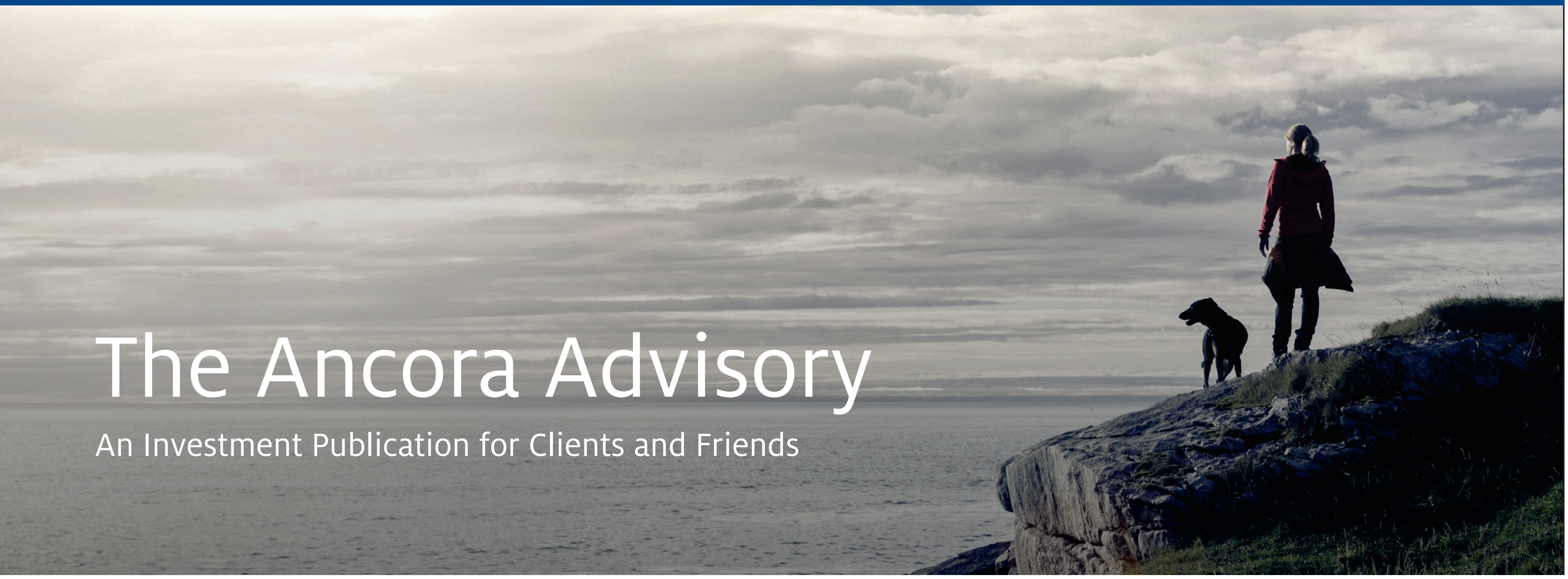

The Ancora Advisory

An Investment Publication for Clients and Friends

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David Swensen (1954-2021): Lessons from an Investing Legend

John Micklitsch, CFA, CAIA
Chief Investment Officer

David Swensen, the pioneering leader of the Yale Endowment Fund, died of cancer recently at the age of 67. While Mr. Swensen was not a household name in the same way a Tom Brady or Tiger Woods is, to the investment industry, his stature and impact was the same. Mr. Swensen amassed an enviable track record over his 35-year tenure at the helm of the Yale Endowment. In 1985 the Yale Endowment stood at $1 billion. At the end of 2020 it stood at approximately $35 billion. All the while processing contributions and withdrawals to support the University and its students.

Under Swensen's leadership, Yale pioneered an approach to investing called the Endowment Model that emphasized riskier but uncorrelated, and frequently less liquid, asset classes that took advantage of the main benefit Yale believed they had as an investor: a long time horizon and a spirit of partnership with their many investment managers. The Endowment Model is not suitable for every investor, but there are several lessons from Swensen's approach and philosophy that we can learn from. Here are a few.

