Winning By Not Losing

A year ago, we wrote about Special Purpose Acquisition Companies, or SPACs, and how they were the hot new investment vehicle for investors who viewed themselves as being on the cutting edge. As a quick refresher, 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. 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. Once the entity hits its capital goals, it goes public. At this point, SPAC shares will typically 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 when you don't even know what you're buying. 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.

SPAC's rose to prominence leading into the pandemic and really took off in popularity once lockdowns took effect. Well, this all seems to be changing – see the recent headlines below:

Ackman's Record SPAC to Return Funds After Deal Hunt Fizzled

By Scott Deveau and Michael Hytha

(Bloomberg) -- Billionaire investor Bill Ackman told investors in the largest-ever blank-check company that it's returning their $4 billion after failing to consummate a merger deal.

Source: Bloomberg July 11, 2022

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FINANCE

Ackman to Close $4 Billion SPAC

The hedge-fund manager is winding up the largest-ever special-purpose acquisition company after failing to find a target.

By Julie Steinberg July 12, 2022 09:39 am ET

> *"... The vehicle had raised $4 billion in an initial public offering on the New York Stock Exchange in July 2020. A shell company that raises money from outside investors, a SPAC trades on a stock exchange and merges with a private company to take public. It typically has two years to do a deal or it must return the money to investors. The deadline for Mr. Ackman's SPAC is fast approaching.*
>
> ***Investors initially poured money into SPACs but hundreds are now facing looming deadlines to find deals amid a selloff in their share prices. Meanwhile, some companies that merged with SPACs are already warning they might go bust."***

Source: *The Wall Street Journal July 12, 2022*

With the "who knows what you're buying" SPAC boom seemingly winding down, there is news of a new "just because you can, doesn't mean you should" investment product – the single stock leveraged ETF.

Wall Street Set for New ETF Gold Rush as Single-Stock Era Begins

- New generation of funds to amplify, invert equity performance
- SEC warns on risks as day traders reel from market volatility

By Katie Greifeld and Elaine Chen

(Bloomberg) -- A new ETF-for-everything era may have just begun on Wall Street, swelling an industry that already boasts nearly 3,000 products and $6.2 trillion in assets.

The booming world of exchange-traded funds is about to get even more crowded after the very first single-equity ETFs launched Thursday -- despite a torrent of regulatory warnings over their risks while retail investors are still reeling from the crash in speculative trades from crypto to meme stocks.

Source: *Bloomberg July 16, 2022*

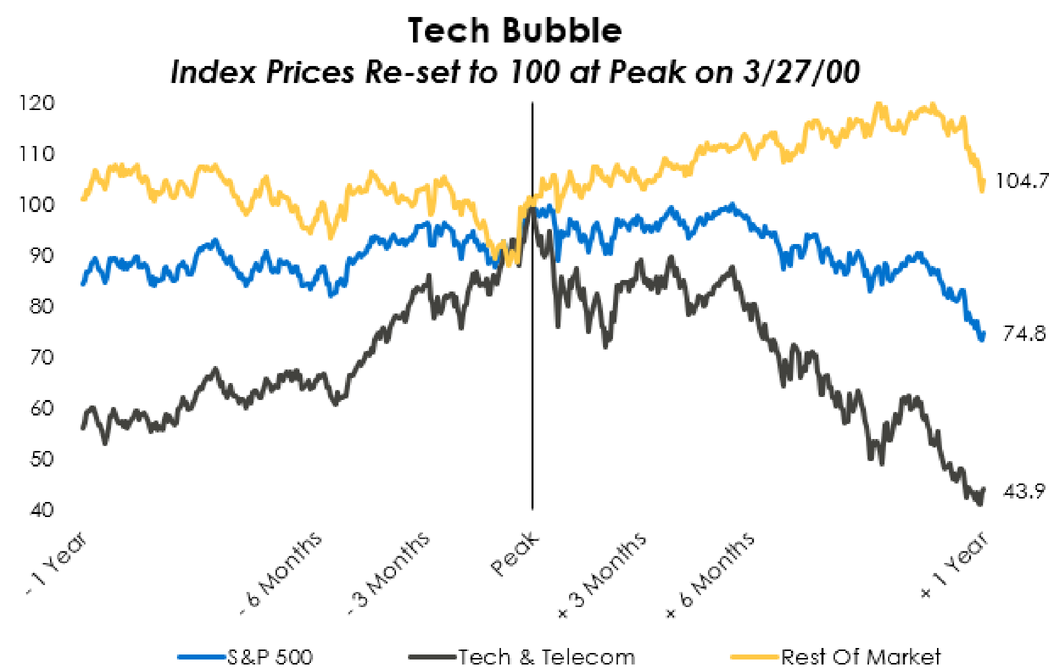
Outside of professional traders – and by that we mean those with a VERY short time horizon – we think there is little need for the potential volatility of a leveraged single-stock ETF. And while we are sure that the innovators

