KANOS
CAPITAL MANAGEMENT, LLC

Third Quarter 2020 Investor Letter

Portfolio Comments

Kanos portfolios advanced strongly during the third quarter, rising during both July and August, but retreating along with the stock market in September as lack of further fiscal stimulus and muddied earnings outlooks impacted all stocks. Our precious metals holdings were absolute stars in July/August, pushing portfolios higher each month due to the impact of 2020 stimulus programs, the drop in the dollar's value and increased gold and silver investing by a larger variety of investors. Our technology positions continued to add to gains as technology was again a leader in growth. Mortgage REITs and Utilities advanced for the quarter, giving us both gains and income. Our US multinationals, concentrated in healthcare and defense sectors, ended up roughly flat for the quarter after giving back earlier gains in September. Our small holding of oil supermajors was flat for most of the quarter but suffered in September, although their high dividends helped mitigate price drops.

Looking forward, our portfolios continue to be positioned for the myriad of possible outcomes from the economy, elections and geopolitical macro developments.

Market Analysis - Looking Forward

Just when we thought 2020 was already a crazy year, the death of Supreme Court Justice Ruth Bader Ginsburg injected another bit of volatility into the US political situation, the economy and markets. Heightened attention to further stimulus, coupled with uncertain earnings expectations, has continued the choppiness we saw in September into October. However, so much thought has been expended on potential outcomes and so much money has been spent on hedges, we are not sure the market on November 4th (the day after the election) will be melting down, as so many speculated earlier in the year, regardless of outcome. We do think that the market will take its cue from election results and adjust over the rest of the fourth quarter and even into the first quarter of next year, and not necessarily in a pleasant manner. So, buckle your seatbelts – it will almost certainly be a bumpy ride!

Economy

One of the prerequisites of our job is to follow and analyze current events, especially economic ones, in order to help keep our economic and market frameworks up-to-date and your portfolios steered in the right direction. However, the US economy is extremely hard to analyze right now, with the crosscurrents of reopenings, rehirings, layoffs, changing input costs and activity indicators all registering confusing numbers. In jobs, we have seen millions of hires over the past six months, but we have also seen a constant +/- 800,000 new weekly jobless claims; these conflicting statistics, coupled with a mixed

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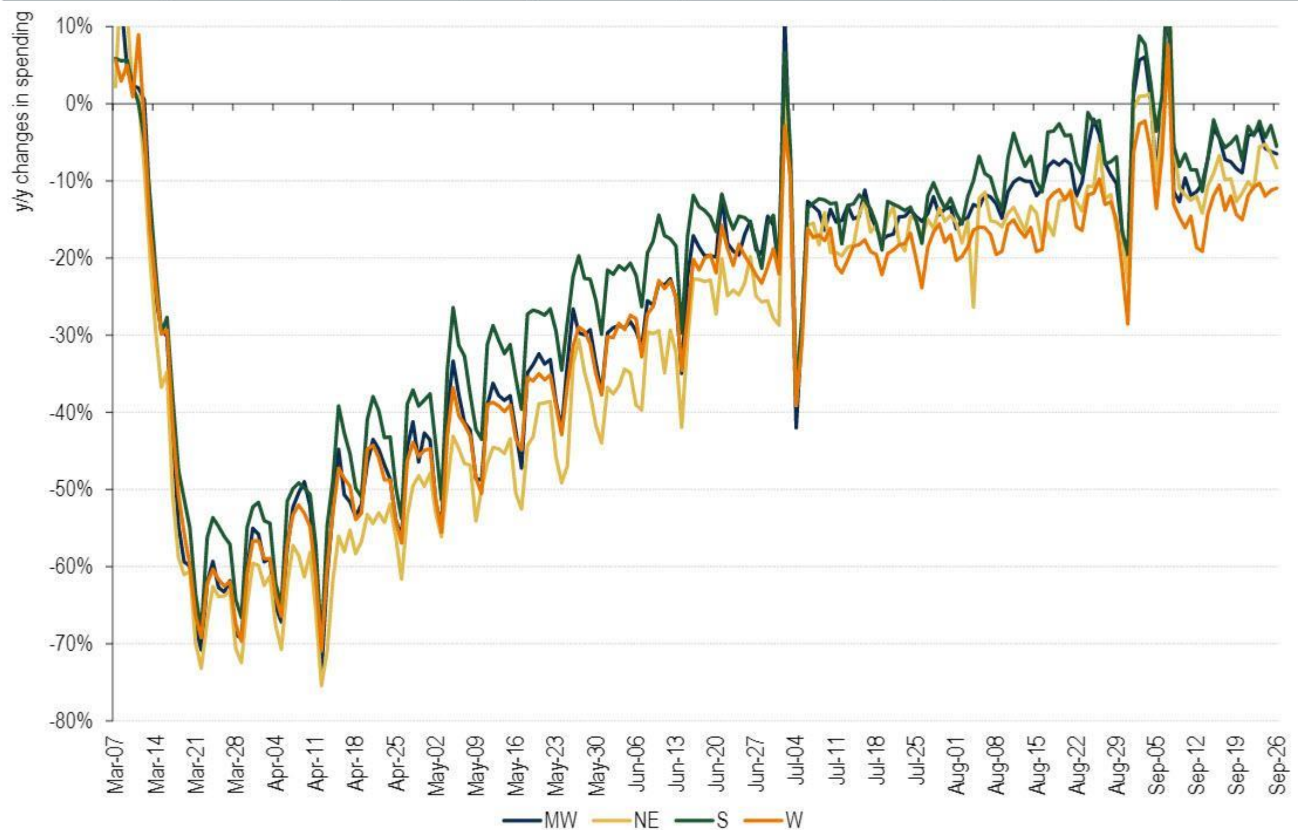
situation of reopenings (like New York indoor restaurant dining) and layoffs (highlighted by Disney's 28,000 recent layoffs around their theme parks) make analysis particularly hard.