- Time is one of the greatest assets an investor has. Time is also the most in-demand commodity in the world. When we are young, we have a lot of time, or human capital as it is referred to, but not a lot of financial capital. As we age, we accumulate more financial capital but lose human capital. Time capital is free, but it is extremely valuable. If we use our time/human capital wisely in our investing journey and in life, the results can be incredibly powerful, as they were for Mr. Swensen and Yale.

- Mr. Swensen looked beyond traditional asset classes to enhance diversification and return potential. If you think about a portfolio as a collection of return streams, stocks and bonds represent two of the major return streams available to most investors. To the extent an additional, uncorrelated, "alternative" return stream is added to the mix beyond the two-asset class portfolio, it can lower portfolio risk further, depending on its return objective and volatility profile. When overall risk is lowered, it creates more room, relative to the portfolio's original risk budget for additional, potentially higher-returning, investment strategies. This can result in higher overall risk-adjusted returns. In the current low interest rate environment, this concept is particularly helpful as we look beyond traditional fixed income to alternative strategies to solve for desired return levels while managing portfolio risk.

- In sports there have been great head coaches that produced family trees of coaching assistants that went on to become head coaches themselves. Bill Walsh, Bill Parcels, Mike Krzyzewski, Pat Summitt, Bill Belichick and Nick Saban, to name a few, all produced prolific coaching family trees. David Swensen had his own coaching tree with numerous employees going on to become heads of other prestigious endowments. Sharing knowledge and experience, like investing itself, is not a zero-sum game.

In closing, it was reported that Mr. Swensen, knowing his time was running short, taught his regular investment class to Yale students and worked in the Yale Endowment office up to his very last day. He was doing exactly what he wanted to be doing; providing another example for us all that high achievement often lies at the intersection of passion, talent, commitment and thinking differently. ◊

Where the Value in Value Investing Is These Days

David Sowerby, CFA
Managing Director, Portfolio Manager

Value investors have had to be unusually patient for the last eight years. Growth indexes had significantly exceeded the value indexes, intensifying that advantage in the first eight months of 2020. Encouragingly, beginning in September 2020, value stocks have rebounded quite well relative to growth and outperformed by 19%, represented by the Russell 1000 Value return of +26.2% compared to the Russell 1000 Growth return of +7.2%, on the heels of encouraging vaccine data and the expected re-opening of economies around the world.

This occurred as concentration of the twenty largest stocks in the S&P 500 index declined from peak concentration levels in September 2020, paralleling a similar peak in early 2000, which saw subsequent outperformance for value stocks, as shown below.

S&P 500 Index: Combined Market Cap Weight of 20 Largest Stocks

Source: Strategas

Annualized Returns by Index

Index	Period 1 Growth outperforms Value **6/30/98 - 6/30/00**	Period 2 Value outperforms Growth **6/30/00 - 6/30/06**	Period 3 Growth outperforms Value **8/31/18 - 8/31/20**	Period 4 Last 7 Months **8/31/20 - 3/31/21**
Russell 1000 Value	2.95%	7.46%	-0.73%	26.16%
Russell 1000 Growth	26.42%	-7.80%	22.65%	7.15%

Source: FactSet

Over the last two quarters, characteristic of the early months of a value rebound, the stocks which have performed best have generally had greater leverage, more discounted valuations and lower profitability, as measured by their ROE or return on equity. This is quite common for deeper value, highly-leveraged stocks to have their strongest returns come in the initial stage of a market rebound, though their longer-term success often lacks sustainability. While the temptation to rush out and add deeply-cyclical stocks to a portfolio can be strong, we encourage investors to focus most of their equity portfolio on quality factors that will endure across a full market cycle, such as:

- Balance sheet strength with the ability to maintain dividend payments and, if needed, access to the debt markets given the high degree of economic uncertainly and business disruption.
- A proven management team with success at capital allocation. This would likely mean experience and success navigating the financial crisis in 2008 and 2009.
- Success in free cash flow generation and subsequent above average free cash flow margins.