on Wall Street will profit handsomely on the creation and sale of these new securities, here at Yellow Cardinal we figure that we'll have no use for them in our client portfolios. We also 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.

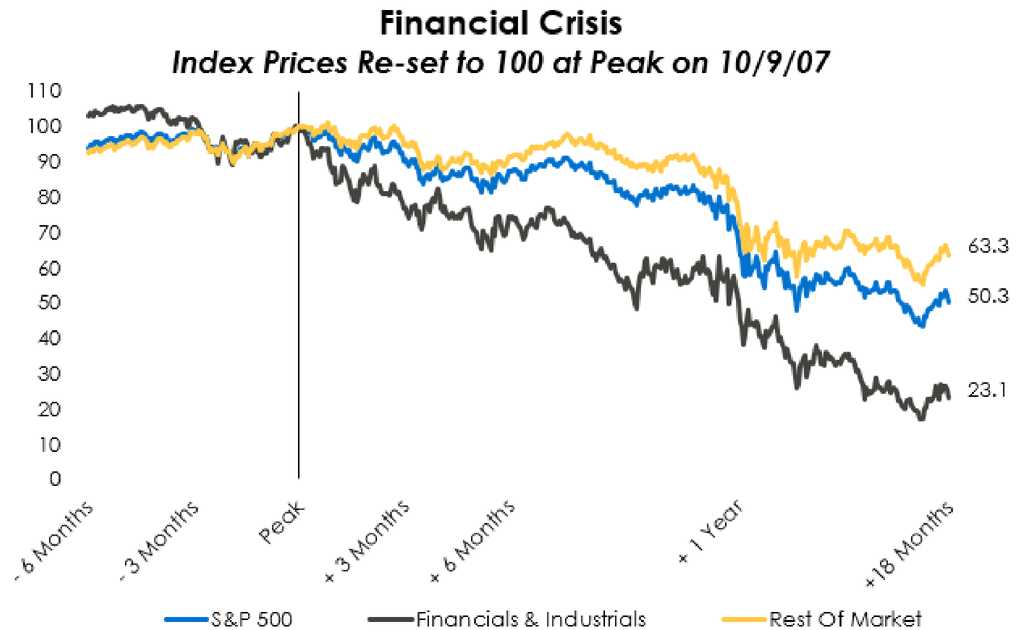
So far, the market environment in 2022 has not been a pleasant one. With interest rates rising and equity valuations heading lower, almost every asset class has experienced losses thus far (with the exception of Commodities). However, we have been able to provide some downside protection to our clients by actively trying to limit exposure to expensive, high growth parts of the equity market that were leadership for much of the previous two years.

Looking back, there are two prominent historical examples of how avoiding the "worst" parts of the market can provide some downside protection. The first example is the Tech Bubble of the late 1990s and early 2000s.

The chart at right illustrates the performance of the S&P 500 Index (blue line), just the Information Technology and Telecommunications sectors (black line) and then the rest of the market excluding Tech and Telecom (yellow line). In the months that followed the market peak, the performance of the Tech and Telecom sectors was abysmal. The active investors that avoided the "bubbly" parts of the market significantly outperformed their counterparts that chased returns in what had been the hottest parts of the market.



