NEWSLETTER
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thehealthyskeptic.
with Jeff Sarti

WHEN HEADLINES GET LOUD, PRINCIPLES MATTER MORE

Dive into what's inside

- Why tuning out today's contradictory headlines is the smarter move for long-term investors.
- The three enduring investment tenets that guide our portfolios.
- Why stocks sitting at all-time highs and consumer sentiment sitting at 74-year lows can both be true at once, and what it means for your investments.

In tribute to the late Rob Reiner and Spinal Tap, the sound flooding our world has officially "gone to 11."

TODAY'S INVESTMENT WORLD IS LOUD

Investors are constantly bombarded with headlines and social media clips promising them instant riches or warning of impending calamity.

In a recent letter, I highlighted one of the key principles of being a Healthy Skeptic: the need to tune out the short-term noise. But how can investors ignore this level of bombardment? In tribute to the late Rob Reiner and Spinal Tap, the sound flooding our world has officially "gone to 11."

Furthermore, if the noise was at least harmonious, we could lean into the music and try to sing along. But instead, the noise in the current news cycle is a disjointed and jarring mess with clarinets colliding with out-of-sync trombones and crashing cymbals. Up is down and left is right, making it challenging to lean in a certain direction, especially as it relates to investment positioning.

The punchline of this edition of *The Healthy Skeptic* is that at times like these it is essential to ignore the noise and go back to the basics of sound investment principles. Before I lay out the investment tenets that are our North Star to keep us grounded and moving along our intended path, I feel it's important to illustrate the schizophrenic nature of the soundbites cascading from your daily news feed.

AI

Let's start with AI, a technology that is already transformative, but where future uncertainty abounds. OpenAI vs. Anthropic, Elon Musk vs. Sam Altman, pick your side. Even more of a conundrum is the debate of whether the positives of enhanced corporate productivity will be outweighed by the negatives of job displacement (massive job layoffs are already being announced).

> Not long ago, graduating with a computer science degree practically guaranteed lucrative job opportunities. Now, even getting a callback from a prospective employer may feel impossible.

From an investment point of view, the stock market is tilting much more towards the "pro" side of the argument as opposed to the "con." Anything tied to AI, whether semiconductors/chip stocks, like Intel or Micron, or the hyperscalers like Microsoft or Google, are rallying upwards. But many are rightfully questioning the scale of this AI buildout since hundreds of billions of dollars are being spent on data centers without a line of sight on revenue to justify these massive outlays. So much noise! As investors, should you overweight this sector of the market because the trend is too powerful to ignore, or are valuations already at extreme levels where "bubble-like" behavior is rising to the surface?

GEOPOLITICAL RISK

How about the noise tied to geopolitical risk, specifically with the current conflict in Iran? Love him or hate him, President Trump adds to the clatter with his countless social media posts that shift from optimism of a peaceful outcome on Tuesday to heightened aggressive rhetoric on Wednesday. With the closure of the Strait of Hormuz, the price of oil rose precipitously, although it has since retreated and is still in manageable territory. However, continued conflict and closure of the strait has the potential to push oil prices to levels that can meaningfully damage the global economy. Yet again, the short-term news lends to a schizophrenic stock market reaction. At the onset of the conflict, stocks swooned. However, within a few short weeks, stocks rallied violently and are now trading near all-time highs. Which side to pick?

STOCK MARKET AND CONSUMER SENTIMENT

One last example of the tension between positive versus negative news is the diverging signals conveyed by the stock market and consumer sentiment. Stocks continue their relentless march upwards and currently trade at heightened valuations on par with the peaks of the dot-com bubble of the late 1990s.

> The IPO market is blistering with companies like SpaceX and OpenAI, garnering valuations on par with the largest companies in the world. Euphoric noise to say the least!

On the other hand, in the 74-year history of the University of Michigan's Index of Consumer Sentiment, we have never reached such lows in terms of the average American's outlook for our country. Think about that: current sentiment is even more negative than during the Vietnam War, the 2008 financial crisis or the Covid lockdowns. Which side of the fence are you on: applauding the stock market at all-time highs or despondently putting your head in your hands about the future of our country?

MORTON'S CORE INVESTMENT TENETS

As I'm wrestling with these same news headlines and, correspondingly, how to position client portfolios, there's nothing like time away from the office to remove myself from the short-term noise and clear my head. It wasn't a vacation per se, but a work trip with our CIO, Meghan Pinchuk. We did an East Coast swing where we met with a half dozen potential investment groups.

