Taking the Complex and Making it Simple

The Wall Chapter Four: Dubious Distinctions

On December 17, 2022, the Indianapolis Colts entered the NFL record books, but not for a reason anyone would want. That Saturday afternoon, the Colts enjoyed a 33-0 halftime lead against the Minnesota Vikings, one of the best teams in the NFL. But after being outscored 36-3 in the second half, the game went into overtime and the Vikings pulled out the improbable victory- the largest lead ever blown in NFL history.

What may be even more dubious is that Colts quarterback, Matt Ryan, has now led the team that blew the largest lead in the NFL regular season and the team that blew the largest lead in Super Bowl history (the Atlanta Falcons blew a 28-3 lead in Super Bowl LI to the New England Patriots). Ryan also presided over the largest blown lead in an NFC championship game in the Falcons' 2012 loss to the San Francisco 49ers.

Many NFL commentators deemed this latest loss a clarion call for Ryan to hang up the spikes. The Colts promptly benched Ryan in their game the following weekend. Ryan's reaction to the loss (and the benching) was a classic Matt Ryan quote: "I've played in this league a long time to know that a lot of different things can happen. Anything can happen. You just have to keep your head down and keep going and find ways to make plays when they present themselves. It's not much. It's a handful of plays in a game. It's three or four plays from an offensive perspective that we have to find ways to execute, and it's a win. We just didn't make those plays."

Ryan's career is not without accolades- he's thrown for over 62,700 yards, putting him 7th all-time in NFL history. His 381 career touchdown passes are 9th all-time, ahead of hall of famers John Elway and Joe Montana. Ryan has also won an NFL MVP award. Yet, these incredible accomplishments will undoubtedly be tarnished, and maybe even overshadowed, by the extraordinary failures Ryan led in both Indianapolis and Atlanta. His place in the discussion of the greatest quarterbacks in NFL history will undoubtedly be impacted by his inability to "close the deal" when it mattered.

The trajectory of Jerome Powell's tenure as Federal Reserve Chairman contains a striking similarity to that of Ryan- any good he has done for U.S. businesses, the U.S. stock market, or the labor market will all be forgotten if he does not manage the economy to a soft landing while battling a stubbornly high level of inflation. Yet, while Ryan is reflective about his role in both the high and low points of his career, Powell seems to defy that he's even playing in the game. Ryan simplified his troubles vs. triumphs to one word: execution. It is the best answer he, or any other results-oriented leader, can give. Ryan did not hide behind his credentials, standing among the NFL's greatest quarterbacks or past successes. He simply said that plays needed to be made at critical moments, and he didn't make them. He didn't execute. Tony Robbins said it very well, "Contrary to popular wisdom, knowledge is not power-it's potential power. Knowledge is not mastery. Execution is mastery. Execution will trump knowledge every day of the week."

Chairman Powell was appointed as the 16th Federal Reserve Chairman on February 5, 2018, by President Donald Trump. Powell previously served as a member of the Federal Reserve Board of Governors after being nominated for that position by President Barak Obama in 2012. Powell graduated from Princeton University with a degree in politics and Georgetown University law school.

By Michael Merlin, Founder of Merlin Wealth Management

Michael's focus has always been on demystifying financial, estate, investment, and philanthropic planning for his clients. With extensive experience in multi-generational planning and advisory techniques, as well as asset management, Michael leads MWM and its clients to partner together and create customized wealth plans that are steeped in the values and best practices of each family. Having built an institutional-quality asset management practice inside MWM, Michael and his team can even align their clients' investment plans with these same best practices.

He worked for the Carlyle Group in investment banking and private equity for most of his career. As anyone can see from his resume, Chairman Powell has plenty of knowledge and experience to succeed in his role as Fed Chair. But much like his predecessors- Janet Yellen and Ben Bernanke- his chairmanship will be judged by his ability to execute at critical moments. As we all remember, Chairman Bernanke's moment was stewarding the country's economy through the Great Financial Crisis from 2007-2010. Yellen was left to custody a recovering economy and presided over one of the most prosperous periods in U.S. history from 2014-2018. Powell's defining moment is here, and he seems to be flailing like an errant Matt Ryan pass.

