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FFG Partners Market Pulse Newsletter, Q3 2023

As we enter the final quarter of the year, we find that many of the same risks and uncertainties that we discussed in our last letter remain. High inflation, high interest rates, continued labor unrest and the contraction in lending are still affecting the economy in a major way. The only difference was the market's revised perception of these risks. Whereas they were overly discounted for much of the year, the third quarter saw a resurgence of fear and anxiety towards them. These pendulum swings between optimism and pessimism are what lead to market volatility in the short term. Issues as complex as these take considerable time to be resolved and their full effects will take many years to be felt. Therefore, the portfolio strategy needs to reflect the long-term nature of these risks and be positioned for the uncertain outcomes that may arise.

When reviewing your FFG portfolio, it is important to consider the different types of holdings and asset classes you are exposed to. It is no longer an equity only based portfolio. This transformation began in late 2021 with the inclusion of fixed income in the portfolios and continued with the addition of structured notes, options, and other alternative strategies. By arranging this collection of different asset classes, we are more able to directly identify and protect against the risks we are taking. This is a deliberate strategy to try and minimize the downside exposure while maintaining sufficient upside potential. As we often discuss, our goal is to earn an overall risk-adjusted return, one that is commensurate with the risks we are taking.

That all sounds well and good, but many of you may be wondering how this actually works. We have divided the portfolio into six different asset classes, each serving a unique and distinct purpose. The six classes are: equities, options, fixed income, structured notes, alternatives, and cash. We refer to this as the Pillar Portfolio*, and many of you may remember this from our annual review. We believe this blend of assets allows us to truly diversify our exposure as each class reacts independently of one another. Alongside the diversification inherent in the equity holdings, this non-correlation provides an organic hedge and acts as a shock absorber within the overall portfolio. However, the return profiles are different for each class and need to be evaluated as such. Many of the positions will have little movement throughout their holding period, with most of the return coming towards the end of the investment lifecycle. Just like real estate, where the day-to-day movements are virtually invisible, the vast majority of the value is "unleashed" upon sale (maturity) of the asset. Would it be appropriate to classify an investment property as a laggard simply because the daily quoted value does not change materially during the holding period? So too with structured notes and fixed income. The value of these positions is twofold. Firstly, they provide a cushion against volatility in the equity markets during the holding period. Secondly, they provide a mixture of current income, principal protection, and appreciation (especially as maturity approaches) that is noncorrelated to the equity markets. So next time you look at your investment returns, remember that there is dormant value that is not quite visible but very much real. This is in stark contrast to the major stock indices, which are completely equity based. There is no cash, fixed income, hedges, or anything other than equities. This makes for a difficult comparison to a portfolio that is composed of many different asset classes. A better comparison is the performance of just the equity sleeve of the portfolio to the index.

Many investors are currently infatuated with the Nasdaq, which is up about 30% year to date. They are hyper focused on the daily performance and agonizing over the fact that their portfolios are not "keeping up." As usual, the headline number does not reveal the whole story. It ignores the fact that the return was driven by the seven largest companies in the world and forgets that it was down over 33% the previous year. Taking a longer-term view, an investment in the Nasdaq on 1/1/2022 through today would still be down over 14%! This means the index needs to return an additional 15%, after gaining 30%, just to be even! This dynamic is not limited to the Nasdaq. None of the major indices have recovered from the 2022 downturn and at best are still down about 10%. How many investors do you think would have been able to stomach the volatility of 2022, and hold on, to be able to "enjoy the outperformance" in 2023? Protecting against the downside is an extremely important aspect of portfolio management that is largely underappreciated.

Being fully invested in an index puts you at the mercy of market movements. This was especially evident during last year's market downturn. If one was fully invested in the index, there was little to no reprieve from the consistent downward trend. However, this does not stop investors from cherry picking the best performing benchmark of the day and comparing current performance to it. There is very little consideration for past performance, volatility, or risk. This is a retrospective approach akin to throwing a dart and then drawing the bullseye around it. However, investing is an exercise that requires making informed decisions about the future with the facts available to us today. Even if one were to get the timing decision right occasionally, it is an approach that is unlikely to be repeated successfully over an investing lifetime. Therefore, it is imperative to have a sound strategy in place that does not rely on perfect timing of investment decisions.

This brings me to the final point about the FFG portfolio and investing framework. The most important thing to keep in mind is that every position we hold is in the portfolio for a reason. There is a central strategy informed by behavioral, fundamental, and technical analysis that is debated heavily by the investment team. We do not own many holdings and therefore each position requires conviction, a strong thesis, and consensus to be added. For instance, our oil and aerospace and defense positions are there for times of rising geopolitical tensions. There is no way to forecast these events, but we felt the likelihood of additional escalation was high due to the rising tensions throughout the world. Unfortunately, we were proven right with the recent tragedies that are occurring in the Middle East. We will not be right with every decision we make but know that there is a thesis behind every investment we put into the portfolio. So long as that thesis holds true, we will continue to hold that position until proven otherwise, and at such point, we will act swiftly and decisively to replace it with something else.

Wishing you a happy and healthy holiday season!

Yours Truly,

Gabriel Levy, CFA
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