SOLAS WEALTH
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MAY 2022 PORTFOLIO UPDATE

ASSET ALLOCATION UPDATE

Current Asset Allocation – May 2022

		← Less Exposure			More Exposure →	
		Strategic Only	Under-weight	Baseline Allocation	Over-weight	Max Allocation
Equities	U.S. Large Cap	▼				
	Foreign Developed	■				
	Emerging Market	■				
Quasi-Equity	Real Estate			■		
Bonds	U.S. Treasury	■				
	International Treasury	■				
	Inflation-Protected	■				
Alternatives	Hedge Strategies			■		
Liquid	Short-Term & Cash Equivalents				▲	

Adjustments can vary across strategies depending on each strategy's objectives.
What's illustrated above most closely reflects allocation adjustments for the Growth Strategy.

■	No change month-over-month
▲	Increase month-over-month
▼	Decrease month-over-month

U.S. Equities: Exposure will decrease, as both the intermediate- and long-term timeframes enter downtrends.

International Equities: Exposure will not change, as both foreign developed and emerging markets remain in downtrends across both timeframes.

Real Estate: Exposure will not change, as both timeframes remain in uptrends.

U.S. & International Treasuries: Exposure will not change and is at its minimum allocation due to downtrends across both timeframes.

Inflation-Protected Bonds: Exposure will not change and is at its minimum due to downtrends across both timeframes.

Alternatives: Exposure will not change, as gold remains in uptrends across both timeframes.

Short-Term Fixed Income: Exposure will increase, as it takes on exposure from all other weaker assets, particularly U.S. equities.

MONTHLY NOTE

“No mind, however dull, can escape the brightness that comes from steady application.” —Sir William Osler

Risk is technically a four-letter word.

Depending on your vantage point, risk can be viewed as either a positive or negative, but in either case, it is typically associated with strong feelings.

Risk is defined in various ways depending on the context. From the perspective of our investment process, we define risk as the permanent loss of compounding due to large drawdowns.

Our process is aimed at preserving compounding regardless of the market environment. In 2022, this has meant toggling equity exposure (mostly downward) to guard against further declines in global stocks. The data tell us that the risk of large drawdowns, while always present, is highest when downtrends materialize.

Abiding by Charlie Munger’s maxim of “invert, always invert,” one can reframe the notion of risk by asking, “What can I do to generate the largest drawdown possible?” The answer is simple: employ a strategy that ignores downside risk, relies on prediction, is not adaptable, and one that assumes the future will play out like the recent past.

In this month’s Note, we discuss the various timeframes we utilize to measure and adapt to market risks. We take the stance that, regardless of the timeframes employed, some investors will inevitably fall prey to hindsight bias. This can lead them to abandon their investment process or, perhaps worse, lead them to conclude that they have predictive powers regarding the future.

Our view is that reliability, adaptability, and consistency should be the focus for investors in all environments, especially now.

But first, here’s a summary of our take on what transpired in the markets in April.

Asset-Level Overview

Equities & Real Estate

U.S. stocks began April having recently enjoyed an 11% rise from the lows in mid-March.

Unfortunately, the momentum did not continue, and April nears its conclusion re-challenging those very same March lows. While some segments have lost less than others, none have been immune. The result is downtrends across both timeframes we focus on in our strategies, and we will shift to minimum allocations across all portfolios.

For international equities, the same headwinds of inflation and rising rates exist but are compounded by the proximity of the conflict between Russia and Ukraine. Despite Ukraine's unexpected success thus far, both the tolls and tensions have escalated for all sides. The result is that global equities have performed poorly and remain in downtrends over all timeframes.

Real estate securities have been a lonely bright spot in April, a segment that has increased since its January low. Uptrends remain in place, and as a result we continue to maintain our baseline allocations.

Fixed Income & Alternatives
It is difficult to come by a rougher start to the year than fixed income has experienced in 2022. In fact the Bloomberg US Aggregate Bond Index is on pace for its worst year…ever. It is perhaps humbling then to realize that we are at the beginning of a rate-raising cycle and pressure should, in theory, remain on asset prices to decline further. On the other hand, markets have a funny way of discounting expectations. When we least expect it, the market may fully price in future rate hikes and begin to stabilize. Either way, trends remain decidedly negative, so rather than try to catch that falling knife, we will remain at our minimum allocation to instruments of any duration.

Gold continues to hold uptrends but is also sideways since early March. Given the generally painful environment for almost every major asset class year-to-date, there's something to be said for sideways. For now, we continue to hold our maximum allocation.

