October 2, 2020

Dear Clients and Friends:

Most have likely heard the expression, "May you live in interesting times." While often attributed to the ancient Chinese, it is neither ancient nor Chinese but is actually of recent Western origin. The true meaning of the phrase can be as murky as its source, as it is often thought to be a blessing, while it is in fact a curse. The current state of the world could definitely be described as interesting, yet I think most would agree that this *annus horribilis* can't end soon enough. Unfortunately, an end to these "interesting times" does not seem to be on the horizon. Multiple factors are simmering just beneath the surface, coiling prior to boiling, with a resolution far from clear and many outcomes decidedly unpleasant.

It is common and perhaps expected for individuals and organizations in our profession to give opinions about or forecast how various things will turn out. We saw the Federal Reserve continue to embarrass themselves with their latest assurance that rates would not change for three years. They have little idea what the world will look like in three months, let alone three years, yet they feel compelled to try, futile as it is, since this is expected of them. Thankfully, we are not a faux omniscient, omnipotent governmental organization, so we don't have the burden of attempting the impossible. So what do we do?

The future can be thought of as a series of possible outcomes to which we can assign probabilities. We can then estimate how these various outcomes will affect asset prices, blah blah blah. This is what everybody does; they just package it differently, and it works well most of the time. Then there are outcomes like the current environment that couldn't have even been imagined, so assigning a probability to them is difficult, if not impossible. This is tail risk; this is 1929/2009; this is 2020. How to protect yourself from this tail risk is always worth thinking through but usually very difficult to do in the short term. It can be expensive. It requires patience.

As a result of these interesting times we find ourselves in, the current environment seems to have more tail risk than usual. The first half of the year provided us with exceptional opportunities, and we took advantage of them. We were hedged very well against tail risk at the end of 2019, and while it was expensive, it was worth every penny. We had no idea what was to come, only that pricing allowed for no negative outcomes.

As we end the third quarter, the market presents us with challenges we have seldom faced and yet implies to us a strategy so obvious it makes us question it. We are faced with a market that has almost no discernable possibility of meaningful positive return yet is chock-a-block full of risk. Much of this risk could produce outcomes that would lead to negative returns, perhaps substantially so. The cost of hedging against these known risks, and even tail risk, is not high. As a result, the strategy seems pretty clear, to hedge against risks, both known and unknown, and be patient.

Why don't others see this, and what makes Reams so smart? Well, maybe the fact that we recognize that being smart isn't a golden ticket to being good investors…please read *When Genius Failed*… and that common sense is a better characteristic. Many can't give up the belief that they have a better model or a keener insight, but more than likely it is simply hard to leave their comfort zone, to recognize the world has changed and continues to change in fundamental ways. Doing things as one has done them for 35 years will no longer be a recipe for success, but inertia is a powerful force. The Federal Reserve should know this and know better, yet they apparently do not. They are very smart people, just ask them. We don't have all the answers, but we know enough to ask the questions.

The strategy for now seems abundantly clear: stay cautious, stay hedged, and be nimble.

Sincerely,

Mark M. Egan, CFA
Managing Director