

The CIO Monthly Perspective

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HISTORY RHYMES

From Cultural Revolution to the Taliban's Return

August 2021 sure lived up to the adage, "The best-laid plans of mice and men often go awry." Israel, a country that has supposedly achieved herd immunity via aggressive vaccination rollouts in early 2021, was suddenly beset with rising breakthrough infections. It turned out that another booster shot is needed as the efficacy of Pfizer's COVID-19 vaccines had decayed faster than expected. The Biden Administration was caught off guard by the rapid collapse of the Afghanistan army, supposedly one of the best equipped in the world. New Orleans' levees withstood the pounding of Hurricane Ida, but more than one million people in the region have lost power in the summer's oppressive heat and humidity. Climate activists had planned to protest at the Fed's Jackson Hole symposium to demonstrate their opposition to Chairman Powell's reappointment. However, out of deference to the Delta variant, the Fed moved the venue online. It turned out to be a win-win move. The activists still showed up in Jackson Hole to enjoy the majestic views of Grand Teton (assuming the haze from California's forest fires did not materially reduce visibility), and Powell was masterful in placating both the monetary hawks and the doves. The former was satisfied with Powell acknowledging that tapering could start before year end, and the latter was glad he made it clear that tapering would not signal a shift in the Fed funds rate expectation.

Despite the economic toll and decline in consumer confidence induced by the Delta variant and elevated inflation, equities continued their impressive runup and real long bond yields remained stubbornly negative. Speculation was back in vogue as rising prices in cryptocurrencies and meme stocks begot more buyers. NFT (non-fungible token) aficionados were busy hyping up the nascent and unregulated market with the JPEG file of a cartoon rock being sold for 400 ether, or \$1.3 million at the time of transaction. This purchase is either as dumb as a rock, or I am too old to learn new tricks.

The highly anticipated August employment data came in much weaker than expected, but with an upside surprise in hourly earnings. It's a somewhat stagflationary reading and will likely complicate the timing of the Fed's tapering plan. The U.S. economy is gradually emerging from the nanny state's cradle as the extra weekly unemployment benefits has expired, and the Supreme Court has struck down the extension on the CDC's eviction moratorium. While Washington will get busy with the \$3.5 trillion reconciliation bill to introduce additional stimulus, it is clear that we are past the peak-stimulus and peak-growth period. There are some bumps ahead - a potential government shut down, higher taxes, and the lingering impact of the evolving pandemic. In short, this is not the time to get complacent, especially with September having a reputation as the cruelest month for the stock market.

THE FLIGHT NOT TAKEN

Ye Qisun is not a household name, but he is widely regarded in China's academic circle as "the master of masters" for having groomed many scientists who wound up building the country's space program, as well as atomic and hydrogen bombs.

Born to a family of mandarins and scholars in 1898, Ye was a child prodigy. In 1911, at the tender age of 13, he was enrolled in the inaugural class of Tsinghua College, the predecessor to the Tsinghua University. Tsinghua was founded at the behest of President Theodore Roosevelt to help modernize China. It was funded with indemnities from the Qing imperial court to the U.S. for the Boxer Rebellion at the turn of the 20th century.

In 1918, Ye came to study in the U.S., first at the University of Chicago and then at Harvard. He earned a doctorate in physics at the latter in 1923. He returned to China in 1924 and was later recruited to teach at Tsinghua University where he founded the university's physics department in 1926. He became one of the most respected educators and scientists in China. At the latter part of the Chinese civil war in December 1948, the retreating nationalist government sent a plane to Beijing to evacuate key scientists and educators to Taiwan. It would have been easy for Ye to move to Taiwan since he was single and had no relatives with him, yet he refused to board the plane as he was looking forward to the founding of a new China under Chairman Mao. Many intelligentsias at the time were drawn to the leftist ideals - the allure of a more equitable society.

The early days under the new regime were stable for Ye as Beijing's scientific circle was shielded from property seizure, land reform, and persecution plaguing former business and landowners across much of the country. Ye's stature was further elevated when one of his former star pupils, Lee Tsung-Dao, won a Nobel Prize in Physics in 1957 at the young age of 30 for his groundbreaking work at Columbia University.