Meeting with these prospective investment managers reawakened my passion around our core investment tenets. We were evaluating opportunities like lending to healthcare companies in the oncology space or providing capital to government-backed projects in the energy and clean water sectors. Short-term news stories about the latest IPO or update on the Iran crisis were irrelevant to our evaluation of these opportunities. Instead, our research focused on our three core, long-term tenets that rise above the short-term noise.

1

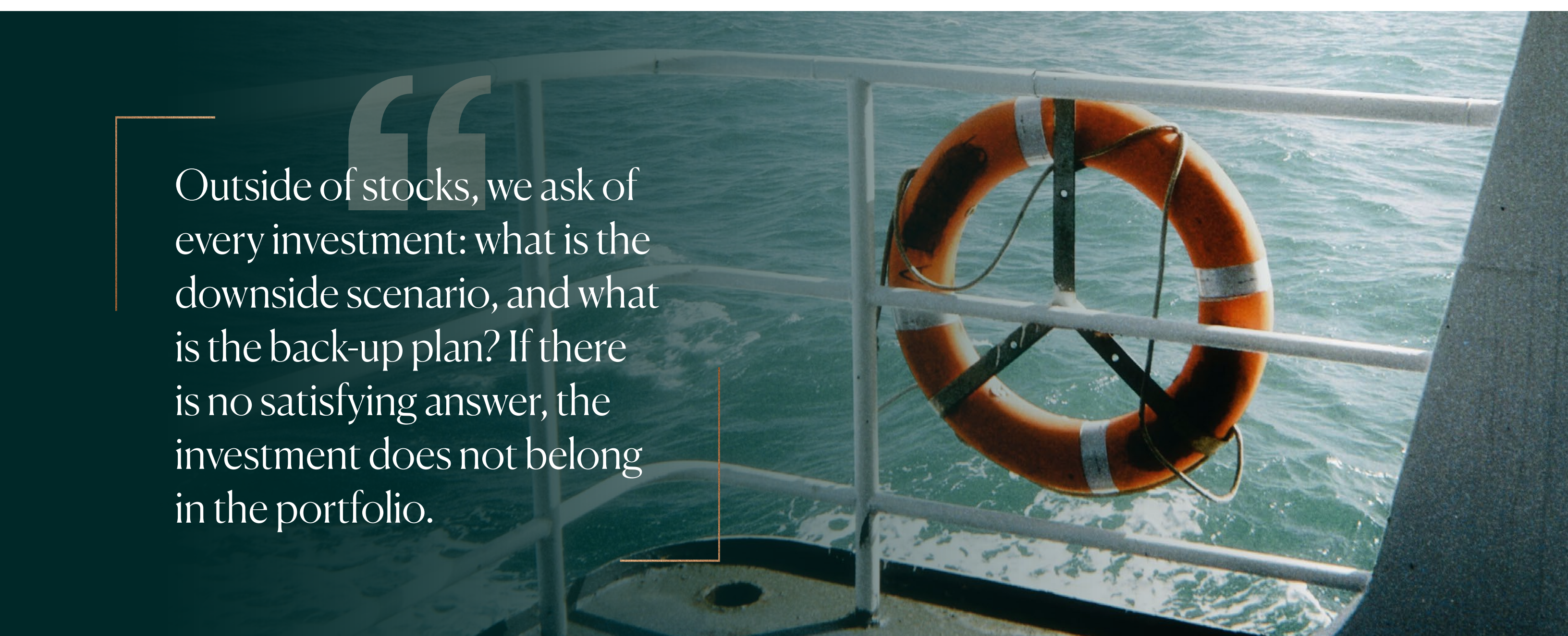
BUILD PORTFOLIOS FOR RESILIENCE, NOT PREDICTION

Most investment firms showcase their prediction acumen. As a result, instead of tuning out the short-term noise, they lean into it. After all, they have to make a "bet" on certain outcomes such as will this IPO outperform, who will be the winners and losers in the AI race, or what will happen to oil prices given the conflict in the Middle East. The goal is to have an opinion and a story and to express them with confidence.

As I wrote in this previous edition of *The Healthy Skeptic*, this is wasted energy. Studies show that this is essentially "coin-flip" investing, a 50/50 bet. Instead, at Morton Wealth, we lean into the uncertainty and acknowledge that prediction is a fool's errand. With all of this freed up time (since we are not forecasting), we can focus our energies on building investment portfolios that are designed to be resilient, no matter the outcomes of the various news stories with which we are bombarded.