Powell continues to ignore the critical data that other economists, legendary investors, politicians, and academics cite, showing that inflation is cracking, labor markets are weakening, and the effects of the rate hikes we've already experienced are just starting to show up. Bill Gross, Jeremey Siegel, Robert Reich, and even the United Nations have openly pleaded that the Fed pause and allow the current rate hiking program- the most aggressive in U.S. history- to take full effect before deciding whether additional hikes are needed. Powell's response was to temper his rate rising, but only by 25 basis points. He's hinted at a pause but, at the same time, does not expect one. I have already questioned in this forum how the U.S. Federal Reserve Bank can operate with such outdated methods of gathering data, so I will not belabor that point here. The amazing thing is that despite the blundering strategy of the Fed thus far, there is still a possibility for the soft-landing Powell desperately needs and we all desire. Several reports have confirmed that if the Fed stopped raising rates now, with the current trajectory of inflation metrics, we would be back to a 2%-3% inflation rate by late next year. To continue with our football analogy, that would be a walk-off field goal for the win with time expiring! All the Chairman must do is call a time-out.

Private Markets: Has the Pendulum Swung Too Far?

As stock markets worldwide continue to consolidate, with high inflation, rising interest rates, and reduced money supply acting as headwinds, the allure of private investments has steadily increased. Investors of all types are gravitating toward private investments for enhanced return potential and more stable mark-to-market pricing.

MWM continues to allocate client capital to private market investments- defined as private real estate, private debt, and private equity- with the vast majority of risk-focused allocations going to private real estate, private debt, and a restaurant franchise opportunity over the course of 2022. While we remain positive on private market investments and plan to introduce several others in 2023 (with the likely recession, the pricing of these investments should be even more attractive), I think it is important to revisit the risk characteristics and proper valuations of these investment opportunities in light of their growing popularity.

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When investing in any private investment, it is critical to understand four elements. First, private investments typically lock in investor capital for 3 to 10 years, with optional extensions at the sponsor's discretion. This means that, in most cases, the investor cannot get their money back until the investment has been completely resolved. This contrasts sharply with public markets, where assets are saleable daily. Therefore, in exchange for this lack of liquidity, investors must expect a higher return from a private investment than they expect from the public markets.

Second, private market investors must also understand that pricing these assets while in the investment stage is typically nothing more than a guesstimate. The value of a privately held company or piece of real estate is an educated estimate mainly based on comparable sales of similar companies or properties. Often, especially during tumultuous public market periods, investors confuse the delayed and often linear pricing of private investments as a sign of safety or lower volatility. This flawed assumption creates a false sense of security in our view. Further, because pricing is not readily available, it's even more important to understand the valuation of the private investment at inception. With the recent flood of capital into private assets, many sponsors are willing to stretch their valuation metrics, hoping that if they buy

high, they can sell higher. This dynamic has also led to historically high debt levels for companies owned by private equity sponsors. According to our colleague Ruchir Sharma's recent article in the Financial Times ("How Private Markets Became an Escape from Reality," December 19, 2022), the typical company owned by a private equity firm has debts of more than five times its earnings, versus one to three times for publicly traded companies. Our advice continues to be selectivity when it comes to all types of private investments.

The third factor to consider when investing in private deals is that the investor return on most private deals can only truly be calculated at the termination or sale of the asset(s). While most private investment sponsors provide investment updates that include a projected return (or "IRR," internal rate of return), the data is only as good as the assumptions used. Additionally, since a large portion of the sponsor's fee is paid on the back end of the investment period through a clawback or carried interest, until the asset is sold, it is tough to calculate how that fee will affect the investor's IRR. According to Sharma, private equity firms reported a 3% return in 2022 versus public markets, which were down approximately 20%. However, Sharma contends that if more current/accurate valuations were used and the potential fees were calculated, private investments may show a lesser return than public funds.

All of this leads to the most important factor: a successful private market investor must have an investment discipline and capital allocation approach. In our experience, MWM families are very disciplined regarding their public market asset allocation, and how that changes with their cash flow, estate, and charitable planning. However, when integrating private investments into the overall investment plan, things become a little less clear. Since the pipeline of private investments that we review comes from three sources- our connections to sponsors, Rockefeller Capital Management's connections to sponsors, and client-sourced deal flow- it is a challenge to do proper due diligence on all the deals we see. Further, when we have a deal we recommend, but its characteristics don't fit a client's particular needs, we are often conflicted because we want to provide private investment deal flow while maintaining proper allocation discipline. Sometimes this decision is taken out of our hands when a client decides to invest in a deal on their own, with little due diligence or consideration of where such a deal fits into their overall allocation plan.

