



July 6, 2020

Dear Clients and Friends:

It is said that one of the most purchased, but never read, books is Stephen Hawking's *A Brief History of Time*. I will admit I have a copy on my bookshelf, and while I found Dr. Hawking's concept interesting and not difficult to understand, the author presented the material in an overly complex and tedious way. I may have made it to page 20. Following closely on the heels of this book is perhaps the second most purchased and equally unread book, *The Black Swan* by Nassim Taleb. Again, the concept is interesting and not particularly complex. A "Black Swan event" is by definition unknowable and unforecastable and the results are typically unpleasant. The occurrence of these events introduces tail risk to portfolios usually through massive spikes in volatility.

Mr. Taleb gained quite a bit of notoriety in 2008/9 for having "called" the financial crisis. He did no such thing. All he did was state the obvious: that completely unexpected events, events out of far left field so to speak, can wreak havoc on societies, markets and economies. The appearance of the novel coronavirus in 2020 was clearly a Black Swan event, and while Mr. Taleb has spent the last 10 years forecasting future Black Swans, he definitely missed this one. It is almost as if he does not understand the book he authored. Attempting to predict these events might make for a good interview on CNBC, but it is a complete waste of time.

Long-term clients of Reams Asset Management will not be surprised that the arrival of this Black Swan coincided with a run of relative strong performance at Reams. While we have no special knowledge of the future, we are dedicated students of volatility and how it can affect the portfolios you have entrusted to our care. As 2019 came to a close, volatility was very low and prices for everything very high. We prepared for an environment that would be markedly different, one that would potentially cause great harm to a portfolio exposed to risky assets and increasing volatility. As usual, we were a bit early in our preparation and this is something we are working on, as there is always room for improvement. Of course, we had no idea of the nature of the Black Swan or that it would even be a swan. A simple spike in volatility à la 2018 would do just fine. It is this inherent inability to know what the future will be that causes investors to be vulnerable. Many waste inordinate amounts of time predicting the future, while we study the past. We ask ourselves whether the cost of insurance implied in market prices is reasonable versus the uncertainty of the future and potential outcomes. At year-end 2019, it was very reasonable indeed. The past does not tell you what the triggering event will be, simply that it will be. Being prepared allowed us, yet again, to gain the advantage on your behalf and produce strong relative outperformance. As an added bonus, we outperformed our peer group.

As we move into the second half of 2020, uncertainty remains elevated, and risk is moderately attractive. This is not the time for extreme positioning in either direction, and we are currently in a balanced stance. Our base case is that the recovery continues and central banks remain very accommodating. In such an environment, risk assets should do reasonably well, but make no mistake, much of the upside has been generated, and there are now several paths ahead that could create unpleasant outcomes. We have begun to prepare for these by increasing liquidity, reducing exposure to both interest rates and credit. We watch with amusement as pundits forecast the future with the efficacy of reading tea leaves or pig entrails. The market has an implied forecast embedded in its prices. Simply asking whether or not it is reasonable, and

what the cost or benefit of various outcomes will be versus the one implied, is a better use of time, but then what would CNBC do all day?

Sincerely,

A handwritten signature in black ink, appearing to read 'M. Egan', with a long, sweeping horizontal stroke extending to the right.

Mark M. Egan, CFA
Managing Director

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