In mid-1966, Chairman Mao mobilized students to launch the infamous Cultural Revolution to strike back at his political opponents. Students were appointed as Red Guards in classrooms and on campus across the country to rid the society of the "four olds" - old customs, old ideas, old habits, and old culture. Intelligentsias were the first targets as schools - from kindergarten to universities - were ransacked while educators and administrators were dragged to "struggling sessions" to confess their "crimes" and bourgeoisie thoughts. The sessions were a form of public torture and humiliation where the "confessants" would kneel with hands tied behind their backs. Many were badly beaten at these repeated sessions, and some were summarily executed.

In 1967, the Red Guards got to Ye and accused him of being a counter-revolutionary and an agent for the nationalist government in Taiwan. He was repeatedly interrogated and tortured at struggling sessions, and eventually sent to a "mafia correctional labor camp." Ye never confessed to any crimes but was so traumatized that he developed schizophrenia.

Equity Markets Indices ¹	7/30/21 Price	8/31/21 Price	MTD Change	YTD Change
MSCI All Country World	724	741	2.4%	14.7%
S&P 500	4395	4523	2.9%	20.4%
MSCI EAFE	2321	2356	1.5%	9.7%
Russell 2000 ^{®2}	2226	2274	2.1%	15.1%
NASDAQ	14673	15259	4.0%	18.4%
TOPIX	1901	1961	3.1%	8.6%
KOSPI	3202	3199	-0.1%	11.3%
Emerging Markets	1278	1309	2.4%	1.3%

Fixed Income

2-Year US Treasury Note	0.19%	0.21%	2	9
10-Year US Treasury Note	1.22%	1.31%	9	39
BBG Barc US Agg Corp Sprd	0.86%	0.87%	1	-9
BBG Barc US Corp HY Sprd	2.94%	2.88%	-6	-72

Currencies

Chinese Renminbi (CNY/\$)	6.46	6.46	0.0%	-1.0%
Brazilian Real (Real)	5.21	5.15	-1.1%	-0.9%
British Pound (\$/GBP)	1.39	1.38	1.1%	-0.7%
Euro (\$/Euro)	1.19	1.18	0.5%	3.4%
Japanese Yen (Yen/\$)	109.72	110.02	0.3%	6.6%
Korean Won (KRW/\$)	1150.25	1159.45	0.8%	6.7%
U.S. Dollar Index (DXY)	92.17	92.63	0.5%	3.0%

Commodities

Gold	1814	1814	0.0%	-4.5%
Oil	74.0	68.5	-7.4%	41.2%
Natural Gas, Henry Hub	3.91	4.38	11.8%	72.4%
Copper (cents/lb)	448	436	-2.7%	23.9%
CRB Index	218	218	0.0%	30.0%
Baltic Dry Index	3292	4132	25.5%	202.5%

Source: Bloomberg

In late 1969, the 71-year-old Ye was released to Peking University's dormitory. This once urbane and dignified intellectual was reduced to a broken man suffering from incontinence, swollen legs, and a damaged spine that forced him to hunch over at nearly 90 degrees. He was still being investigated for being a spy and was denied visitors. Some claimed to have seen him wandering around the neighborhood begging for money. One of Ye's former star pupils, Qian Sanqiang, who was revered as the "father of China's atomic bomb," once saw Ye on the street and tried to greet him. Ye quickly waved him off for fear of implicating his former pupil.

As the intensity of the Cultural Revolution wound down in 1975, the investigation and the isolation of Ye were finally over. His

stipend was restored in 1976. In early 1977, his nephew paid him a visit and found his health deteriorating rapidly. Ye was taken to the hospital and passed away three days later. Before he swallowed his last breath, I wonder if he had any regret for the flight not taken in 1948.