In practice, this means:

- We prioritize investments that are designed to meet their return objectives across a wide range of economic outcomes, not just in a healthy economy. Loans backed by hard assets and/or to companies in "necessity-based" industries such as the food or healthcare industry don't care much about the latest winners and losers in the AI race or whether or not we sign a peace treaty with Iran.
- We include stocks in portfolios as one of many asset classes as opposed to treating them as the main event. In today's environment, our target stock allocations are typically in the 10-40% range rather than the industry standard of 50-80%. There is a place for stocks in portfolios. But especially in the current environment, with heightened valuations, stocks exacerbate exposure to uncertainty rather than mitigate it.
- Outside of stocks, we ask of every investment: what is the downside scenario, and what is the back-up plan? If there is no satisfying answer, the investment does not belong in the portfolio. We understand that things may go wrong, but if and when they do, we want to limit losses as much as possible.
- We favor strategies with tangible collateral, accelerated principal payback, or structural protections that should reduce risk over time.
- Traditional bonds play a role in portfolios, but similar to the comment above about stocks, they represent a much smaller piece of portfolios as compared to most in the industry. We find value in certain traditional bonds for the liquidity they can provide. But the dogma of our industry that traditional bonds are the "safe haven" of the portfolio is wrong! In the last few years, we have entered a new regime, with more volatility tied to higher interest rates and inflation. In 2022, the Bloomberg US Aggregate Bond Index, a broad-based index, fell 13%, far from being a safe haven.
- Gold is a core allocation in portfolios and serves a distinct role as a store of value and insurance against dollar debasement and government debt imbalances. Gold cannot be printed, while new dollars are created every day. Gold's role in the portfolio is as a store of value to mitigate these risks.



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2

DIVERSIFY WHERE IT ACTUALLY COUNTS

The investment industry preaches the benefits of diversification. “Don’t put all of your eggs in one basket” is an adage we all embrace. Yet despite this lip service, I find it massively frustrating that our industry is still stuck in the Stone Age when it comes to truly diversifying and protecting portfolios. It is our mission at Morton Wealth to rise above these inadequacies.