On the plus side, hundreds of thousands of people hired each month since March hints at true recovery and an economy growing. Seemingly plentiful job openings indicate that there is still demand in many industries as local economies gear back up toward prior levels. The government reports that the jobless rate is under 8% after peaking in April at 14.7%. High freight levels for both container ships (carrying consumer goods) and bulk carriers (carrying raw materials like grains, ores, etc.) indicate that world trade is definitely on the mend. Bank of America put out some research in the first week of October, using September credit and debit card data, showing that restaurant usage had improved to only down 8-9% from last year's levels (see chart below); the piece also looks at individual states and some data from Outback Steakhouse showing wait times increasing also.



This data all points to an economy growing toward health again. However, other data is not as positive.

The opposite view is well articulated in the September 30th article in the UK's Financial Times, by economist David Rosenberg (ex-Merrill Lynch now heading Rosenberg Research & Associates) called "We're in a Depression, Not Recession – and the Scars Will Take Years to Heal." In it he argues that

the virtual destruction of many industries, and consumers' reticence to return to "normal" economic activity, will negatively affect the US for a couple of years. The article cites a report from the Chicago Fed in which 670 companies responded; businesses in the entertainment, tourism, recreation, restaurant and retail sectors "are in danger of financial distress … many businesses are facing very difficult challenges." He also cites the US Chamber of Commerce: "25 percent of small businesses have already shut down; and a study by Ipsos: "Two thirds of people are still nervous about leaving their homes; 59% say they intend to remain locked down until the virus is "fully contained." Another poll, this one by Washington Post/UofMaryland shows "only 56% of consumers intend to shop at the supermarket; just 33% say they are comfortable entering a retail store … and a mere 22% say they are willing to dine in a sit-in restaurant." Rosenberg argues "the dynamics of a depression are different than they are in a recession because depressions invoke a secular change in behavior … [c]lassic business cycle recessions are forgotten about within a year after they end. The scars from this one will take years to heal." We cannot dismiss the points espoused by Rosenberg – so many people's attitudes toward economic activity have changed, and their reticence to shop/eat/go to entertainment means economies won't regain 2019 levels for years. In addition, as we are fully aware of here in Houston, energy consumption (and prices) haven't come close to reaching pre-Covid levels. Crude oil under $40/bbl is a killer, driving many companies, both producing and service, out of business. This further hurts economic activity and obviously contributes to increasing unemployment.

Thus, combining data from the two viewpoints, we have a lot of activity that indicates many industries returning to, or at least near, 2019 capacities. On the other hand, a number of businesses are affected by changed consumer behavior, leading many to try to survive on a smaller base of customers or succumb. It seems that large companies are much more able to survive than smaller companies due to the ability to access financing. Other industries are in dire straits: a large number of entertainment, recreation and tourism companies are disappearing as prohibitions and customer behavior starve them of the revenue needed to survive.

In Europe, things are similar to the US, except a number of countries in Western Europe, most notably France and Spain, are battling full blown second waves of Covid outbreaks that have caused governments to impose new lockdowns, including in Paris. Much like the US, economies are recovering slowly, with gun-shy governments trying to reopen economies but trying to limit activity in "hot spots" where infections blossom. We still think Europe was in recession before Covid, so recovery will be slow as consumers and businesses lack the resources to increase economic activity. We will be avoiding stocks concentrated on European economies.

In Asia, Covid outbreaks on the whole seem to have crested and most countries are reopening their economies on a wholesale basis. India, the scene of the worst recent Covid outbreak, had limited daily new cases to just 61,000 in early October, the lowest number since late August.

China, first into and first out of the Covid mess, continues to show that it has the strongest economy in the world currently. Exports in August have recovered to pre-Covid levels, and imports are at extremely high levels as China re-stocks and stockpiles excess materials at current bargain prices. China currently represents the majority of actual economic growth in the world as other economies just try to recover to pre-Covid levels. We will be looking at China for interesting situations going forward.

Other emerging markets are harder to judge. For the most part, they are not well equipped, either physically or financially, for a pandemic, and are probably still suffering reduced economic output as they fight off the virus.