THE EDUCATION ARMS RACE

China's "struggling session" got its name from class struggle, a concept that Karl Marx used to explain all societal ills. The Chinese Communist Party (CCP) had taken this concept to the extreme, judging people solely on their social class. Virtuous people supposedly came from the "Five Red Categories" - poor peasants, proletariats, revolutionary soldiers, revolutionary cadres, and family members of the revolutionary martyrs. On the other hand, people from the "Five Black Categories" - landlords, wealthy farmers, rightists, and counterrevolutionaries, bad influencers - were deemed wicked and in need of re-education. During the Cultural Revolution, the "blacklist" was expanded to nine categories with intellectuals at the bottom. Such a critical class theory with Chinese characteristics created a new social caste system and encouraged retribution. Members of the "black classes" were systematically discriminated against in education, employment, housing, and even marriage prospects. The persecution was also extended to their children, coaxing kids to virtue signal by outing their parents for "impure" thoughts or behaviors. It was common to see young people criticizing and even beating their own parents at struggling sessions.

The disastrous Cultural Revolution, which had set China's progress back by more than a decade, was finally over after Mao's death in 1976. As Deng Xiaoping worked on normalizing the country, education was reprioritized, and the intelligentsia were gradually rehabilitated. In late 1977, China's standardized college entrance examination was restored. It was a very competitive process as nearly 6 million people took the test that year, and only 4.8% were admitted to universities.

The one-child policy introduced in 1980 drove many families to plow more of their growing disposable income into after-school learning as education has been viewed by most families as the best investment for their kids. Deng's opening to the West also generated a strong desire among the Chinese to learn English. In general, kids started learning English in the third grade, and most students chose it as the required foreign language test in the country's National College Entrance Examination. In 2020, it was estimated that around 400 million Chinese people were learning English, a number greater than the U.S. population. This tremendous interest in English and the competitive nature of the college entrance examination have created great demand for tutoring services and cram schools. The for-profit after-school tutoring industry thereby has become one of China's fastest growing industries. It was estimated to employ about 10 million people in early 2021. The for-profit education gravy train also benefited Western institutions as Chinese students flocked to foreign universities

and even secondary schools in search of more valuable academic credentials.

A NEW CULTURAL REVOLUTION?

There were rumors in early 2021 that regulators would introduce a significantly tighter regulatory framework for the private tutoring industry to reduce the financial burden on families. It was part of an effort to reduce the cost of child rearing in order to boost the country's fertility rate to stave off a one-child policy induced population crisis. On July 24th, China officially introduced a "double reduction" policy aimed at decreasing the burden of homework and after-school training programs. To the horror of domestic and foreign investors, all existing subject-based, off-campus tutoring entities were mandated to convert into non-profit organizations. Suddenly, these after-school tutoring companies, once the darlings of public and private-equity investors, had essentially gone bust.

Given the Confucian society's emphasis on education, the double-reduction policy may portend that the Chinese consumer's discretionary spending power is weaker than their high savings rate would indicate. It is also a harbinger of further decoupling between China and the West. To wit, China is phasing out the required foreign language test in the National College Entrance Examination as the powers that be do not want most Chinese people to learn English. Don't be surprised if the CCP uses zero-COVID as a convenient excuse to extend its suspension of non-essential in- and out-bound travels in the years ahead to shield its citizenry from direct contact with "harmful" Western values and ideas.

The double reduction policy is also part of a broader effort to reshape China's economy and society under Chairman Xi Jinping's "common prosperity" initiatives. Wealth inequality is a concern for Xi as the country's Gini coefficient, a measure of inequality, puts China among the most unequal major economies in the world. Under the banner of common prosperity, the CCP has vowed to "reasonably adjust excessive income and encourage high-income groups and enterprises to give back to society more." Regulators have expanded the targets of crackdowns on monopolistic, anti-competitive, or even socially undesirable practices from leading Internet companies to traditional industries such as real estate brokerage and insurance. The government is also trying to micromanage behaviors and entertainment deemed socially harmful - post-work drinking, video games (the spiritual opium!), and karaoke songs with "harmful" lyrics. Of course, "Xi Jinping Thought" - a set ideas derived from the writings and speeches of Xi Jinping - will likely be mandatory for all school children to study.