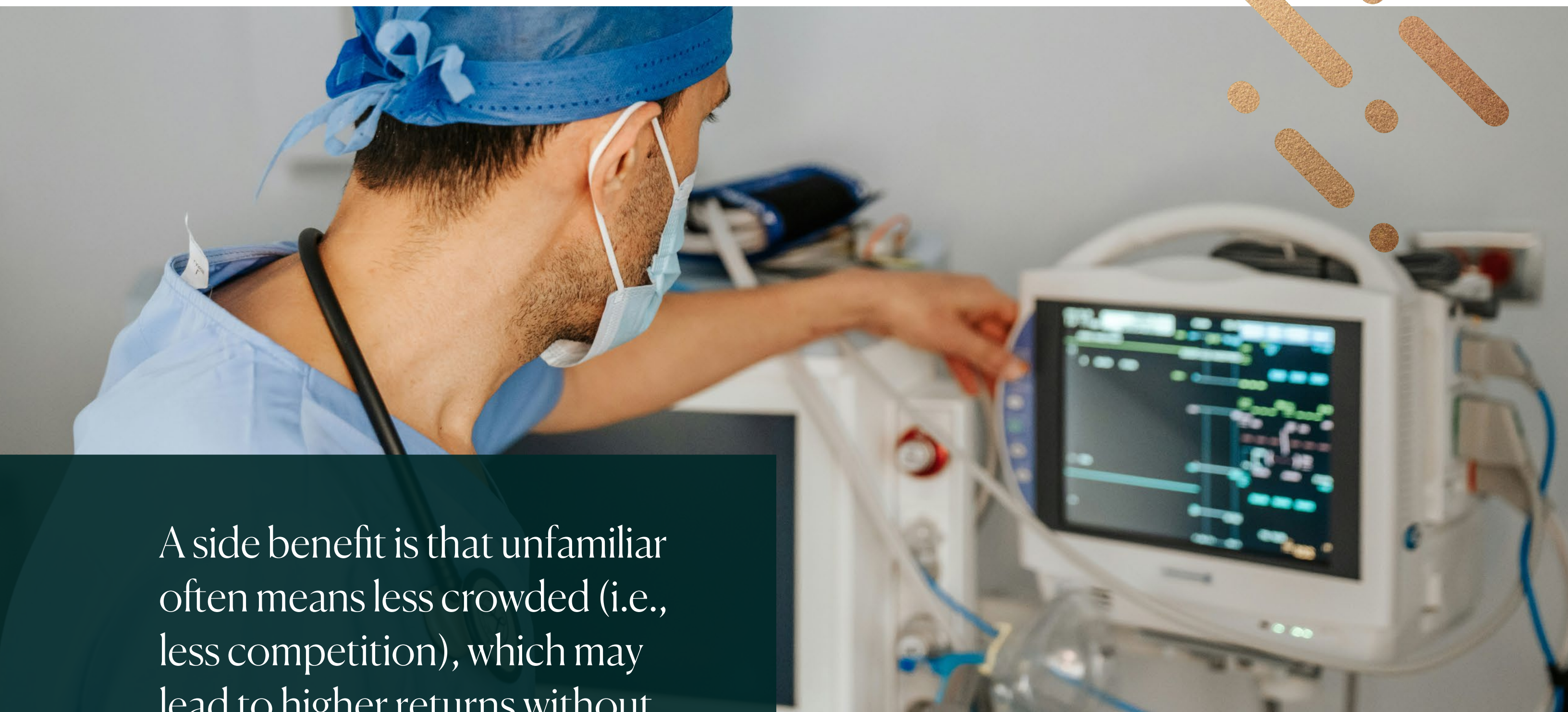
The “modern” theories of diversification were developed at the University of Chicago in the 1950s. While groundbreaking at the time, these theories have not evolved with the changing investment landscape. In a nutshell, those dated theories profess that a diversified portfolio of traditional stocks and bonds can create “efficient” portfolios where sufficient returns can be generated with the least amount of risk. Well, times have changed. We now live in a much smaller world than in the 1950s. Today, stocks and bonds, even those of different shapes, sizes and flavors, may move in lockstep more than ever before. Think of the global financial crisis of 2008: no matter how many stocks you owned in different industries, diversified across the globe, they all cascaded downward together. Think about 2022, when interest rates rose for the first time in over a decade and stocks and bonds all cratered together.

This isn’t rocket science. It just takes experience, discipline, and courage to challenge stale, academic dogma and veer away from the herd to bring in other pieces of the portfolio “pie” beyond stocks and bonds.

In practice, this means:

- True diversification is not simply owning more stocks. It means owning investments designed to behave differently from one another across a variety of economic environments. Stocks in particular are predominantly exposed to economic growth on both the upside and downside. To actually create diversified portfolios, it is crucial to mix in investments that are not as susceptible to economic growth and will perform as expected even in challenging economic conditions. This doesn’t mean you avoid risk! Counterintuitively, this approach to diversification means you are actually seeking risks that bring in new components to the portfolio that are exposed to different risk factors that should “zig” when your stocks and bonds “zag.”

- We lean into the unfamiliar when looking to enhance diversification. Most investors traffic in the same areas and chase the same trends. Searching in unfamiliar places is where truly different, diversifying investments can be found.



> A side benefit is that unfamiliar often means less crowded (i.e., less competition), which may lead to higher returns without necessarily taking on more risk.

- On the flip side, we shun investments whose value is driven primarily by trend, social media, or momentum. Trends that are crowded and devoid of substance are often overpriced and not built to last.
- We embrace illiquidity in client portfolios. No investor needs to keep 100% of their portfolio liquid, and if they do need such ready access to their funds, they likely should not be invested at all. Illiquidity opens up a whole new world of opportunities, including investments in real estate, loans on various types of collateral, royalty streams, and many others. Illiquidity also has a key feature of reinforcing disciplined, long-term investor behavior. As I opened in this letter, tuning out short-term noise is paramount. Nothing is better at helping investors do just that than knowing that you are in investments that are designed to be long-term in nature that can't be traded daily. A private loan backed by a piece of real estate will not have a ticker symbol flashing red on CNBC, tempting you to buy or sell.
- Most investors solely focus on "financial" assets, such as stocks, which are bets on the future, and avoid "real" assets, which have inherent value in the present. We, of course, embrace investments in financial assets and stocks, as well. But "real" investments, backed by tangible assets, whose values are more designed to have staying power, should be core parts of portfolios. Similarly, we target exposure to necessity-based industries such as healthcare and the food industry. Most traditional investors overlook these sectors because they are boring and not part of the latest fad. We ask the question of whether these investments can help diversify and protect portfolios in a range of different environments. That is an easy "yes" for us.