Value Investing over Full Market Cycles

Through our internal research and conversations with external research firms, we have identified five periods within a typical market cycle. They are:

- Stage 1: Initial rebound from market trough and recession
- Stage 2: Expansion phase where economic and profit growth accelerates
- Stage 3: Sustainability period as the initial acceleration moderates
- Stage 4: Deceleration period where growth rates remain positive, but at a decelerating rate
- Stage 5: Recessionary period and the next trough

During each stage of the cycle, different factors can have a greater influence on which specific stocks fare the best. For example, in the latter periods of Stage 4 and certainly in Stage 5, a greater emphasis on earnings and sales consistency and less use of leverage are financial variables essential for downside protection. Simply look at the periods prior to both the 2008 and 2020 crisis for proof.

In contrast, in the Stage 1 initial rebound, companies with greater cyclicality, higher beta and greater dispersion of earnings and sales typically fare best. Often these are companies that have survived a recession and bear market, but have a lower conviction for their longer-term financial success. They subsequently experience short-term outsized gains during the earliest phases of recovery, which is the period we believe we have just experienced.

Identifying which stage of the cycle we are in and modifying holdings accordingly may temporarily lead to higher excess returns. Though the ability to correctly identify when the five stages of a cycle would turn would be enviable for any investor, we are skeptical of placing too much emphasis on successfully making such macro forecasts due to the high portfolio turnover that would result and the lost compounding opportunity spent courting less enduring and lower quality long-term assets. The portfolio management team I am part of utilizes investment processes that emphasize quality combined with lower turnover under the belief that patient capital in high-quality businesses will outperform. We believe that approach will prevail in the majority of the five stages of an investment cycle and, therefore, the full cycle. We believe quality has the bonus effect of mitigating risk of permanent impairment to capital for the patient investor interested in owning businesses, not renting them. ◊

Federal Reserve Policy Update: The Tapering Dance Begins

Kevin Gale
Managing Director, Head of Fixed Income

The Federal Reserve is taking a (micro) first step towards tapering one of its accomodative policy tools by announcing on June 2, 2021 that it will begin to unwind its corporate bond portfolio. The portfolio consists of $5.2 billion of single name Investment Grade bonds and $8.6 billion of Investment Grade and High Yield ETFs. Given the relatively small size of the portfolio and the still high demand for credit, we would expect this to be an orderly unwind and have minimal impact on the overall credit markets.

By way of background, the Fed began purchasing ETFs in May of 2020 and individual corporate bonds in June of 2020. ETF purchases ceased by the end of July and no additional individual credit purchases took place after December 2020. The individual security purchases were all within 5 years to maturity (2025). AT&T, Comcast and Verizon are the three biggest positions the Fed owns, each consisting of about $100 million of securities on the Fed's balance sheet.

The bottom line is that this should have minimal impact on the bond market, in our view, given the small size of the portfolio. However, this likely is just the beginning of the Fed's tapering. As of now, the Fed is still purchasing $120B per month of Treasury and mortgage-backed securities (MBS). We expect the Fed to begin that taper talk by the end of the summer and begin slowing their monthly purchases shortly thereafter.

What will the bond market's reaction be when the Fed does begin to taper? During the "taper tantrum" of 2013, the 10-year Treasury yield rose from 2.0% to 2.9% as investors sought to get in front of the Fed's selling. During the same time period, however, the S&P 500 index rose 10.7%. Volatility in the stock market is always a possibility, but it is important to remember that taper talk is on the table because, generally speaking, the economy is strengthening and requires less policy support.

One thing to note is that while the 10-year Treasury was at 2% when the taper talk began in 2013, it initially fell to around 1.7% before beginning its ascent in the following months and by 2016, the 10-year was back under 1.5%, so runaway rates are not a sure thing. We do believe that initially, the market is more prepared for the taper this time around as expectations for it are increasing by the day given economic conditions and inflation pressure. This will likely lead to modestly higher yields in the long end of the yield curve but, in our opinion, the nearly 100 basis points (1%) increase we saw during the 2013 taper is not as likely. In our view, the inflation outlook will likely have a bigger impact on yields this time around. ◊

Human Progress, Optimism and the Stock Market

Jeff van Fossen, CFA
Managing Director, Portfolio Manager

Human Progress

I recently had the wonderful opportunity to spend three days rafting through the Grand Canyon with friends. If you ever get the chance to do this, don't pass it up. It was an amazing experience. Geologists estimate that the Grand Canyon is some 70 million years old. Although it's always changing, that change comes very slowly over millions of years, so it's largely the same as it was at the dawn of human civilization.