Equities

Equities in the US appear to be waiting for the results of the election, with the possibility of an exceptionally large fiscal stimulus package also hanging over the market. The election and politics in general have started to dominate the financial as well as news headlines as last-minute revelations and clarification of candidates' positions push sentiment around. In addition, the growing unease and budding anti-trust movement involving big tech stocks has helped blunt stocks' advances in October.

We are not going to go through the analysis of which stocks win depending on which candidate wins and who controls which house of Congress, but we will say that a Trump victory would almost certainly propel stocks upward (expansion of his programs under a new mandate), while a Biden victory could also lead to an upward move initially (even larger stimulus expected, plus bailing out all states and cities), tempered by the threat of higher taxes, which would cause a late year sell-off (as investors lock in current lower tax rates).

Having said all that, we still believe the sputtering economic recovery will require further stimulus, both fiscal and monetary, and that will continue to fuel stocks, or at least a number of sectors of stocks. We think many of the current themes in the market will continue on their current paths, mostly due to Covid concerns. As the virus waxes and wanes, our experiences are telling us that people will continue to be cautious toward possible infection, meaning a large number of the US populace, both young and old, will continue to avoid crowded places. This means entertainment (music, movies, professional/college sports, etc.), travel leisure (airlines, cruises, hotels, destinations (think Las Vegas, Disney parks, etc.), leisure (gyms, bars, sporting activities, etc.) and to a lesser extent, restaurants, will continue to suffer from lower demand. Banks/financials, which typically generate at least some income from interest, will continue to suffer with Fed Funds rates at 0% and longer-term interest rates being historically low. Meanwhile, we think those industries that support staying at home and working from home will continue their elevated demand. The aging of Millennials continues to provide demand for single-family houses, so we think homebuilders will continue to see demand, at least for lower-price homes. The lockdowns of the spring/early summer (and some being re-instituted recently) led to a great de-stocking of US retailers' shelves and warehouses; we see the resultant re-stocking leading to robust transportation sectors and elevated manufacturing activity. Raw materials producers (ex-energy), with very little capital investment post-2011/12, are showing capacity limits, meaning things as diverse as chemicals and copper are showing strength even with the world in a kind of "rolling depression" of certain segments of world economies. Working from home/lockdowns has/have also taxed utility infrastructures as changing demand patterns and environmental concerns lead to supply concerns in some states. Our view of energy is contained in the energy section below, but we were right to stick to the largest companies – the sector has been devastated to the point that much of the US industry is in decline or facing possible bankruptcy (for over-levered companies like many shale producers).

Thus, we continue to hold a number of stocks in sectors we think will benefit from the factors mentioned above, while avoiding less attractive sectors. We continue to hold precious metals and mining (benefit from more stimulus, lower dollar and low energy prices), defense stocks (growing geopolitical threats and continued need for US military upgrades and massive overhauling of current weapons systems), and pharmaceuticals/healthcare/testing (continued parade of new health remedies and procedures, even before Covid). We also own utilities for their financial strength, yield and potential growth as electric vehicles and stay-at-home activities increase. We own some technology that we see as essential and doesn't rely on an ad-selling model. We own homebuilders but feel that the sector may be approaching a peak (at the same activity level as 2006 peak during the housing bubble). We own some select industrial sector stocks that we see expanding in the next few weeks/months if the US economy shows any real momentum after the bounce-back from the Covid/lockdown recession is finished.

We have avoided restaurant, movie, travel, airlines, and entertainment stocks due to Covid concerns. We have avoided financials because their net interest rate margins are compressed and interest levels, on an absolute basis, are microscopic, making it very hard for banks to cover their expenses. We have avoided international equities for the most part as we saw recessionary conditions affecting weaker international economies as a whole more than the US. Other developed economies, most notably European ones, have not found an engine of growth from their near-recessionary pre-Covid conditions; in addition, many European countries are facing a true second wave of widespread Covid infections, leading to reduced economic activity as people isolate. Asian countries, most notably, China and Japan, as goods providers to the world, have become interesting as the rest of the world re-stocks. So, as economic conditions crystalize and US political conditions become more certain, we could put capital to work in Asian equities.

One last thing (which we address further in other parts of this letter): stimulus. The Fed's easy money policies (that went into overdrive in the second quarter to help overcome the Covid recession) combined with the US Government's fiscal stimulus packages ($1,200 to individuals and PPP/EITF support payments to small/medium businesses) has led to a stock market bubble in high growth companies, especially technology companies. We have tried to avoid these situations because of their poor future appreciation prospects and danger of large price drops if corporate disappointments occur. Some have continued to be good long-term holds, while others have been shown to be profitable trades if one is day trading, so we do own and have owned a few of them.

Bonds

The bond market is in similar valuation straits as equity markets. Rates are low (bond prices high) and supply is high and rising. US Treasuries are being issued in historically high volumes, but with a backstop from Fed buying in the secondary market, they have been absorbed by investors with no significant rises in rates. However, the US Government will have to continue to issue large amounts of bills and bonds to finance current budget deficits and stimulus programs. While we don't see any appreciation in bonds going forward, we believe the Fed has become an ally of the government, implicitly guaranteeing low rates by adjusting their ongoing quantitative easing buying to keep rates around these levels. We also think they will resort to actual Yield Curve Control, explicitly keeping

Treasury rates in published rate bands, if need be in the future. So, we continue to favor holding some Treasury bonds (in the form of ETFs) for safety and some income.

