NEW AGE ALPHA®

CIO Outlook

CIO OUTLOOK: Q3 2021

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The first quarter of 2021 showed us the market was no longer buffeted strictly by headwinds and tailwinds; it was dictated by a rogue's gallery of opportunists no longer obeying the commonly accepted laws of Wall Street. Since then? Well, in the second and third quarters, it showed us that this is no temporary phenomenon and that some of the traditional assumptions held market-wide may truly be in question. As of this writing, the shares of AMC Entertainment Holdings, Inc. (AMC) and GameStop Corp. (GME) remain elevated leagues higher than what their respective fundamentals indicate. And those are merely the two most obvious examples of the so-called "Meme Stocks," with untold dislocations occurring as retail investors continue to mine for the next "most shorted stock ready to go to the moon."

Meanwhile, reopening across the globe continues in fits and spurts and no one is exactly sure what this means for inflation. Deficit hawks continue to insist that the historic levels of stimulus offered in 2020 and continuing through 2021 will ultimately trickle down and reduce the value of the dollar. Others insist, however, that such inflationary readings are temporary and the result of supply chain disruptions. Atop all of this looms the shadow of the Delta virus and what it—and potential other Covid-19 variants—means for world economies. While it feels like most analysts continue to favor equities over bonds despite the market uncertainty, the continued "noise" only presents further opportunities for disruptions on short-, medium-, and long-term performance. That's why, at New Age Alpha, our ethos remains the same: Focus on fundamentals to help mitigate the risk of human behavior. In so doing, we aim to avoid overpriced stocks in a portfolio—losers.

Looking Ahead

As we begin the fourth quarter of 2021 and continued “Reopening,” new financial topics have come into vogue. In the 2000s, even in the face of the bailouts from the Global Financial Crisis, very few people took the threat of inflation seriously. Apart from those on the fringe, there were few signs of it in the actual data and it remained associated with the so-called ‘Gold Bugs’ of the market. That all changed in the second and third quarters of 2021 as signals started to indicate that the latest pandemic-inspired stimulus had increased prices at the consumer level. Specifically, this carried even greater implications as investors began to imagine the Federal Reserve’s next moves. Up until now, many would argue that the “Fed Back-Stop” was the single most important driver of equity prices. But suddenly, the question became less about “*Would* the Fed continue its accommodative monetary policies keeping interest rates low?” and more about “*Could* the Fed continue its accommodative monetary policies keeping interest rates low?”

Carl Isernhinke, Managing Director at New Age Alpha, examined the scenarios in which inflation may come to the fore and summarized them below:

Reasons TO Expect Inflation (long term)	Reasons TO Expect Inflation (short term)	Reasons NOT TO Expect Inflation (short term)	Reasons NOT TO Expect Inflation (long term)
Economy is recovering as it reopens	Stimulus spending in the trillions	Temporary supply constraints	Share buyback at its highest since 2018
“Fed backstop” remains unchanged	Persistent lack of employees	Unemployment declining overall	Pernicious deflation narrative

Reasons TO Expect Inflation

There has been a lot of discussion about the possible shift to a new inflationary paradigm. Most would agree that the current inflation is primarily driven by supply bottlenecks brought about by COVID and that these pressures are likely to subside in the future. There are longer-term pressures forming as well, however, and the chief factor for the inflation case is undoubtedly the huge amounts of stimulus and its effect on the money supply.

Firstly, we must remember that an expansion in money supply does not automatically constitute an increase in new money. We need commercial banks to make loans against the deposits. The inflation argument stems from governments’ response to the pandemic whereby they have guaranteed loans to the private sector – effectively backing any loans that default in the private sector. The theory is that these government guarantees (if done on a large enough scale) would solve the commercial banks’ lending problems since, suddenly, the risk of lending has diminished due to this government backing. This would cause new money to flood the economy and dramatically increase money velocity. This, in turn, would spur economic growth - essentially there will be more money chasing fewer goods, which by nature would be inflationary.

Another cited reason from the inflation camp is the overbearing amount of debt at the government level. Such elevated debt levels give governments a reason to keep interest rates artificially low. Should yields rise too much, then the US and most other developed governments might risk interest payments ballooning to unsustainable levels. Some claim the governments have a vested interest in keeping rates low, even in the face of inflationary pressures.

Reasons NOT TO Expect Inflation

Disinflation has been the predominant trend of the past few decades, driven by certain key fundamental factors. One of these has been the globalization of the world economies. When countries around the world joined the global economy and created the international markets we have today, they also received the benefit of sourcing cheaper labor and resources. Similarly, globalization also increased competition by giving customers access to a global array of companies, products, services, and technologies. The combination resulted in a decline in the cost of many goods and services.