These developments demonstrate that Chairman Xi is serious about realizing his Orwellian vision of socialist paradise, and wealthy Chinese individuals and private businesses will likely play a major role in funding this effort. The CCP has made

Zhejiang province, Xi's power base and one of China's wealthiest regions where Alibaba is headquartered, a role model to showcase the road to common prosperity. Investors should monitor Zhejiang's policy initiatives - from taxation, wage guidelines, to corporate "philanthropy" - as a leading indicator for the rest of China.

The Chinese government's heavy-handed intervention has hurt its leading companies' stock performance. The recent lockdowns in multiple cities as a result of the country's zero-COVID policy have dented its economic momentum. Many foreign investors have ditched Chinese stocks on the ground that they have become uninvestible. It's hard to dispute this view upon seeing an industry being forced to become non-profit. The new reality is that businesses exist for the benefit of the motherland, not necessarily for shareholders. That said, given the precipitous drops among various Chinese stocks and signs of investor capitulation, some of these stocks may be due for a bounce, especially given the rising odds of policy easing in the face of slowing growth. However, I would view Chinese stocks as "trading sardines" rather than longer-term buy-and-hold commitments.

IN SEARCH OF EXCELLENCE

While the double reduction policy is aimed at reducing social and economic inequality, the opposite is likely to happen. Wealthier Chinese families can afford to hire the best private tutors for their kids while middle-class families will struggle to find extra help with cram schools closed. Real life is full of unintended consequences. Interestingly, China is not the only country where policymakers seek to narrow inequality by attempting to rein in some students from outachieving others. France's left-wing politicians have long advocated banning homework on the ideological ground that it's unfair that wealthier families can better help their children. Here in the U.S., some school districts have already eliminated homework, and activists are now looking to ban advanced classes for talented students. New York City and California are both working on eliminating the Gifted and Talented Education programs on the ground that categorizing kids by talents is inherently discriminatory and promotes segregation. While these activists don't want to categorize kids by talents, they do not seem to have a problem propagating controversial theories that teach kids to judge people through the narrow lens of race starting at an early age. It's as if tactics from the Cultural Revolution such as the cancel culture and class purity pecking order have been adopted here. While it may be well-intentioned to right a historical wrong, these developments have created bitter divisions among parents, educators, and school boards across the country.

The zeal to eliminate inequality has also pressured some elite schools to change admissions standards. San Francisco's school board has ended merit-based admissions in favor of a lottery system for the city's highly regarded Lowell High School. There is an ongoing effort in New York City to get rid of the

Specialized High School Admissions Test for top schools such as Stuyvesant and Bronx Science. A record number of colleges have stopped requiring standardized testing for admissions. Even the ultra-competitive STEM powerhouse Caltech has suspended the consideration of SAT and ACT scores for undergraduate admissions.

As a geeky former engineering student, I cannot vouch for the value of standardized tests for liberal arts. However, my own experience is that SAT math scores are a good predictor of competency for STEM fields. Accepting students who may not be as well prepared for the rigor of STEM disciplines in highly competitive programs may wind up hurting their progress and career. Of course, our schools have become quite compassionate in dealing with the disadvantaged. Oregon Governor Kate Brown has signed into law a bill that suspends the requirement of "showing proficiency in Essential Learnings Skills" to earn a high school diploma. A May 2018 WSJ article reported that as many as one in four students at some elite U.S. colleges were classified as disabled largely due to mental-health issues such as depression or anxiety, a situation that likely has gotten worse with the pandemic. These disabled students are entitled to special accommodations like additional time for exams and bringing comfort animals to school. While we all want to help the disadvantaged, is waiving reading proficiency for high school graduation and giving students extra time to complete tests really helping to prepare them for the dog-eat-dog world? I doubt most employers would be willing to let their new hires with fancy degrees bring comfort animals to work or take much longer to complete tasks. Given that productivity improvement is key to driving wage and economic growth, not to mention a nation's competitiveness over the long run, the declining academic standards and the degradation of meritocracy should be a concern to us all.