Corporate bond issuance has been near historically high levels for the past few months as corporations take advantage of extremely low interest rates and investor's appetite for yield (and increased safety over equities). While we continue to buy some shorter-term A-rated corporates for our income-oriented customers, we are less enamored with the risk of lower rated corporates with historically low yields (and low protections in the form of watered down or missing covenants), so we don't anticipate adding to allocations of corporate bonds.

While municipal bonds have historically provided enhanced yield and freedom from federal income taxes in the past, we feel the increased consumption by state and local authorities for Covid treatment and prevention, coupled with lost sales tax revenues from business closures and bankruptcies, introduce too much risk into muni bonds. The federal government is supposed to reimburse state and locals for their costs, but the politics of getting stimulus money passed through Congress and then to the right entities, along with worries about still-reduced economic activities cutting down on local tax receipts, make munis unattractive to us.

We find international bond markets unattractive also, due to the same risks faced by US state and local governments. In addition to budget overruns that may or may not be subsidized by allies or by extra-governmental entities like the IMF or World Bank, emerging countries may have reduced income due to lower commodity prices and lower world consumption of exports, making their bonds harder to pay off. Finally, many developed world bonds are still negative-yielding, making them singularly unattractive for virtually all profit-seeking investment entities.

Currencies

The US dollar has been weak for much of the summer, bouncing during September as further stimulus, long expected, did not materialize. The flight-to-safety aspect of the dollar also continues to attract flows when political, economic or geopolitical events occur. Having said all that, we continue to expect the dollar to lose value over the next few months as inevitable stimulus package are passed by Congress and continued monetary stimulus through Fed QE buying erode dollar value. Thus, we will continue to hold less cash than we would normally, expecting dollar value erosion.

The euro has been the beneficiary of investors' recent need for diversification from large dollar positions, but unless the EU can start to show more unified behavior, as well as resolve all of the Brexit issues with the UK, we don't see long-term appreciation of the euro. Thus, we will not be looking to hold euros or euro-denominated investments for the euro factors.

Yen are similar to euros for us – not attractive for long-term holdings but still reasonable for interesting investments in Japan.

Like their bonds, emerging markets' currencies continue to be unattractive due to the same factors making their bonds unattractive.

One alternative "currency" that has benefitted this year (and has just broken out technically) is bitcoin. While it is a cryptocurrency and acts more like a commodity than a currency, bitcoin has been gathering more proponents lately due to its perception as a safe haven and an alternative to the US dollar. We own some bitcoins in the form of the Grayscale Bitcoin Trust ETF, and we anticipate buying more if the dollar continues its descent.

Energy

Crude oil market dynamics continue to be buffeted by constant demand concerns, taking down prices as producers attempt to keep market share. Covid concerns have caused Western economies to keep stay-at-home conditions in place, leading to lower motor fuels consumption and lower worldwide economic activity than anticipated. Oversupply continues, especially by developing countries dependent on oil revenues to fund governments. We don't see current trends changing for the rest of 2020 or early 2021: we still think demand will be at lower levels than 2019 while supply is slow to come offline. Unfortunately, we see the US exploration and production business continuing its decline as ruthless cost cutting leads to poor or non-existent service sector profits and only slow rationalizing of production levels, meaning plenty of supply to keep prices in the $30s/40s per barrel for the next few months. Only vicious production cuts and reduced service capacity levels can restore any profitability into the surviving companies.

We also think natural gas produced in association with crude oil production will continue to hamper natural gas prices and company profitability as gas production stays relatively high, while gas in storage for winter is also at high levels. Early cold weather could give natgas prices a shot in the arm, but the sheer volumes available for heating over the winter point to any price spikes being short-lived.

These commodity price dynamics mean that exploration and production companies, as well as upstream service companies, still face daunting economics and are not currently attractive to us. We continue to hold small positions in the supermajor companies, because we think their non-upstream assets (chemicals, refineries, pipelines, etc.) are worth more than current valuations, and we believe they will continue to maintain higher than S&P 500 dividend levels, even at these lower commodity prices. We are also attracted to some of the pipeline / midstream companies which we think will continue to pay dividends due to still-high utilization levels and their scarcity value (environmental groups have virtually shut down any new pipeline development, making current infrastructure more valuable).

Commodities/Precious Metals

Precious metals investments continue to be extremely attractive due to both macroeconomic and investment reasons. As discussed above, the Fed's and other central banks' efforts at increasing monetary stimuli (both QE and extraordinarily low interest rates), coupled with countries' programs of fiscal stimulus, have "goosed" consumer spending and people's participation in financial markets. This continued application of stimulus continues to help lots of assets, precious metals included.