Another key factor has been the rapid growth in technology. The digitization and innovation brought about by technology have increased productivity and efficiency dramatically. This increased productivity through the substitution of labor (automation) and cheaper substitutes has been driving down costs for decades.

The deflation narrative also includes an important point about commercial lending. Many believe that the stimulus has caused an increase in the money supply and with it the velocity of money. This isn't entirely true, however. The Fed merely creates reserves (called deposits), for commercial banks to lend against. New money is only created once commercial banks decide to make loans to the private sector. Thus, if commercial banks don't lend against these deposits, typically no new money is created.

The above factors are the predominant reasons for the continued deflationary pressure experienced in many developed economies in the past. However, given the extraordinary conditions that we have all experienced recently, there are other factors to consider. In the very near term, for example, the availability of employees vs. persistent unemployment needs to play out. Also, the unintended effects of share buybacks may not be fully realized yet.

Many narratives emerge when assessing the topic of inflation. Beyond the question of "If?" is also the question of "When?" It feels as if a valid case could be made for any scenario currently, and that doesn't even speak to potential shocks down the road. In the end, our stance is simple: we continue to focus on the information that we can know and disregard the rest. In our opinion, it's better to avoid the vague and ambiguous information that leads to stock picking. And when attempting to predict the potentiality of inflation, and thereby the Fed's actions in response, all we see is vague and ambiguous information. As we look at the various scenarios *for* and *against* inflation above, our opinion becomes obvious: we don't know. And we'll admit that. We'd rather avoid the losers than try to gamble on the winners. Over the long term, we believe that will lead to a new source of alpha that doesn't hinge on reading the tea leaves of the many faces of inflation.

The State Of The Stock Market According To The Human Factor

By applying an actuarial-based approach to asset management similar to that used by the insurance industry, New Age Alpha has developed a proprietary risk metric called the Human Factor. We use it to calculate the probability a company will fail to deliver the growth implied by its stock price. As of September 30, 2021, the median Human Factor of all companies in the S&P 500® was 37.8%. As a result, we believe that many opportunities remain in the market by simply avoiding the losers with the highest Human Factor. The critical component? One's investment horizon.

In our opinion, one of the most important qualities of an investor (as opposed to a gambler) is patience. If a person is gambling, he or she is hoping for a quick payoff while rarely knowing the odds or, importantly, the risks involved. Investing is much different. Proper investment requires patience and a structured plan regarding the risks involved even if such a staid approach doesn't make headline news.

At New Age Alpha, we have the historical data to show that our methodology works approximately 65% of the time. It's time-tested and built on actuarial processes that have evolved over centuries in the insurance industry. By avoiding the losers, we know that—over time—we can generate outperformance. Other portfolio managers pick a group of stocks and gamble that at least a few companies will provide enough outperformance to balance out all the other losing stocks. But that's not a plan. It's a roll of the dice. And it's almost impossible to replicate consistently.

When we look out at the events so far this year, we can't help but notice the vital importance of a plan when investing. The retail crowd isn't going anywhere...neither are hedge funds like Archegos and their absurd amounts of leverage. And who knows when, much less if, inflation will rear its ugly head. The risk of human behavior in the market is endemic and only exacerbated by market events suddenly splashed across the nightly news.

A better plan is needed. Below, we present ten years of performance for New Age Alpha's Core Indexes in the US relative to their respective benchmarks. (More information can be found here) The preponderance of green coloration speaks to their outperformance. But that belies the most important aspect of the offerings. By using an actuarial-based approach to focus solely on known information and not vague and ambiguous information, our Indexes avoided those securities most impacted by human behavior bias over the long term. In the process, we created a differentiated source of return that can be used to complement any of the major benchmarks or investment universes in a consistent, long-term manner.

	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011
U.S. Large-Cap Leading 50 Index (TR)	22.84%	37.81%	2.25%	30.76%	14.02%	10.41%	18.14%	31.21%	21.04%	6.44%
S&P 500	18.40%	31.49%	-4.38%	21.83%	11.96%	1.38%	13.69%	32.39%	**16.00%**	2.11%
U.S. Small-Cap Leading Index	12.49%	27.30%	-8.66%	16.97%	28.69%	-2.31%	9.57%	44.15%	18.85%	4.10%
S&P 600	11.29%	22.78%	-8.48%	13.23%	26.56%	-1.97%	5.76%	41.31%	**16.33%**	1.02%