The lack of light pollution in the wilderness makes stargazing easy and marvelously different from what we are normally used to. One evening, while watching the night sky, we were suddenly astonished to see a train of some 40 or so bright lights moving slowly but steadily overhead. Following a brief interval, another 60-some lights passed over. The experience raised the hair on the back of my neck. Someone explained that these lights are low Earth orbit satellites, launched by Elon Musk's SpaceX. The satellites are part of something called Starlink, a project to launch many thousands of satellites into orbit to achieve universal internet access. SpaceX hopes to use the profits from this business to fund eventual missions to Mars. This, is human progress!

So, why discuss this in a newsletter on investing? Because progress and wealth creation go hand in hand. Investing, especially in stocks, is a long-term proposition and much of your willingness to own equities should depend on whether you believe progress will continue. If it does, markets will likely continue to reach new highs, if not tomorrow then in 5, 10 or 20 years. The contrary is equally true. If you don't believe progress will continue, then wealth creation, and the markets, are likely to stall.

Optimism

I just finished reading *Ten Global Trends Every Smart Person Should Know: And Many Others You Will Find Interesting* by Ronald Bailey and Martin L. Tupy. The book lays out evidence that, by objective measures, the world is not only a better place than it's ever been, but it also continues to get better, faster. Some highlights:

Life expectancy has been on an almost constant upward march since the beginning of the industrial revolution. In 1701, life expectancy was approximately 37 years. Today, it's closer to 82. Satellite data show that total global forest area has been expanding since 1982. Surprisingly, natural resources are becoming cheaper and more abundant. Average IQ test scores have increased by 30 points over the last 100 years. Vaccines are saving lives. In the 20th century alone, smallpox is thought to have killed between 300 million and 500 million people. It has now been eradicated. Cancer death rates have fallen every year since 1991. Famines have all but disappeared outside of war zones. The global absolute poverty rate has fallen from 90% in 1820 to 8.6% today. Democracy is still rising. Most of the world is healthier, better fed, better educated, more literate and has more free time and entertainment options than at any time in human history.

Of course, problems never end. Climate change, nuclear conflict and marine pollution, to name a few, are serious contemporary concerns. And solutions beget more problems, often unanticipated ones. But the lesson of history is that the ingenuity of humans to solve the problems of today and the future is real. It's easy to argue that if newspapers came out every 50 years, as opposed to every minute on our smart phones, the headlines would be almost universally positive.

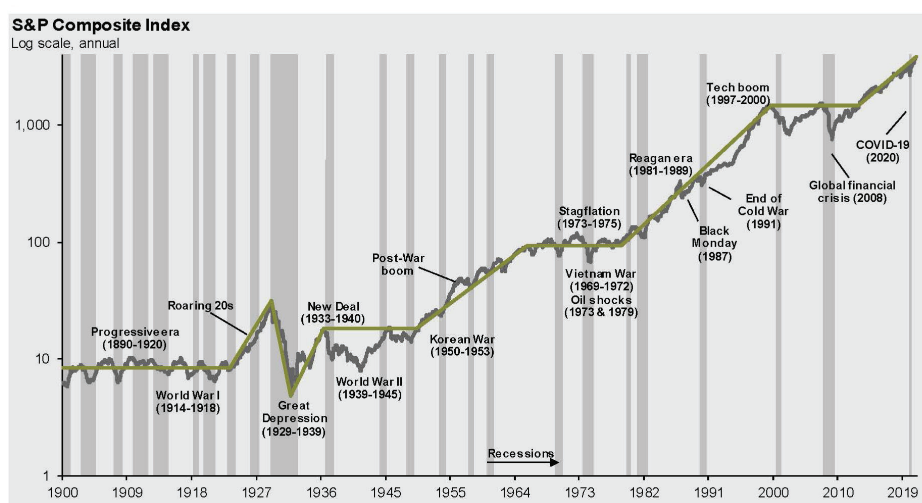
The Stock Market

Based on the progress outlined above, optimists are clearly on firm ground. In the long run, your base assumption about the stock market should be positive, even if we don't know what will happen tomorrow or the next day. The ride will inevitably be bumpy and there can be prolonged periods of market declines before recovery and eventual advances.