The lesser-known attractiveness of precious metals mining companies is the good fundamentals surrounding the companies. With gold having traded up near $2,100/oz and finishing the quarter at $1,887 (and silver at high prices also), profit margins for mining companies have expanded due to better pricing. As opposed to 2010-2011, costs increases are subdued; in a capital-intensive industry like mining, costs are dominated by 1) cost of capital, 2) cost of people and 3) cost of energy/fuel. Today, cost of capital is the lowest in human history, so borrowing money or issuing equity is as cheap as it has ever been – important for all miners because there are capital expenditures for operating mines as well as new mines. So far, capital discipline has been under control (which has historically not usually been the case). Cost of people/labor has actually gone down in countries whose currencies have gone down versus dollars (many emerging currencies have fallen versus the dollar, even though many developed country currencies have appreciated). Even labor margins have either stayed relatively flat or improved as labor costs have not risen as fast as sales prices or other costs. Finally, oil and natural gas prices have dropped precipitously and stayed down, improving margins through reduced fuel costs. This is in contrast to 2010-2012 when fuel costs rose to near the highest in history and interest rates bottomed and started rising, both of which raised miner costs and hurt margins. This cycle, costs containment has dominated operations, and in many companies, helped profitability.

Rarely does one get to observe a true phase shift in one's core investment thesis, but in regard to the precious metals, we actually have observed one in each quarter this year: 1) In the first quarter, after the Covid panic in February-March drove the stock market down more than 36%, the Federal Open Market Committee (FOMC) brought an almost unbelievable amount of monetary stimulus into financial markets to support prices and stop the panic. This gargantuan monetary injection supported the prices of all assets, with precious metals (PMs) shooting upward from their Covid panic lows to re-energize the PM bull market; 2) In the second quarter, the initiation of a massive fiscal stimulus (the CARES Act) which gave stimulus money to individuals (much of the country received $1,200 personally), small businesses (the Paycheck Protection Program made money available to banks for loans to keep people on the payroll) and grants to essential businesses (like airlines) pumped money to individuals, allowing spending to buoy the economy during lockdowns and extreme fiscal uncertainties for individuals and businesses. This money helped stoke inflation as demand continued while supply shocks limited supplies of goods as diverse as toilet paper, lumber, beef and chicken and even cars and watches. Some of this liquidity in the hands of the US population found its way into financial markets, and precious metals benefitted too, with gold setting a multi-year high at $1,788/oz in early April. 3) In the third quarter, the real surprise occurred. On August 15, when all large investors in the financial markets must report their positions to the (SEC), the investment world found out that Warren Buffett's Berkshire Hathaway had not only sold all of its stake in Goldman Sachs (and reduced its large positions in JP Morgan and Wells Fargo), it had acquired a $500 million stake in Barrick Gold, the second largest producer of gold. This rocked the investment world because a) Buffett has been famously derisive of the use and ownership of gold, and, more importantly, b) Berkshire's lead in acquiring a gold investment legitimizes having gold in one's portfolio. For all the money managers who have eschewed owning gold because they thought it is considered a volatile, fringe investment, Buffett's purchase has made it a legitimate investment. Apparently, the attractiveness of one of the biggest, most efficient and well-known gold miners made Buffett and Berkshire go against his long-time advice of avoiding a gold investment. This is a very important moment for the gold mining industry, having the most admired generalist investor dump iconic Goldman Sachs to buy a gold mining stock; the entire precious metals

complex rallied the day after the announcement with Barrick closing up 11% and most miners up 5-10% as others were expected to follow Berkshire's investment.

With Berkshire Hathaway's imprimatur, investments in the precious metals sphere should continue to rally, especially with the uncertainty around November's election and the expectation of further stimulus from the US Government, as well as the Fed (and other central banks worldwide). Central banks themselves have continued to buy gold for reserves during 2020, although some large buyers, most notably Russia and India, have limited their purchases this year due to higher prices. We expect that investment demand from investment managers, continued purchases from central banks and lack of industry growth in production of gold and silver will lead to higher prices, both this year and in coming years. Sure enough, right on cue: on August 27th, the $16 billion Ohio Police & Fire Pension Fund approved a 5% allocation to gold "to help diversify its portfolio and hedge against the risk of inflation, as reported by The Bureau of National Affairs, Inc. on BloombergLaw.com. More importantly, the fund was following the advice of its investment consultant, Wilshire Associates, in adding the 5% gold allocation, according to Pensions & Investments 8/28/2020 article, "Ohio P&F redeems $186 million from 3 real estate funds." Wilshire is an industry-leading pension consultant who is almost certainly suggesting a similar allocation to pension funds around the country. European pensions and consultants have already started adding gold to portfolios, as shown by Swiss private bank Lombard Odier & Cie SA's mid-July announcement adding gold to its strategic asset allocation, a move already instituted by many European banks after gold dropped to decade lows in 2015-16.

As mentioned earlier, re-stocking from Covid lockdowns has re-invigorated goods producers, and the expectation for continued government stimulus programs around the world, with some focus on infrastructure, has put a bid into raw commodities from iron ore to copper. Weather and economic conditions have caused poorer food production worldwide, leading to higher export demand from large food producers like the US, Brazil, Ukraine, etc., driving up the cost of grains and other soft commodities. We have some small investments in some grain companies, but we expect to commit more capital to other commodity ideas as world economies continue to recover, helping us better gauge supply/demand elements.