With COVID-19 having forced many schools to conduct remote learning, it seems clear that technology holds the key to modernizing our education system and reducing inequity without degrading meritocracy. It's amazing that, given all of the technological advances, most of our classrooms and lecture halls are still operating pretty much the same way as they did in the 1800s. A good Caltech professor's lectures, delivered in the great tradition of the legendary Dr. Richard Feynman, should not be confined to just students on campus. Perhaps a great school like Caltech can leverage technology to expand its total undergraduate enrollment beyond just 900-plus students. In elementary and secondary schools, data analytics ought to be able to flag where each kid could use extra help. Remote learning could enable local schools to pool their resources to expand curriculum. Artificial intelligence could help enhance the college admissions process as it can minimize human bias relative to predefined screening criteria.

With spending on education accounting for roughly 6% of U.S. GDP, there should be plenty of incentives and opportunities for innovators and investors to make a difference. However, there are only a handful of publicly listed companies in this space

with uneven performance. While there is no shortage of innovative ideas to reform our education system, there is probably a lot of resistance from entrenched interest groups that are benefiting from the status quo. It seems like dysfunction has become the hallmark of our special interests dominated and ideologically driven system.

THE END OF AN ERA

The longest war in American history came to an end as the last U.S. military aircraft took off from Kabul at 11:59 pm on August 30th. The chaotic end of this failed nation-building project and the trauma over the last few weeks have triggered visceral reactions and questions among many of us. How can the most powerful and technologically advanced country in human history be so humiliated by a relatively small band of religious zealots and ragtag fighters left behind by modernity? How could Afghanistan's 300,000-person strong standing army, backed by superior equipment and air power, have disintegrated completely in less than a fortnight? Why did we pull our troops out before evacuating the civilians? Why did many Americans in Afghanistan ignore the U.S. embassy's repeated warnings since April to leave the country? There will be much soul searching for decades to come.

The Taliban's victory demonstrates that - as with most revolutions, social or political - a small group of highly determined extremists can prevail over the general populace because the latter is largely apathetic and passive. People in general try to avoid conflict and would look to others to defend their collective rights. When the others turn out to be corrupt leaders who talk a good game while keeping one foot out the door, the advantage goes to the insurgency. Our intelligence's assessment that the Afghan government could hold up for about a year or two underestimated the Afghan soldiers' will and cunning to survive, an instinct honed over thousands of years of tribal wars and shifting allegiance. While some of these soldiers may be illiterate, they can read the writing on the wall and draw the conclusion as well as our intel analysts. They might have been asking themselves why they should serve as cannon fodder to buy time for the elites to abscond with money. Leaving aside duty and honor, these soldiers made the logical decision for self-preservation. To use a market analogy, they took profits on a meme stock called Afghanistan while our intel analysts were still expecting greater fools to prop up the price despite shaky fundamentals.

While most Americans agree with the withdrawal, the botched execution will likely cost the Biden Administration much credibility and political capital. Fair or not, some were already drawing a parallel with the Iranian hostage crisis that weighed on Jimmy Carter's presidency. While I still expect Democrats to stay united to pass big spending and tax packages in the coming months, the party's unity will likely fray leading up to the 2022 midterm elections where Republicans look well positioned to win back the House and to send Speaker Pelosi into retirement. A resounding electoral defeat for the

Democrats in November 2022 could embolden some in the party to call for President Biden to pass the baton to Vice President Kamala Harris in order to salvage the 2024 general election. While this may sound farfetched, just remember the assessment that Kabul would collapse rapidly was dismissed as improbable by our esteemed leaders only a month ago.

On the international stage, our allies will privately worry about our competency and commitment while our foes may be itching to test our resolve. One immediate test will likely be the Iranian nuclear negotiation - will the mullahs toughen their demands on the expectation that the Administration would be desperate for a "win"? Ukraine could come under renewed pressure from Russia as Putin may suspect that there is no love lost between Biden and Ukraine given the controversy during the last election. The chubby man of Pyongyang is reportedly restarting North Korea's nuclear program to see what ransom we would offer to appease the hermit state. Chairman Xi Jinping could be tempted to tighten the screw on neighboring countries in territorial disputes over the South China Sea. In an extreme case, Xi could gamble on making a move on Taiwan.

