



PERSPECTIVE

with Jeff Sarti

DIVERSIFICATION TO COMBAT UNCERTAINTY

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mortonwealth

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Another holiday season is in the books. Hopefully everyone enjoyed time with their families, celebrating holiday traditions. And let's not forget the age-old tradition of making predictions about the stock market for the coming year. As is typical come January, we are flooded with articles regarding which stock will perform the best in 2024, how much the S&P 500 will rise and where inflation and interest rates will end up.

I am regularly approached by periodicals to make similar predictions. However, if you read my latest Perspective letter on uncertainty, you are probably not surprised that I politely decline such invitations. After all, predictions are futile.

But if I had to make one prediction for 2024, it's that uncertainty is more elevated and may increase from here. Inflation, interest rates, Israel/Gaza, Ukraine/Russia, China/Taiwan. These are not minor issues but rather major tipping points that can change the outlook for the global economy in a heartbeat. Oh, and I didn't even mention the 2024 election. Fun times ahead! Harkening back to my previous letter,

do we try to outsmart this uncertain future and catch the perfect wave, or do we ditch the surfboard altogether and build a bigger, more resilient boat? Seems like a simple choice to me. At Morton Wealth, we talk a lot about building resilient portfolios, but what precisely do we mean by “resilient”?

Maybe the simplest approach is to start with what’s NOT resilient. Traditional stocks and bonds are, of course, a core part of crafting a diversified portfolio. But as you are well aware, we strongly believe that these traditional assets are not designed to be as resilient as many other strategies and should therefore make up smaller percentages of a portfolio than most others would recommend. Starting with stocks, they are a wonderful way to get exposure to global growth and diversify across various sectors of the economy. But in looking at the various geopolitical and financial risks I list above, are stocks immune or exposed to such risks? Stocks are not a mitigant to uncertainty but instead exacerbate your exposure to these negative events. This is a key reason why we believe the standard stock allocation of 50-80% of a portfolio is way too high; we instead typically target allocations in the 10-40% range.

How about bonds, the go-to safe haven asset in times of uncertainty? Bonds should hold up better than stocks in challenging economic environments.

But higher inflationary periods can be disastrous for bonds as the 1970s clearly showed. In fact, in 2022, the broad-based bond index was down a whopping 13%. So much for being a resilient asset class.

When we look for resiliency, we look for asset types that we believe can meet their targeted return objectives across a wider range of economic outcomes as opposed to being overly dependent on just a rosy economic scenario. In other words, these asset class returns have drivers beyond just a strengthening economy. This may sound pie in the sky but there are numerous examples: short-term loans on real estate where you own the keys to the property if the loan defaults, short-term loans to corporations based on their assets (think inventory, machinery, equipment), and royalty streams (percentage of sales) on FDA-approved pharmaceutical drugs targeting life-saving treatments to combat critical illnesses, to name a few. Beyond having a diverse set of drivers behind these strategies, another critical component that makes these resilient is that they have back-up plans if something goes wrong. The back-up plan often takes the form of tangible assets backing the loan, or major controls in place to allow lenders to protect themselves if things go sideways.



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Let's dive deeper into another example that illustrates resiliency: equipment leasing. Most of us have likely leased a car at some point in our lives because it's easier to handle the monthly payment than come up with a big chunk of cash up front. An important factor that impacts your monthly payment is the residual value, or the estimated value that the car will be worth at the end of the lease. The car company estimates the residual value at the end of the three years, tacks on an interest rate or profit, and then calculates your monthly payment. At the end of the three-year term, the car company takes back the car and can hopefully resell the vehicle for more than this residual value. If the economy falls into a recession, the car company may be left holding an asset that is worth less than this residual value, thereby taking a financial loss.

Similarly, companies often choose to lease, as opposed to purchase, equipment they need

to operate their businesses. For example, a company in the agricultural industry may decide to lease a fleet of tractors to run its operation.

Typical equipment leases also have three-year terms, similar to the car example above. The key difference is that the equipment lease will assume zero residual value when calculating the lease payments. The result is that the loan de-risks quickly as you, the lender, receive larger principal payments on a monthly basis. Within a short 18 months, you will receive half of your principal back. After 36 months, full amortization has occurred, and you will have received 100% of the cost of purchasing the equipment as well as profits for making the loan (with annual interest rates in the double digits in the current interest-rate environment).

HOW EQUIPMENT LEASING WORKS



Think about the resiliency of this investment. Given the accelerated payback of principal on a monthly basis, you have received back a large portion of your loan and de-risked your position in a very short timeframe. If the farming company runs into trouble and defaults on its lease, after, let's say, two years, the lender has already received the majority of the principal back and still retains ownership of the tractors. The tractors are still relatively new and can either be re-leased or sold to more than recoup the original investment. This is very different than the car lease where the car company is hopeful that it can sell or re-lease the car at more than its residual value after the three-year lease term ends. Hope is not an investment strategy, and we investors should find tremendous comfort with equipment leases where we are paid large principal payments along the way, thereby quickly de-risking our investment.

The point of this illustration is to show the types of investments that we absolutely geek out on! As a starting point, these niche investments earn higher interest rates than you can earn in the public bond markets. If the world hums along in a healthy fashion, equipment leases such as this should perform well. But more importantly, our obsession is to think through what happens on the downside, if events don't go as planned. If uncertainty rises, or a recession takes hold, we want resilient investments with back-up plans in your portfolio; investments that will still pencil out, no matter who wins the presidential election, what happens to inflation or interest rates, or what geopolitical conflicts may arise. A bigger, more resilient boat indeed!

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DISCLOSURES





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