Summary

Thus, in spite of depressionary conditions in some industries worldwide, we see enough economic activity that we can put your capital to work in attractive situations while trying to avoid high valuation situations which is a concern in at least a few US equity sectors. With some Treasuries and more defensive sectors like utilities and precious metals, we feel our barbell of multinational companies and defensives has served us well in the up and down markets we have seen during 2020 and will likely see in 2021 and forward.

Kanos Quarterly Commentary

Concerning Issues In The Stock Market

This quarter, we have decided to discuss some issues that we see affecting the stock market in the medium to long-term. They could start to affect the market in the short run, but we are not sure about when they become problems; we are just sure that they will become big concerns if current trends continue.

Robinhood and the rise of novice investors

The first issue is the potential problems that surround unsophisticated investors in a risky market environment, as best epitomized by the customers of the financial firm Robinhood. The emergence of the brokerage firm Robinhood Markets, Inc. into the financial landscape in 2015 was initially greeted with skepticism and derision. Launched from Silicon Valley, the brokerage company was aimed at the Millennial demographic of investors by offering commission-free trades that could be initiated from a phone app (as well as computer), in a format that resembled a fantasy football or video game app. As the late 2010s bull market continued through 2020, Robinhood grew appreciably, with its ease of use, $0 commissions and its introduction of purchases of fractions of shares (allowing investors to buy stock with as little as $5 of capital). With no need for substantial capital and little qualification for traders/investors, Robinhood has become the "go-to" brokerage for new stock market players, forcing discount brokerage heavyweights Charles Schwab, Fidelity and E*Trade (and others) to cut stock commissions to zero and also start to offer fractional shares, in competition with Robinhood.

But there are some ugly issues that are not as well known about Robinhood. The brokerage makes it easy, quick and "fun" to buy and sell financial products. However, there is truly little in the way of training, warnings of how one could lose money and warnings about market losses (they have since added some more market training and tutorials). This means young traders and investors have been given little guidance and don't have to access any human "filter" to implement trades, some of which can be risky and put much or all of their capital at risk. In addition, Robinhood in the past has been liberal with allowing traders to leverage their capital: they can borrow money (which becomes a source of income for the brokerage that partially allows for free commissions) to invest in a higher amount of securities. Finally, options and cryptocurrency trading allows for highly volatile trading, which, if coupled with leverage, could wipe out all (or more) of one's whole balance. In one instance this year, an inexperienced young trader, Alexander Kearns, committed suicide after his account lost so much money that he owed the brokerage $730,000 more than he had; his suicide note referenced Robinhood giving him too much credit. Thus, we think Robinhood is playing into traders' greed and making it easy to increase their leverage substantially without warning them adequately of the risks involved.

To us, however, the ugliest part of the backstory of Robinhood involves another source of revenue for the brokerage: payment for order flow. Robinhood, the brokerage, sells all of its customers' orders to market making firms and pockets the proceeds from the sales of the orders. Why would someone pay

for orders? By seeing a large number of these orders, some of which are stop-loss orders at fixed prices, those market-making firms can trade their books in a more profitable fashion. While the law says one can sell orders, the small customers are supposed to legally be getting the best price on the National Market System. The fact that large market makers / brokerage firms are willing to pay for this order flow illustrates its value for them. We believe this is something virtually all Robinhood customers are unaware of, and while legal, it strikes us as unethical to sell your customers' orders with little notice. We, at Kanos, are Registered Investment Advisors that must act as a fiduciary; this means that we must put our customers in front of our own interests. As a brokerage, Robinhood is not bound by fiduciary duty.

Finally, Robinhood also sells its aggregate customer data to other firms, and some firms try (and most probably succeed) in scraping trading and positioning data from Robinhood in order to study, systematize and trade profitably against these "small fish." Again, while legal, we find the sale of this data unethical and thus, disturbing. It seems as though a group in Silicon Valley studied the retail financial markets, identified the attractive revenue streams (selling orders and data to other financial firms), set up a business to capture those streams of income, and then designed an attractive computer app to attract millennial customers. They then added the disclaimers and compliance info to satisfy their lawyers. Not an attractive proposition if you are a customer.

Passive Investing

The second issue is the takeover of the financial markets by passive investing and indexing. When John Bogle at Vanguard invented the first popular index fund, which took the Standard & Poors 500 Index of 500 large US stocks and populated a mutual fund with the correct proportion of those 500 stocks, he did so because it could be done at low cost, and investors could get the benefit of a diversified basket of US stocks without the large commissions of trying to assemble such a grouping oneself and without the costs of an actively managed fund which required higher costs to compensate the investment managers. As US stocks boomed in the 1980s and the Fed became more and more a part of the investment landscape, a more distinct upward bias in stocks (and later fixed income) attracted investors to invest in low cost investment funds (now expanded to many different indices, and later to industry segments of stock markets). The boom in large capitalization technology stocks in both the 1990s and then the 2000s-2010s led to their large weightings in the indices (especially the Nasdaq Composite and Nasdaq-100 indices). As some large-cap tech companies got larger and more investors bought their stock, a much smaller number of companies came to dominate the indices.