It is said that the best investors marry the vital ingredients of short-term pessimism (often contrarianism) with long-term optimism, keeping one's emotions grounded. Short-term pessimism prevents one from becoming greedy and euphoric. Conversely, long-term optimism keeps one from falling victim to fear and despondency.

So, the next time you're at a dinner party and someone starts to tell you all the reasons why the world is going to hell and the market can't ever rise further, smile and nod, but know that the facts are not on their side. ◊

Stock Market Since 1900



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns. Past performance is not indicative of future returns. Chart is for illustrative purposes only.

Source: J.P. Morgan Guide to the Markets - U.S. Data are as of March 31, 2021.

Inflation Update Q&A

Kevin Gale
Managing Director, Head of Fixed Income

Paul Caruso
Director, Commodity Investments

Q: Kevin, from a fixed income investor's perspective, what is your inflation outlook and how do you think the Fed will play its hand in the coming quarters?

A: Continued aggressive monetary policy and increased fiscal spending will likely drive growth rates to be well above normal in the near term. The increased demand, combined with tighter supply chains, has put upward pressure on prices. Recent economic data has shown a significant uptick in inflation with CPI rising 4.2% year-over-year and 0.8% month-over-month in April.

All the "easy money" is putting fixed income investors on edge over inflation. Last year, the Federal Reserve adopted a new policy of "average inflation targeting," meaning it will allow inflation to drift above 2% after periods of below 2% inflation. We are now clearly in the phase where the Central Bank is allowing it to drift higher. To date, the Fed believes the recent inflation data is transitory in nature and we will start to see these numbers subside in the coming months. Market participants are not as certain about this as the Fed is.

We believe that modestly higher inflation is likely here for a more extended period. In our view, this will force the Fed to begin taking their foot off the accommodative gas pedal sooner than they anticipate. As of now, members of the Fed do not anticipate a rate hike until early 2023. Although they have started with baby steps, we expect the Fed to begin to taper its monthly bond purchases potentially more earnestly by the end of 2021, with additional tapering to begin in the coming months. We do not anticipate any rate hikes in the near term, but if inflation remains elevated that could be the catalyst that forces the Fed to raise rates before mid-2022.

Q: Paul, there is a lot of discussion if inflation is transitory or more secular, what is your opinion on this topic? Are there pockets of inflation where you think the answer is different?

A: This depends on your definition of transitory but, in my opinion, inflation pressure will last more than just a few months and may even last a couple years. Eventually, innovation, which is deflationary, supply improvements and policy adjustments will kick in and erase upward pressure on prices.

Let me give you a specific example which highlights this scenario – take a meat processing plant. The plant is designed to process various cuts of meat, some of which are sold to grocery stores while others are sold to restaurants. The plant will have designated lines to process and package the cuts to meet the end users' specifications. When COVID-19 hit, the demand mostly shifted to grocery end-markets versus restaurants, exceeding the plant's capacity for grocery while shuttering its restaurant capacity. In addition to the shift in demand, labor constraints slowed throughput. Plants couldn't reconfigure processing lines to compensate for the shift in demand, not to mention the capital investment that would require. As the economy reopens, industries are still reeling with labor issues at a time when demand is increasing at an accelerating rate, but eventually market forces will balance supply and demand.

This example transcends across a multitude of industries right now – labor is still an issue and manufacturing plants, or more generally supply chains, were never designed to meet a rapidly changing demand picture.

Furthermore, if you think about commodity-intensive industries, there has been a dearth of capital investments over the past decade due to low prices and poor margins. So, when it comes to answering how long inflationary pressures will last, I think its twofold. First, how long does it take for capacity to recover or even expand, and second, is the demand we are seeing a permanent shift higher, or just a short-term phenomenon due to the reopening of the economy. It is difficult to answer these questions, but it is going to take more than a few months to realign the supply and demand curves, in my opinion, and therefore what we are experiencing isn't transitory if we define it by that time horizon.