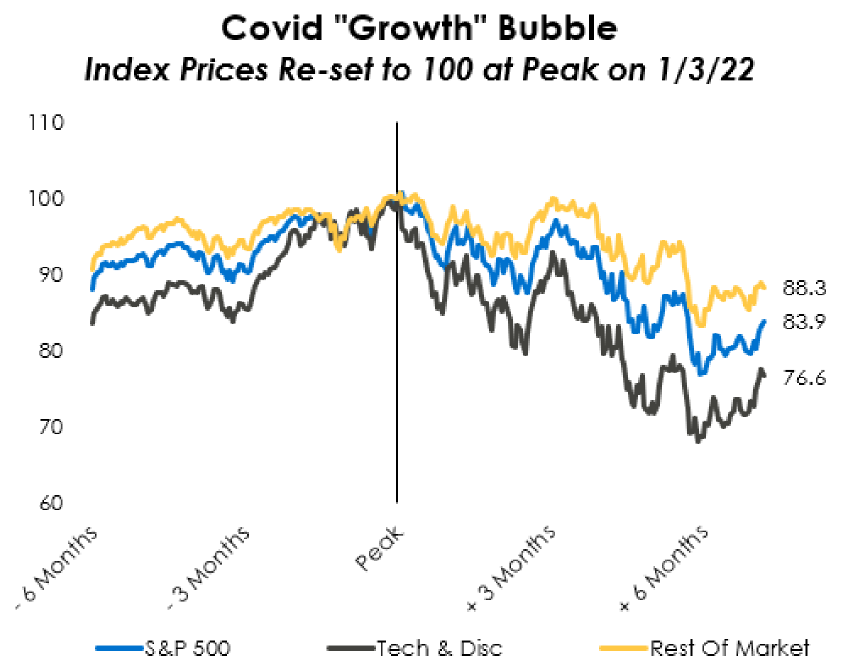
The Financial Crisis is another example where avoiding the worst parts of the market resulted in significant outperformance. The chart at right illustrates the equity market before and after the October 9, 2007 peak. The blue line is the S&P 500 Index, the black line is just the Financial and Industrial sectors, and the yellow line is the rest of the S&P 500 Index, excluding Financials and Industrials.



Source: Bloomberg, Yellow Cardinal Research

While none of the performance is anything to write home about, the managers that were able to avoid the most problematic sectors of the market significantly outperformed. By seeing that Financials and Industrials were in bad shape, active investment managers could have avoided those sectors and therefore protected their clients' capital to the downside.

The current picture looks similar (see chart at right). This time, we've isolated the Technology and Consumer Discretion sectors as the areas where "growth" stocks were most prominent (black line).



Source: Bloomberg, Yellow Cardinal Research. Price data through July 22, 2022

While the overall market is down (blue line), avoiding the "growthiest" sectors results in losses that are much less significant (yellow line).

At Yellow Cardinal, our goal is to provide our clients with superior risk-adjusted returns over full market cycles. Our investment philosophy – based on the tenets of diversification, flexibility and an emphasis on quality – was developed in order for our clients to

participate when the market is ripping higher while providing some downside protection when things go south. We actively manage our client portfolios versus their long-term asset allocation targets in order to succeed on our mandate.

As a quick refresher, active management means that an investor has constructed a portfolio to be different than the benchmark index against which their results are being compared. These differences can be expressed in a myriad of ways, but the two most common are via overweighting (or underweighting) various sectors and / or securities. Passive money management, on the other hand, looks to replicate the benchmark index as closely as possible.

With active management, there are two primary ways for an investment manager to beat their index. One way is to pick stocks and / or that perform better than the index; the other is to avoid the worst areas of the market.

While we aim to always select good stocks, avoiding the worst parts of the market is where we'll likely deliver outperformance relative to our benchmarks over the long haul. What this strategy may lack in sizzle, history has shown it can deliver on the steak.

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You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

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