Passive investing, including vehicles like target-date mutual funds, swept through large investment pools (pension funds, hedge funds, foundations and other managed groupings of retirement funds, especially 401k plans) as computerized trading found its way into the investment markets. Algorithmic programs, formulated to take advantage of recurring patterns or certain events in markets, led to a certain amount of money invested by formula and by timeframe. For example, there is thought to be a large amount of capital that is invested on the first of every month by retirement funds; thus, a large amount of passive money is put to work regardless of timing, positioning or conditions in the market. And passive investing, following an index, invests all of the funds available.

So, passive investing started as a way for a small part of the market to mimic the performance of much larger investments by pooling small amounts and investing in an index. Now, passive investments are calculated to be at least 45% of the investment universe in the US and have been rising in market share. But passive investors are "price takers"; they just buy at the prevailing price at a formulaic time without regard to market conditions. As passive investing grows further and becomes the majority of new investment, prices could diverge from traditional value metrics, leading to more risk in more of the investments. What does this mean in plain English? Active managers, who decide how much to invest in certain investments when they are "cheap" (for fundamental analysts) or "at the low end of the range" (for technical analysts), and to sell when they consider investments "expensive" (for fundamental analysts) or "at the top of their range" (for technical analysts), are traditionally the "price setters" of the market. They buy when they consider things "low" and sell when they consider investments "high." Historically, active managers have held 5-10% of their capital in cash to invest when things look attractive. Passive managers don't analyze the markets; they put cash to work in all index components regardless of value or attractiveness or technical patterns. Thus, when markets are rising, passive investing tends to outperform active investing because there is more capital at work (there is no investment underperformance due to cash balances) and there is no market timing, which active managers utilize when markets are "high" in valuation or technical positioning.

Passive investing is now one major force in the investing universe, and except for a handful of exceptions, passive investing has had positive flows to invest in the US stock market every month for the past 30+ years. This means that there has been an almost constant bid in the markets, and as passive grows, there should be an underlying bid for many more months and possibly years. Thus, when indices are rising, active managers, to keep competitive, have to make choices: 1) do they invest in a way to try to reproduce the index performance, keeping less cash and putting in almost all of the capital (what have been called "shadow indexers")? The problem is that shadow indexing managers want to be paid like active managers (0.5 – 2.0% per year) but are not providing much more value than indexing (which only costs 0.01 – 0.25% per year, or 2) the other choice is to choose investments that perform better than the indices (harder to do consistently, as values/technicals change constantly in markets). Beating the index has been difficult to do consistently, which is why passive has continued to grow in market share. And as passive grows, more of the "cash on the sidelines" is deployed instead of kept for bargain hunting. This phenomenon has led to markets moving up to a point which is near the top of valuations never before seen in US market history. What happens when large cap companies underperform? The indices, based solely on market cap weighting, will then being to underperform. The "law of large numbers" which entails that entities can only grow so large before finding too much resistance, implies that companies can only become so big before too much selling or a lack of buying occurs to the point that the stock price of an entity underperforming may stop going up.

And what happens when passive strategies decide to sell? The passive manager just tells the computer system to sell the proportional amount of all the components of the index at the then-prevailing price. Since passive has been growing consistently, even when selling occurs, passive strategies, as a whole, have been "net overall buyers" for all but about six months in the last three decades. And active managers are there to be the judges of value, stepping in to buy at attractive prices but standing aside from buying until prices drop to attractive levels. If active managers continue to drop as a percentage of market participants, their ability to determine the value of investments will continue to fall over time.

Meanwhile, passive investing will continue to take whatever current market price prevails when capital is allocated to the markets.

Here's the issue: what happens when passive becomes net sellers? At that point, passive investing will have become large enough, when passive funds become net sellers (which could happen in a market dislocation, after a natural disaster, if disease were to kill a large number of retirees, etc.), who will be buying and at what price? If passive becomes the majority of the market, and passive strategies become net sellers, active managers could only buy so much (their cash for bargain hunting), and then there could be a dearth of any buyers. At that point, prices would quickly fall, until capital could be attracted from non-stock market sources. To the extent that would not happen instantaneously, the "price taker" passive funds would just sell at any bid shown, which could be $0.01/share. This is the nightmare of having too much passive investing – there is an eventual reckoning that comes when the price takers cannot find ANY takers. This is most likely what happened on May 6, 2010, when the famous "flash crash" happened in the US stock market; a large number of very large, liquid blue chip stocks, along with mostly smaller or less liquid stocks, all of a sudden dropped in price and no buyers immediately came in to buy. Prices dropped 30-50% in some cases in just a few short minutes. Luckily, buyers, realizing that there was no catastrophe that was causing these large losses in most stocks, moved in relatively quickly, and within an hour, most stocks had recovered most or all of their sudden drops. However, this was a warning: if something that occurs that either convinces humans or computers that stocks in passive strategies must be sold in quantity and quickly, we could experience another "flash crash" that isn't accompanied by a large rally afterward. Even the Fed could not move quickly enough, or in a large enough amount, to "fix" the market if such an event were to happen.