The threat of terrorism around the globe will likely escalate. The black market for military equipment may soon be flooded with weaponry seized by the Taliban. It is estimated that the Taliban now possesses the world's fourth largest military helicopter fleet (behind the U.S., Russia, and China), not to mention more than 16,000 night vision goggles and nearly 170 armored personnel carriers. Unfortunately, as long as there are Westerners left behind in the Islamic Emirate of Afghanistan, our drones probably cannot fire missiles to destroy the Black Hawk helicopters and attack aircrafts in their possession. The proliferation of advanced weaponry and equipment could strengthen Islamic terror groups in South and Central Asia, the Middle East, and North Africa. Anti-India terrorist groups, like Lashkar-e-Taiba and Jaish-e-Mohammed, will likely launch deadlier attacks in Kashmir or other parts of India. The flood of Afghan refugees into neighboring countries will eventually reach the gates of Europe and create more social division and instability. In short, the Afghanistan debacle may have unleashed a new phase in Islamic terrorism and a realignment of regional power and alliances. While it is coincidental that the Saudis just inked a military cooperation agreement with Russia, it's a sign that our traditional allies have been working on contingency plans as the faith in our commitment and support wanes.

THE SALT OF THE EARTH

The sad reality with the return of the Taliban is that the world's attention will soon shift away from the country while Afghan women are left to bear the brunt of the dire consequence. The persecution and retribution that the Taliban is poised to unleash could make China's tumultuous Cultural Revolution look amateurish. Ayaan Hirsi Ali, a Somali-born advocate for the rights of Muslim women, poignantly wrote, "In today's perverse American culture... more attention is devoted to the use of

preferred gender pronouns than to the plight of women whose most basic rights - to education, personal autonomy, the right to be present in a public space - are either removed or under serious threat." She further observed that our embassy in Kabul flew the rainbow flag to display LGBTQ pride just a couple of months ago, and now abandoned Afghanistan's gay community to fend for itself. The lack of cultural sensitivity is astounding, and it makes one wonder if our political leaders have become too focused on words and optics rather than deeds and outcome.

While the chaotic scenes at the Kabul International Airport showed the limit of America's power, they were also a reminder of our values and compassion as a beacon of hope for the oppressed. Desperate Afghan parents outside the Kabul International Airport would rather hand their infants over barbed wires to American soldiers than run the risk of their children growing up under the Taliban rule. We are still the lone superpower that the world looks to during times of crisis, and it will be a much darker world when we fail.

Much of the burden of maintaining our superpower status falls squarely on our heroic service members. Some of them are not even 20 years old when they go on their first tour of duty. They put their young lives on the line with courage and maturity while some of their contemporaries in the states are being coddled in safe spaces on campus. They don't shirk from responsibility on the frontline by claiming mental exhaustion, and they don't get triggered by blunt talks. However, despite all these admirable attributes, some of them are still denigrated by our cultural elites, and some will unfortunately suffer a lifetime of PTSD. These people are the salt of the earth to whom

we owe a debt of gratitude.

DON'T OVERSTAY THE WELCOME

Financial markets have so far dismissed the Afghanistan debacle as a non-market moving event. However, there will likely be some longer-term impacts. A less stable geopolitical backdrop could lead to higher market volatility and valuation contractions over time. Inflationary pressure could become more acute if the regional instability winds up disrupting the fossil fuel ecosystem in the Middle East. Washington's dysfunction could also become more acute if President Biden fails to reverse his sinking polls.

The economic backdrop has turned less market-friendly of late. The Citi Economic Surprise Index has turned negative while the Inflation Surprise Index reached all-time highs. The Delta variant, elevated inflation, and supply chain disruptions are having a dampening effect on the strength of the recovery -- the Atlanta Fed's GDPNow model has revised down the current quarter's real GDP growth estimate from 6.2% annualized in mid-August to 3.7% as of September 2nd. These developments portend a bumpier road ahead, yet the stock market has managed to sustain the greatest bull market opening since 1932 with extremely low volatility -- the S&P 500 Index has more than doubled in price in less than 18 months from the March 2020 trough. Borrowing a page from the Afghanistan experience, investors should take the Fed's "inflation-is-transitory" assessment and their economic and rate projections with a grain of salt. Keep a contingency plan ready in case the consensus view turns out to be off the mark.

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