be used. The historical perspective of this phenomenon took place.

Today there are specific uses for the Conservative Portfolio as a direct substitute for bonds while the Total Return Portfolio is a substitute for a combination of stocks and bonds. The two managers 3EDGE Asset Management and Forefront Analytics have worked with our clients for many years and have become an integral part of client portfolios.

Private High Cash Flow Investments

Historically we have had investments other than equities that paid reasonable income and were a safe place in times like these. They were liquid investments, but today there are no liquid investment with reasonable income. We do have, however, a private fund run by Red Oak with a 6% yield maturing in a little less than two years. It pays semiannual income and it can be transferred if an emergency arises. Red Oak will be willing to purchase it, but more likely one of our clients will purchase it. The yield drops to 4% if liquidated early, but that means you still get 4%, which in today's world looks reasonable. This portfolio is available in very small pieces with a $10,000 minimum.

A Small Allocation to the Ark Concentrated Portfolio

No one in the financial world has gotten more publicity over the last few years than Cathy Wood at Ark. Her returns have been phenomenal and volatile. Our investment with Ark is a concentrated 11 stock portfolio. Last year, it had a negative return of 9% but that was considerably better than the more diversified ETF which was down 23%. In 2020, the ETF was up over 150%, so no one with a faint heart should be using this portfolio. Ark concentrates on disruptive technology companies, and we are living in a time of unprecedented technological change. So, the volatility suggests a small allocation, but the future suggests everyone should have an allocation.

Bitcoin

This is the most controversial of all of our investments. We believe Bitcoin will be a gold substitute in the new digital world. If you read data from Bitcoin zealots, it is easy to think you should fill your portfolio with Bitcoin. It started 13 years ago and for 12 of those 13 years it has been the best investment in any universe. Cathy Wood of Ark believes Bitcoin will rise twelve-fold over the next five years from 46,000 to 560,000, and she looks understated compared to the Bitcoin fanatics. There will certainly be some Bitcoin regulations over the next couple of years, but the voices to destroy it or curb it are simply too late. The total value of Bitcoin is simply too large.

This is the personality trait you will need to succeed over the next three to five years: patience.

By any standard, we are in difficult times. Investing is easy when prices are low, but we are hard pressed to find low prices today anywhere. In addition, some of our ideas lack liquidity and perhaps more will in the future. So, make no mistake about it, the easy times are over. Our future will be one of getting reasonable but not great returns. Our goal is to make them positive returns.

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