

Wait – You Bought What?!?!?

“Risk comes from not knowing what you’re doing.”

- Warren Buffett

Imagine reading about a new space transportation company that was poised to deliver satellites into orbit. The company claimed its technology was a real game changer, and already had contracts lined up with NASA and major aerospace and defense companies. Having done a little digging, you decide to invest some of your hard earned money into the company.

Now, imagine that after the company goes public and its stock starts trading on the NYSE, you come to find out that the game-changing technology actually failed to deliver on its promises. And that the company had lost track of a satellite in space. And that the company’s founder was deemed a national security risk by the US government, had his work visa revoked and his request for permanent resident status denied.

Your first reaction would probably be one of shock and dismay – “how could the SEC allow such a sham to get listed on the stock exchange?” Then you’d probably call your financial advisor and ask how they could let you buy such a stock.

Well, it turns out that this hypothetical situation almost played out in real life – in 2021 – but not exactly how it was laid out above. Instead of the company (Momentus, Inc.) going public via an initial public offering (IPO) it nearly got listed via a special purpose acquisition company, or SPAC.

SPACs are commonly referred to as blank-check companies that hold nothing but cash. The purpose of a SPAC is to buy private companies and take them public, while avoiding the hassles of a traditional IPO. There are three basic phases in the life of a SPAC – fundraising & listing, deal hunting, and post-merger.

During the fundraising and listing phase, the SPAC entices investors to purchase shares in their blank-check company. The SPAC’s sponsors – usually big name backers from the world of finance and popular culture – help drive interest in the endeavor. Often

these sponsors will announce a specific industry target for their search. Once the entity hits its capital goals, it goes public. Generally speaking, SPAC shares at this point trade right around their \$10 listing price since there's nothing behind those stocks but cash.

Once the SPAC goes public, then it's time to find a business to buy. Once a SPAC merges with a private company, the shares will change to reflect the newly acquired entity and trade according to the fortunes of the underlying business. If the SPAC can't find any targets within two years, then the shareholders get their money back (plus a little interest).

Now, there's nothing *inherently wrong* with SPACs. However, from our point of view it's difficult to imagine investing in something that you don't even know what it is. Momentus, Inc is a perfect example of what the risks are associated with a SPAC. In a traditional IPO, an investment bank would conduct thorough due diligence on the underlying company so that investors are at least armed with accurate information about the company and its prospects. In a SPAC, that due diligence process isn't nearly as robust. Also, while a SPAC may announce a target industry during its fundraising stage, it is not beholden to that pledge. So investors in SPACs have no idea what they are investing in, other than the expertise of those leading the charge.

At First Financial Wealth Management, we prefer to know what we own. Whether that may be individual equities or well-established mutual funds, we perform our own due diligence on the securities in our client portfolios. Along with flexibility and diversification, an emphasis on "quality" is one of the primary tenets of our investment philosophy. Knowing what we own should help us have a better understanding of how our client portfolios will behave in different market environments, allowing our clients to sleep better at night with the knowledge that investment professionals are keeping an eye on the money they worked so hard to earn.

Aside from not knowing what you're buying, another issue with SPACs is that there are just so darn many of them. Because there are so many SPACs being created, and each one only has a finite amount of time to get a deal done, competition for attractive targets

is heating up. More suitors means more bids and higher prices, which means higher valuations for SPAC investors.

Now, valuation isn't a great timing tool for calling market tops. Where valuation has a better track record is in predicting future long-term returns. The higher the price-earnings multiple of a stock when you start, the lower the future returns are likely to be. This makes sense when considering that investors are paying now for future growth. The greater the expectations for growth in the future, the higher the valuations today. If valuations are high, that means that expected earnings growth is likely pretty high, making it more difficult for businesses to outperform expectations. As Warren Buffett said, *"For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments."* The opposite is true for out of favor areas of a market – the cheaper the multiples, the lower the expectations and the easier it will be for those companies to exceed expectations.

One area of the stock market we see as overvalued continues to be the “growth” sectors. We've talked about how we see “value” taking market leadership from “growth” and how higher interest rates would impact growth stocks more than value.

Currently, what we own reflects our belief that the macroeconomic picture is one of rising growth, rising interest rates and rising inflation. This “reflationary” environment has historically benefitted cyclical “value” stocks which should lead the market higher from here, though with the potential for some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. We believe that, as we enter the second year of the current Bull market, earnings growth will be more important in driving returns rather than expansion in

valuation multiples. This just reinforces our position that cyclical “value” stocks should benefit more than expensive “growth” stocks.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we recently increased our exposure to “real assets” (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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Are not deposits	Are Not FDIC Insured	Have No Bank or Federal Government Guarantee	May Lose Value
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