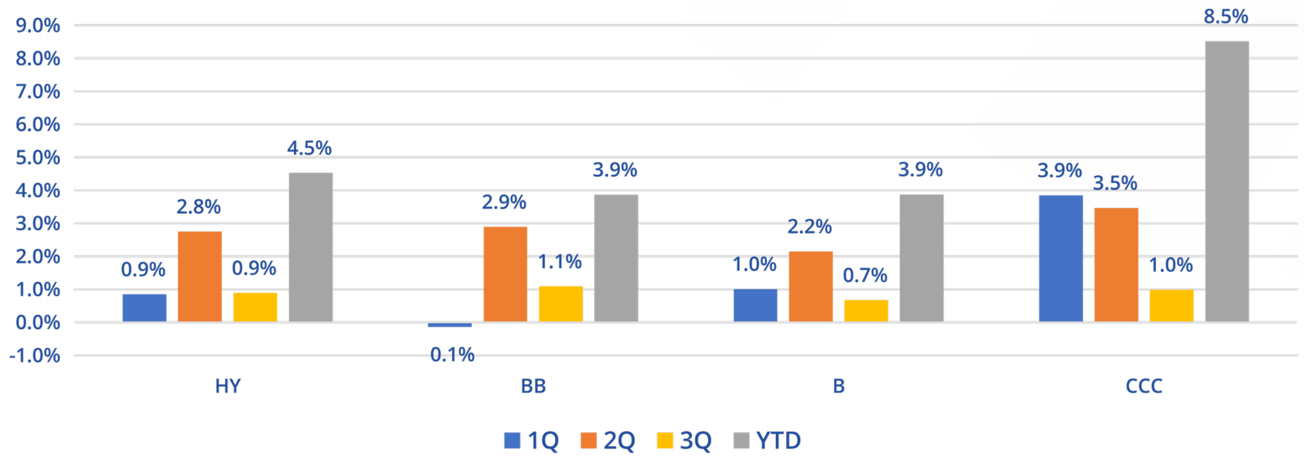
Table Key	
	> 100 bps outperformance
	0-100 bps underperformance
	> 100 bps underperformance

Source: New Age Alpha, S&P 10/1/21

Thoughts On The Fixed Income Market

The Bloomberg Barclays US Corporate High Yield Bond Index was up 4.53% through the first three quarters of 2021. The third quarter showed consistent performance across ratings, and the market remains very compressed from a historical perspective. On a YTD basis, we can see CCC's strongly outperforming the other ratings classes at 8.52%. BBs and Bs returned 3.87% and 3.88% YTD, respectively.

Quarterly 2021 Returns by Rating



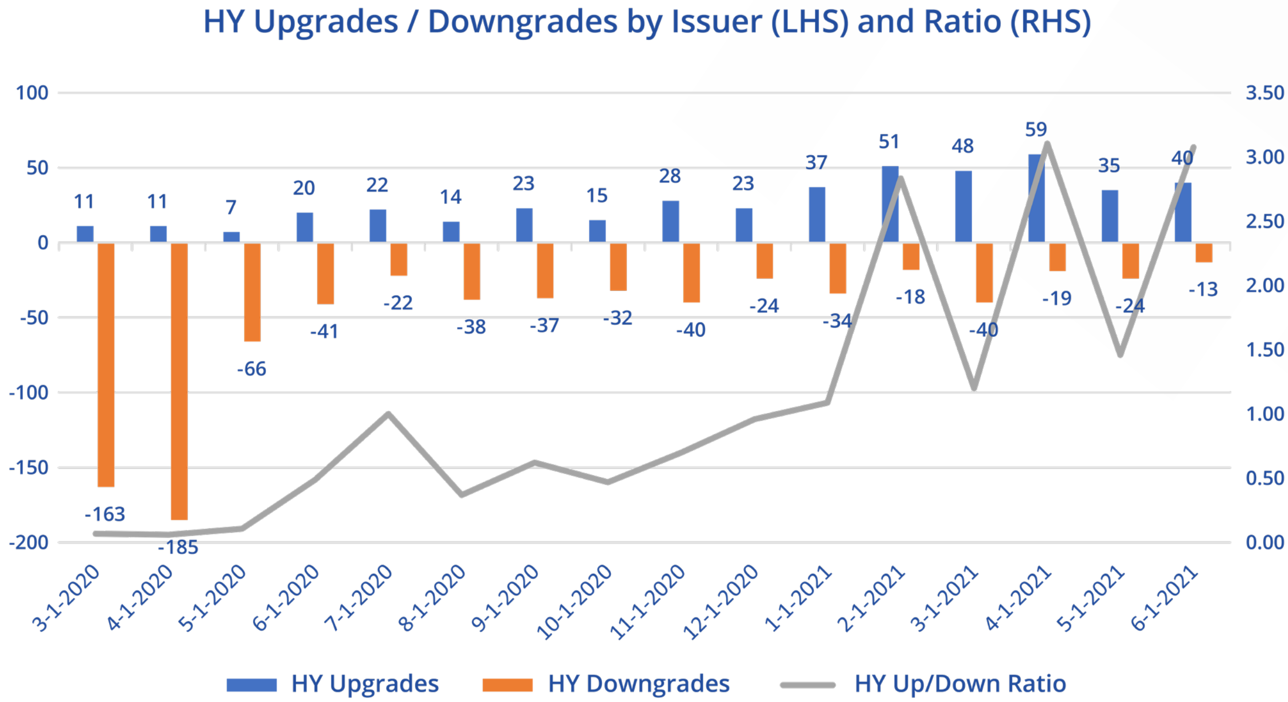
Source: New Age Alpha, Bloomberg, LP as of 9/30/21