3

GENERATE INCOME

We love cash flow! We love it both as it relates to how we evaluate and monitor the investments we target but also for the income that flows through to you as an investor.

When evaluating investments, the ability to generate consistent income is a great barometer of an investment's health. Price appreciation and "paper" gains are nice and welcome. But distributions of cash flow are as real as it gets when illustrating the success of an investment. Imagine running a hair salon, dental practice or software company. What do you look at with each passing year when evaluating the success of the business? Is it the appraised value of your business (assuming you even waste your time getting annual appraisals) or is it how much your income is growing with each passing year? The answer is pretty obvious to us.

Beyond its function as a barometer, many of you, our clients, look to us to generate consistent income in your portfolios. The purpose of your nest egg is to empower you to live the life you want, and income generated from your portfolio gives you tremendous flexibility (and even hopefully the ability to splurge too). You can choose to reinvest the income into other investments and compound the growth of your portfolio, build a cash bucket for emergencies and/or immediate spending needs, or replace your salary and income in retirement.

In practice, this means:

- Income generation is a structural portfolio objective, not a secondary consideration. As a result, income-producing investments represent meaningful parts of client portfolios. As an extension of our diversification theme, we also seek out a variety of different asset classes to produce this consistent cash flow.

> We don't want you to just have one "salary" but instead a handful of different cash flow components, so that if one falters, the others can pick up the slack.

- We apply our experience navigating alternative investments to find niche opportunities that generate higher levels of income outside of traditional bonds. The 2008 financial crisis warped interest rate policy, not just here in the United States, but around the globe. Zero percent interest rates forced investors to shun income-producing investments and lean further into stocks to generate satisfactory returns. In other words, most investors were forced up the risk spectrum. At Morton Wealth, we believe we have found different solutions in higher yielding alternative investments, and this area continues to be a key focus of ours given its attractive risk/reward attributes.

- We target income-generating investments that have structural protections in place designed to protect that income. These protections may include tangible collateral or accelerated principal payback/amortization. Most investors target income-producing investments that depend on economic conditions remaining favorable. We prefer to have a back-up plan if the economy takes a turn for the worse.

Should we invest heavily in liquid bonds with paltry yields, inadequate protections and meaningful interest-rate risk because that's Wall Street's playbook? Or should we embrace illiquidity and build in better protections with the goal of generating higher levels of income to support your goals? Come on now!

Safety in numbers is incompatible with who we are. We do not embrace looking different from our competitors just for the sake of being different. Trust us when we say that if we lived in a world where stocks were cheap and traditional bonds could generate high levels of safe income, then those asset classes would get larger allocations in our portfolios.

CONCLUSION

These three investment tenets have been honed over the last 40+ years at Morton Wealth. They are our North Star when we construct portfolios and seek new investment opportunities. But a key question is why do we take such a different approach to most in our industry? The answer is simple: we will do whatever it takes if it means a better outcome for you, our clients.

Should we lean into the short-term noise and chase trends by making fruitless predictions like the rest of our industry? Or should we tune out the noise and embrace resiliency and sound long-term investment principles? Easy answer for us!

Should we be complacent and rigidly adhere to stagnant academic dogma surrounding diversification principles because that's what everyone else does? Or should we search for untapped opportunities that can truly diversify and protect portfolios? No-brainer!

But that is not the world we live in. We must deal with the cards that we have been dealt and that means we must look far and wide to find investments that meet the three investment tenets that we hold dear. We are more than up for the challenge.

DISCLOSURE

Information presented herein is for educational purposes only is not intended as investment advice. References to specific investments are for illustrative purposes only and should not be interpreted as recommendations to purchase or sell such securities. You should consult with your financial advisor to thoroughly review all information before implementing any transactions and/or strategies concerning your finances.

Reference to “stocks” generally throughout this presentation refers to the S&P 500 Index, which is widely regarded as the best single gauge of the U.S. equities market. indexes are unmanaged, and an investment cannot be made directly in an index.

Many factors affect performance including changes in market conditions and interest rates, and changes in response to other economic, political, or financial developments. There is no guarantee that your investment objective will be achieved, and Morton Wealth makes no representations as to the actual composition or performance of any security. Morton Wealth makes no representation that the strategies described are suitable or appropriate for any person.

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