3 Potential Macro Catalysts for Trend Changes

GDP Woes: The U.S. economy contracted in the opening months of the year, as strong consumer demand and supply constraints at home brought in a flood of imports. Gross domestic product fell at a 1.4% annual pace in the first quarter, as private inventories shrank and the trade deficit ballooned. This means that the majority share of first-quarter consumption was due to inventories or imports rather than American output.

Future Inflation: The World Bank expects commodity prices to remain elevated for years, as the war in Ukraine alters how commodities are traded, produced, and consumed. In its latest Commodity Markets Outlook report, the multilateral bank said that energy prices will soar 50.5% this year from last, after nearly doubling in 2021 in some parts of the world. Food prices are projected to rise 22.9% this year after rising 31% last year.

Food Costs: Corn and soybean prices have risen nearly to record highs, signaling higher food costs. If corn and soybeans notch new highs, they will be the latest raw materials to do so in the broadest and sharpest commodities rally of the modern trading era. Vegetable oils, oats, and wheat have already set record high in 2022.

Speed Kills

"Life moves pretty fast. If you don't stop and look around once in a while, you could miss it." —Ferris Bueller

The common thread of this year's Notes has been on having the proper perspective about markets.

We've done this in recognition that after such a great run for equities in 2021, it was only natural for that to end, or at least pause.

Going into January, we emphasized the importance of process over outcome, knowing that last year's winners might not be this year's opportunity. Our process is always ready for the reversal of major trends in either direction, so we wanted to prepare our clients accordingly.

After January's sharp retracements proved that to be the case, going into February, we emphasized the importance of measuring the costs and benefits of outperformance. In other words, the same process that captured a bulk of positive performance from growth and technology stocks meant it was worth suffering through January's negative performance. That was the tradeoff of 2021's great returns.

After adjusting the portfolios entering March and April, the theme has been the unpredictability of future performance in financial markets and the emotional difficulty associated with following the data to remain adaptive in a choppy market. In our opinion, investor behavior is where investing is won and lost. Even great strategies can be overlooked or even discarded if the proper perspective is not maintained, which brings us to May.

This environment is fertile ground for our biases to show up. One of the more common biases that we encounter with investors is "hindsight bias," which essentially means that by looking back at an event humans are inclined to believe the outcome could have been predicted. The idea is that, once we know the outcome, it's much easier to construct a plausible explanation.

One of the difficulties of trend following – and one we've written about extensively – is the selection of timeframes. By taking a longer-term focus, it is often tempting – and perhaps convenient – to look back and conclude that a longer-term trend following strategy is "too slow" to react to changing conditions.

We readily agree that trend-based systems such as ours can seem slow in the face of a news cycle that is constantly changing and bombarding us with new information that generates substantial emotional responses. War in Ukraine, COVID lockdowns in China, Elon Musk buying Twitter. The constant drumbeat of activity demands action, doesn't it?

Not. So. Fast.

The methodical speed at which we make asset allocation decisions is deliberate, and that's not by accident. It's true that there have been scenarios where we stayed with a trend for "too long." On the other hand, there are situations when staying with the trend meant we were able to continue to ride an uptrend the "experts" said was about to end, or where we captured a sharp rebound we would have missed had we pulled exposure quickly. Again, hindsight bias involves revising the probability of an outcome after the fact.

During an emotionally charged environment where human biology screams for action now, it is natural to forget or even ignore times when acting too quickly would have cost money (errors of commission vs. errors of omission). This is why the data is so important. If one can boil the question of when to act down to a single data point over many samples, then it is less difficult (notice we didn't say easy) to remain committed and execute in a cold-blooded manner.

Here's an example of what the cold-blooded data says, and it's a point that may run counter to what emotionally feels true to many investors: What can seem slow in the moment has a way of looking fast in hindsight. The S&P 500 is a little more than 10% below its all-time peak as we write this Note, which puts it in proximity to its 200-day average. Over the last 30 years, the 200-day average of the S&P 500 has compounded at 8-9%, which is perfectly fine to accomplish an investor's goals. If the market truly is headed for disaster in the way of a bear market, then taking portfolios fully defensive at a 10% decline in the S&P will only seem prescient if markets ultimately end up in a 50% drawdown.

Tax considerations is another practical factor. "Faster" systems are inherently less compatible with U.S. tax law because they generate more short-term gains. Accounting for taxes in investment performance can be tedious and thus is frequently ignored, bblut the cost can be substantial. Wash sale rules complicate the tax matter even further. If a faster system could even outperform the slower one on a risk-adjusted basis (in our research, they rarely do), the after-tax returns typically negate the benefits.

Again, perspective is everything. Our aim has always been to help clients meet their goals by being reliable, decisive, and consistent. During times like 2021, this will seem easy. Early in 2022, it's not. However, these times are when we show our mettle, so we are grateful for the opportunities that lay ahead.

Best,

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