Q: Kevin, how does your inflation outlook impact asset allocation and the role of fixed income in portfolios?

A: We believe that Treasury yields will gradually move higher as investors adjust to higher growth rates and increased inflation. Short-term yields will likely remain muted as the Fed continues to support the economy. This makes for an extremely challenging environment for fixed income investors as bond prices move in the opposite direction of yields. In addition, corporate credit spreads are near all-time tight levels, adding to the difficulty in finding value in the fixed income markets. Our view is that, while fixed income should remain an important part of a portfolio, we believe better value can be found in other asset classes that have low correlations to equities, such as commodities, strategic income (preferred stocks and real estate) and alternatives. We believe that investors with long time horizons and the willingness to take on a bit more risk in the form of market volatility should be underweight fixed income as we expect returns to be muted for the foreseeable future.

Q: Paul, commodities have historically been an attractive way to hedge against inflation. Any reason to think it will be different this time?

A: No, I don't think this time will be different. In fact, commodities have performed well over the past several months as inflation expectations have crept higher. And, since we are still in the early stages, I suspect the general trend will still be higher across the board, like in previous cycles.

However, as the inflation theme matures over the medium-term, I think we could see a decoupling within the asset class over that time frame, different than in previous cycles. In other words, I think the inflationary pressures will last longer in certain segments of the economy than in others and there will be a trickle-down effect to the individual commodity markets with some outperforming others. As one example, the green energy wave could result in deflationary pressures for fossil fuels while producing inflationary pressures for other inputs.

Q: Kevin & Paul, what is something non-consensus or a derivative of the inflation outlook that you believe the market might be overlooking?

A - Kevin: While we are making progress towards the end of the pandemic, I believe that the market is pricing in very little chance that we have any significant setbacks in the United States during the fall or winter. Any possibility of additional closures of the U.S. economy are not priced into the markets. Should we get a scenario where this happens, a flight to quality is likely to ensue, pushing Treasury yields significantly lower.

A - Paul: There seems to be this general belief that consumer habits will slowly shift back to pre-pandemic preferences. For example, consumer spending on travel and entertainment will increase as we reopen, which probably occurs at the expense of in-home spending (i.e., home projects). What happens if this shift does not occur? I think that will continue to constrain supply chains, exacerbating the current situation.

Another question I would raise is how quickly can capacity recover? As unemployment benefits expire, will labor capacity recover quicker than we think? Everyone seemed surprised at how fast capacity was taken offline during the pandemic, so will the same be true on the upside as we emerge? We live in a very innovative society and I think a quick recovery in capacity, or throughput, is something that could derail the inflation bulls' thesis. ◊

Our Take on Potential Income and Estate Tax Policy Changes

Howard Essner, JD
General Counsel, Family Wealth Advisor

Vanessa Mavec King
Vice President, Financial Planner

Most years we face uncertainty in tax planning and 2021 is shaping up to be among the most uncertain in recent memory. With so much information (and misinformation) circulating about possible changes and strategies, we thought this would be a good time to review the current tax situation, discuss some of the proposed changes and the likelihood of enactment, and then share our thoughts about what to do.

What We Know

The Tax Cut and Jobs Act (TCJA) enacted at the end of 2017 made many significant changes to individual income taxes and estate and gift taxes staring in 2018. However, because of the machinations of the budget reconciliation process that was used to pass TCJA, most of the changes came with an automatic sunset at the end of 2025. Key provisions of the TCJA that will end in 2025 include:

- The reduction in individual income tax rates at almost all levels of income and the income thresholds to which those new rates apply.
- The nearly doubling of the standard deduction and elimination of the personal exemption.
- Changes to capital gains, dividend, and alternative minimum taxes.
- Limits on how much state and local income and property taxes are deductible.
- Doubling the estate and gift tax lifetime exemption from $5.6 million to $11.2 million per person (currently $11.7 million as indexed for inflation).

If Congress does not act, we will live under the current tax regime until 2025, and then revert to the 2017 system starting the following year. Of course, everything can change between now and then if Congress takes action.

What We Don't Know

Many proposed tax changes are circulating in Washington. Most of the news has concentrated on the tax changes proposed by the Biden administration, but other changes (some bipartisan) are also on the table.