In the end, as our MWM Investment Discipline states, we want to help our clients invest in the highest quality assets possible. That doesn't change when an investment is privately held versus publicly traded. We turned down many deals this year based on incomplete information or what seemed to us to be wild valuation assumptions. We may be wrong about those investments, but we will always pass on a potentially good opportunity rather than risk rushing into a bad one. Said differently, while it is comforting to look at the relative stability of our private investment allocation during a volatile period in the equity markets, we should never compromise our due diligence, asset allocation, or overall investment discipline just because an asset or asset class seems to be in rare supply or other investors are flocking there. In fact, when these conditions are present, it can signal a bubble forming. Sharma wrote that private equity funds raised more than $1tn last year, up a record 20 percent, according to the most recent data. That certainly looks like a stampede running through a closing door. With tight money upon us and valuations still in question, there is every reason to maintain a calm and disciplined approach to private investments, albeit a potentially constructive one as 2023 unfolds.

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2023 Predictions: and recap of 2022 predictions...

With 2022 in the rearview mirror, it's time to present a few predictions for what we think will make the headlines in 2023. Before we do that, we thought it would be fun to review our 2022 predictions and see how they played out:

1. **Artificial intelligence starts to consciously direct our lives (and we are ok with it).** There is no doubt that artificial intelligence was front and center in 2022. Any investor in the company formerly known as Facebook knows about the metaverse and Mark Zuckerberg's

vision of what it will mean to business and society. I'm not claiming victory based on "Zuck" or the metaverse, as it is quite unclear how successful that adventure will be at this point. However, I can point to some real advances in A.I. within consumer-facing businesses. Look no further than in our hometown, where Coca-Cola is a market leader for A.I. adoption in the consumer goods sector. For instance, it created self-service drinks machines where customers could mix their own drinks, then used that data to develop the new Cherry Sprite flavor, as this proved most popular. The company also tracks their social media presence using computer vision to identify its drinks, or those of its competitors, in users' pictures. Targeted ads are developed based on this data. In another project, the company introduced a pilot of intelligent vending machines in Japan. Customers can download the Coke On app to access a loyalty scheme, collecting points when visiting a vending machine by connecting their phones. Coke's Global Director of Digital Innovation, Greg Chambers, stated, "A.I. is the foundation for everything we do."

2. **The U.S. Federal Reserve Bank begins working on a digital dollar.** In November, Citibank and Mastercard announced they entered a 12-week pilot program with the Federal Reserve Bank of New York to test the functionality of a digital dollar. Earlier in the year, President Biden issued an executive order on the responsible development of a digital dollar. In September, the White House followed up with a comprehensive framework for developing a central bank-issued digital currency. Part of the motivation for these efforts was to keep pace with China and other countries testing a digital version of their currency. While it is unlikely that a digital dollar will be widely used for years, its development is undoubtedly a high priority if the U.S. plans to maintain its status as the world's preferred currency. Further, the collapse of the current stable of cryptocurrencies put a dent in the counterargument that Bitcoin and others will replace the central bank-sponsored currencies on a broader scale, another part of our prediction that seems to be playing out.

3. **We stop asking Facebook to manage our personal shortcomings.** I tried articulating the distinction between social media and journalism with this prediction. I'm not sure Elon Musk read my piece! The question of what person or organization should be held responsible for the veracity or appropriateness of social media posts was a rhetorical one, but we now seem to be faced with Mr. Musk's belief that he should be such a judge. As long as Musk is in the spotlight on this issue, it will likely remain unresolved. However, I am encouraged by the positive changes many digital advertising businesses have made to increase transparency and optionality around sharing personal information online.

4. **In 2022, China continued to pose a clear public threat.** When it comes to China-U.S. relations, 2022 turned out to be much less eventful than we thought. This year's focus on China was on their zero-Covid policy and the havoc it played on global supply chains. The impact of that policy created a new vulnerability for President Xi as his citizens staged widespread protests across the country, something not seen in China for decades, considering the personal danger assumed by the protestors. Our question at the beginning of the year was whether Western powers would be willing to press China economically should they continue their antagonistic foreign policies, but that question has been temporarily overshadowed by the political and financial toll the current Covid policy is already taking on the Chinese. Global companies are moving their supply chains out of China at a break-neck pace, handing that business over to India, Vietnam, Thailand, Malaysia, and Bangladesh, countries eager to take on the role of the global factory. More to come on this developing narrative in 2023.