The strong performance of High Yield corporate credit has pushed the market into uncharted yield territory. Specifically, option-adjusted spreads reached levels not seen since 2006, though we've seen some widening since the July lows. The outperformance of triple-Cs also led to record compression with spreads between double-Bs and triple Cs reaching levels not seen since before the financial crisis in the second quarter. Tight spreads leave less room for upside from improving fundamentals and less compensation for risks looming in the economy.

Compression of Ba - Caa Spread Historically

Source: New Age Alpha, Bloomberg L.P. as of 9/30/21

Recent inflation concerns have pushed yields slightly higher, but a general risk-on attitude and a search for yield that got us to these levels continue to define markets. The fundamental backdrop also remains strong with revenue and cash flow numbers helping leverage. One way to track the changing fundamentals is the ratio of credit ratings upgrades to downgrades. As shown in the graph below the number of ratings upgrades has exceeded the number of downgrades every month in 2021, this is quite an improvement from the pandemic challenged 2020.



Source: JP Morgan, Bloomberg, LP as of 6/1/21

At the same time, the overall leveraged credit market continues to grow and evolve. We continue to see many new issuers in the market. The number of bond issuers in the market is at a five-year high, though still short of the 1999 peak. The number of loan-only issuers still exceeds the number of bond issuers, which has been the case since 2018.

Year to date, HY issuance has included 2 of the 3 most active months on record. HY issuance totaled $395bn, or $141bn ex-refinancing. This compares to a 2020 all-time high of $450bn of total issuance and a 2013 high of $175bn of issuance ex-refinancing. With continued positive flows driven by the search for yield, issuance was easily absorbed. There is a record number of currently callable bonds in the market as well as an expected increase in debt-financed M&A, two factors that should keep issuance elevated.

Our overall outlook is cautious. The market consensus appears to be that default risk is extremely low in the next 12-24 months and that flows will remain positive. This optimistic scenario is fully priced in at current, largely unprecedented levels. This translates into high Human Factor risk and we believe the focus on downside protection will pay off for investors in the coming quarters. In this compressed environment, investors are simply not getting paid to take additional credit risk. With a new COVID-19 variant, lofty growth expectations, geopolitical risks and inflation risks looming, issuer selection and avoiding the losers is the key to generating alpha.

Conclusion

The stock market is a constantly evolving organism. How many times has the phrase, “It’s different this time” been uttered on the cusp of another correction? It’s practically a contrarian signal unto itself. But apart from the major corrections or 2008, 2000, etc., there are also lesser changes that nonetheless result in gains or losses. Think of the “Taper Tantrum,” or the collapse of LongTerm Capital. Both of these caused ripples in the financial universe that continue to be felt. The rise of the retail investor—via newfound investment access and the democratization of information—is no exception. It’s the very nature of the market to grow and evolve. One constant, however, is speculation. There will always be gamblers who think they’ve found a new way to pick winners that no one else has discovered. And yet, invariably, those same people have trouble replicating their initial success.

At New Age Alpha, we won’t try to predict the next investment fad or guess when inflation might show its face. We’ll leave that to the stock pickers. We’d rather rely on proven actuarial-based probabilities and simply avoid the losers.

About Us

New Age Alpha is ushering in a new age of asset management by applying an actuarial-based approach to investment portfolios. Utilizing these principles built by the insurance industry, we construct portfolio solutions, indexes, and tools that aim to identify and avoid a mispricing risk caused by investor behavior. Embedding well-established principles of probability theory in our investment methodology, we construct solutions that aim to avoid overpriced stocks in a portfolio—losers. We combine the alpha potential of active management with the advantages of rules-based investing to build differentiated equity, fixed income and ESG-themed portfolios that drive long-term outperformance.

Disclosures

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