SPACs

The final issue is the re-emergence of the SPAC, or Special Purpose Acquisition Company. A spac is a "blank check" company that a sponsor takes public; the sponsor sells shares to the public with the proviso that you "trust them" to search for attractive companies to buy with their pool of public money. It ends up being a way for private companies to go public without all the prospectus-writing, due diligence, roadshows and being picked over by large investors.

Spacs typically occur near the end of economic or at least financial booms. They are driven by people who have been missing out on large appreciation in growth stocks / recent IPOs; these investors reason that they can be in on the next big thing by buying in before the "next big thing" is even bought – the spac then merges with a growth company, and voila, these investors own a "hot stock" at the IPO price (of the spac).

Recent successful spac companies include: DraftKings, the internet sports gambling company, that merged with a spac and has thrived in the market as professional sports re-opened and the public avoided casinos and other more traditional gambling venues, Nikola Motor, the electric truck company, which merged with a spac and followed a Tesla-like trajectory skyward after it went public, and Virgin Galactic, Richard Branson's space tourism company that promises to take tourists into space in the near future. There have been dozens more spac mergers taking other private companies public in the last 24 months.

So, what is wrong with a spac? In addition to avoiding the scrutiny of a going public process, spac mergers are not subject to investor scrutiny – thus, once the sponsor completes the initial offering, they have complete control over: 1) which kind of company to target, 2) what companies to approach, 3) the price and valuation at which the target company will be bought and 4) who will run the resultant company. There is a lot of "trust me" in this process.

Another problem is that after a long run of higher stock prices and countless IPOs and completed acquisitions, the universe of available targets is generally less attractive. Many of these companies had considered IPOs but didn't complete them – in many cases because the hoped-for valuations probably wouldn't survive the IPO process. But the spac allows them to potentially realize higher valuations and face a lower level of (or possibly very little) due diligence.

This is brought home in the Nikola Corporation example. The spac was trading in the mid-$30s per share, but after Nikola became the merger candidate, the price catapulted above $90/share on the excitement of Nikola becoming the "Tesla of trucking." The price dropped back into the $50-70/share range as development continued, eventually dropping back into the $30s/share. When Nikola announced a partnership with General Motors, the stock shot back up above $50/share. Subsequently, more investors investigated the company and it was found that the video showing off Nikola's "prototype" truck was rolling down a hill and was unpowered. It was also found that almost nothing within Nikola was proprietary: virtually all elements were bought from other companies and the founder had a history of promotion without a lot of success to back it up, while also facing business and sexual harassment lawsuits. All of these issues would have been disclosed or at least discovered in a public offering setting. The stock dropped under $20/share and currently trades at approximately $23/share, with the GM deal in question and the development of an actual production truck model left with an indeterminate introduction date. Nikola is a poster child for how a spac can go wrong – the target company facing less due diligence than it should and only finding out unpleasant facts as the stock drops. Virtually all public holders of the stock who bought after the Nikola merger was announced are underwater on the stock.

The Virgin Galactic spac merger shows another type of spac danger – a "concept" company, with the ticker SPCE (or space). In this case, it is space flights for tourists which sounds attractive but may never be realized by the company. Space flight is very expensive and can face a lot of potential dangers. Commercial space tourism has been in development for years now, and so far, no space tourists have flown, while most companies have faced expensive setbacks in their programs, causing a need for more money and possibly involving accidents. Virgin Galactic has had its share of setbacks during its development, and now SPCE investors are on the hook for at least part of the costs, instead of just Richard Branson and his ownership group. Many concept companies run out of funds and are unable to realize their vision – a vision that would be much more developed if a company had to go through the rigors of a public offering.

Those issues are some of the concerns that surround spacs, and the appearance of spacs only after long bull markets are a definite red flag that: 1) investors are showing extreme enthusiasm, 2) companies not able to go public are able to acquire a public listing through a spac, and 3) many past spac failures were

caused by either questionable (or even fraudulent) operators/assets/business plans or due to underdeveloped business structures that could reach commercial viability before going bankrupt. Avoid spac deals unless you can feel good about extensive due diligence on such companies.

We believe these three issues in finance: 1) the involvement of a large contingent of novice investors, 2) the robotic investment of larger slices of investments into companies based on passive elements and not for fundamental or technical reasons, and 3) a larger and more visible element of "trust me" spac investing by investors who want to cash in on the "next big deal" at IPO prices but with far less scrutiny are signaling a speculative top in US financial markets that historically high valuations have signaled for months or even years. These three elements are further evidence that show there is a growing amount of riskiness in the market. We believe these conditions are more reason to have a large defensive portion of your investment portfolio, which is not only prudent but can function as insurance against a market downturn, which, at this point, could take away most of your profits earned over past years.

The Managers of Kanos Capital Management
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