Our 2023 predictions expand on some themes we wrote about throughout 2022 and one new, bold forecast:

1. **After many years of outperformance, the U.S. market underperformed the rest of the world in 2022. This trend will continue in 2023.** 2022 marked the end of a massive 14-year streak of U.S. markets outperforming the rest of the world. While we are still extremely optimistic about the long-term prospects of the American-based companies in MWM strategies, we now recognize that there is another game in town. An incredible amount of investment capital poured into American stocks during the Covid-19 pandemic in 2020 and continued into 2021. We believe investors will begin to diversify back into other countries like Europe, Japan, Mexico, and Canada in 2023 and beyond. We discussed the possibility that generational opportunities could emerge in Europe as the effects of the recession, overleverage within European banks, and the continuing energy crisis all unfold simultaneously. As such, more attractive investment opportunities may emerge globally; if so, we will take advantage of them. We started slowly adding international positions to our Sustainable Income and New Era portfolios in 4Q22.

2. **In the years following the Dotcom bubble burst, there were a series of scandals- Tyco, WorldCom, and Enron, to name a few. We will experience a similar rash of scandals that, as Warren Buffett likes to say, "will show who was swimming without their bathing suit on."** I admit to cheating a bit on this one. Our call for the collapse of cryptocurrencies was a 2022 item, and the continuation of that saga will be of interest in 2023 as well. However, I don't think that will be the only "scandal" uncovered in 2023. The "meme" stocks like Bed Bath & Beyond, GameStop, and AMC Theater will also be revealed in 2023 as paper-mâché, hopefully showing those who invested in these broken businesses that any gains made were just dumb luck. Now that we are squarely in a tight money environment, poorly run companies will no longer be able to hide. We'll see what else may shake out as the year unfolds.

Our equity market thesis going into 2023 is that the U.S. stock market tests the 2022 lows in the first quarter of 2023, with the S&P 500 inching toward 3,250.

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3. **Markets end up being way more boring in 2023 than may be expected. The large imbalances that required dramatic Central Bank moves over the past few years are contrasted with a year of relative calm.** I could end up eating my words since many things can still go wrong with the economy, the market, a dysfunctional U.S. government, and rampant geopolitical issues. However, looking exclusively at markets, they are functioning well going into 2023 and are certainly starting at a much better place for investors to see more normalcy. Capital is actively rotating to bonds, taking advantage of substantially higher yields across all credit markets. This is a healthy and very common occurrence and one we wrote about in 1Q22. Typically stock and bond markets decline in tandem as interest rates increase. Bonds stabilize as investors take advantage of higher yields (happening now), stocks tend to steady after valuations moderate, and the Fed concludes its rate hiking program. At the beginning of last year, one was buying the S&P 500 at 21 times expected earnings, could grab no more than 1.8% in yield from 10-year Treasuries, and the Fed had all of its tightening ahead of it. Now, the S&P is trading under 17 times, with the 10-year delivering double the yield and the Fed just about done lifting rates. It doesn't mean things are cheap and forward-returns compelling, but it pays to recall that when asset prices and valuations fall, risk comes out of the markets, and potential future returns are being restored.

4. **The Russia-Ukraine war ends in 2023.** There are several scenarios where the war ends, from a total victory for either side to a negotiated freeze or cease-fire. My money is on a "combat draw" where Ukraine's borders are reestablished without Crimea and potentially a small portion of the Donbas.

MWM Strategies and Outlook:

Our equity market thesis going into 2023 is that the U.S. stock market tests the 2022 lows in the first quarter of 2023, with the S&P 500 inching toward 3,250. Additionally, disinflation ensues sometime in 2023, and it becomes painfully clear that the U.S. Federal Reserve raised interest rates too much. These two factors prompt us to maintain our defensive posture in our equity strategies while ramping up our sense of urgency to extend the duration of our bond portfolios. So, for now, we are focusing new money on fixed income and select private investments while warehousing cash for equity dollar cost averaging later in the year.

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Important Information. For comparison purposes, the Composite is measured against the S&P 500 Index. The S&P 500 Index measures the performance of the large cap segment of the U.S. equities market, covering approximately 80% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The index is unmanaged and do not reflect commissions or fees that would be incurred by an investor pursuing the index. It is not possible to invest directly in the index.

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