The administration has proposed several changes to collect more tax revenue from the wealthy. These proposed changes have been announced over the past months, but were formalized a bit more in the President's budget proposal announced just before Memorial Day. The key provisions include:

- Increasing the top marginal ordinary income tax rate to 39.6% from the current 37% rate.
- Increasing the capital gain tax rate to 39.6% for taxpayers making more than $1 million a year.
- Eliminating the step-up in basis at death for appreciated assets for gains of more than $1 million ($2 million for couples). Unrealized gains would then be taxed at death at the new capital gain rates.

The budget proposal sets 2022 as the effective date for these changes with one very notable exception. There have been reports that the budget proposal assumes that the capital gain tax rate increase for those making more than $1 million will have a retroactive effective date to late April 2021. More on this below. One item is conspicuously absent from this list; President Biden campaigned on the promise to reduce the estate and gift tax lifetime exemption. It seems that this idea is not part of the administration's legislative agenda for this year.

We must also note that these are proposals only, and many details are still missing. As of this writing, the administration has said the the new highest marginal rate of 39.6% will apply to anyone making more than $452,700 a year, or $509,300 for couples, but currently the 37% rate applies to income of more than $523,600 for single filers and $628,300 for married couples. Likewise, the administration has said that the changes to the step-up in basis rules will not apply to family farms and businesses, but no details have been provided.

Most political commentators believe that it will be difficult at best for the Biden administration to get these proposals enacted into law. The Senate Republicans have said that they will not support tax increases. This leaves the Democrats two options: pass the tax changes through the budget reconciliation process that requires only a majority vote (as the Republicans did in 2017 with the TCJA) or eliminate the filibuster. At least two moderate Democratic senators have said that they are reluctant to support major tax increases or eliminate the filibuster. Also, after the announcement of the retroactive effective date for the capital gain tax rate increase, a few more Democratic members of Congress went on the record expressing concern. Today, uncertainty is the only certainty.

Two other tax proposals have been made in Congress that are worthy of note:

> Reduction of the top estate tax rate to 20%.
> Changing the starting date for Required Minimum Distributions for retirement accounts to age 75 (from the current age 72).

These proposals are included in pending bills with bi-partisan sponsors. Even so, passage of either bill remains uncertain.

What We Should Do

Even though it goes without saying, we're going to say it anyway: Tax planning these days is a dicey proposition. While tax considerations are important in asset allocation and portfolio construction, we have always believed that taxes take a second seat to sound investment principles. With this thought in mind, our main message these days about taxes is caution. Too many times in the past we have seen clients make decisions they later regret based on some presumed Congressional action or inaction, only to see Congress act, not act, or act in an unexpected way. One must think carefully about any decision based merely on an assumption that a proposal may be enacted into law.

Most of the questions we receive these days are around capital gains, especially now that reduction to the estate lifetime exemption seems to be off the table. Many want to know whether gains should be realized to lock in the lower current capital gain rate before it changes. The announcement of a retroactive effective date back to late April throws a bit of a monkey wrench into that option. If this comes to pass, which we believe is unlikely, then it would be too late. Even then, we must remember that the proposed capital gain rate change will only apply to taxpayers with income of more than $1 million. Also, investment decisions in retirement accounts are not affected by this change. For those who will be affected by the change, it is probably best to wait to see how the legislative process unfolds, while still letting sound investment principles guide your decisions, regardless of taxes.

Some action this year is still warranted. Even though a reduction in the estate and gift tax lifetime exemption is not currently proposed, the sunset of the current exemption at the end of 2025 is rapidly approaching. If your estate will be subject to estate tax either now or after the sunset, you might consider acting soon to reduce the future tax burden while the higher exemption still exists. Possible strategies for this include outright gifts, special spousal support trusts, life insurance owned by a trust, charitable giving and grantor retained annuity trusts, among others. We are available to discuss these ideas if interested and, as always, we encourage you to speak with your tax professional for a holistic view. ◊

As always, don't hesitate to contact your Ancora advisor or relationship team if you have any questions or would like to learn more about these topics. Visit our website at www.ancora.net to read past newsletters and find other news and insights from the investment professionals at Ancora.