The Conservative Strategist

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Private markets and the Groucho Effect

"I would never belong to a club that would have me as a member."
— Groucho Marx

In the wake of financial deregulation and in the name of democratizing financial markets, there have been a spate of offerings recently to the smaller investor of private asset classes that previously have been available only to institutions and ultra-high-net worth investors. These asset classes include private equity, private real assets, and private lending. The offerings have come in the form of either limited partnerships or, more conveniently, interval funds — open-end mutual funds that carry a feature that allows the manager to limit quarterly redemptions to a preset percentage of assets in the fund.

It is natural to be skeptical about retail investors now being given access to investments previously the province of professional and highly sophisticated investors. The question arises: Are the pros distributing product to the rubes near the top of a major bull market? Or is this a club that we want to join?

We're cautiously positive on this new development, for at least three reasons.

We can be selective

It's reasonable to be skeptical of *private equity.* There's a lot of capital in that space looking for a limited number of opportunities. But in *private real assets,* there is little or no evidence of a bubble. In fact, they are quite reasonable relative to financial assets. Asked recently to name the cheapest asset in the world, *DoubleLine Capital* CEO and bond king Jeffrey Gundlach answered simply: "Farmland. Farmland is the cheapest asset in the world." And there is much value in the *private lending* space, where solid returns are being earned amidst a reopening economy and a number of product and service shortages. Our focus is on these la tter two areas.

Big investors maintain their stakes

There is no evidence that large institutions are getting out of private assets. The recent release of year-end 2020 asset allocations for major university endowments, for instance, shows them holding more than a third of their portfolios in private assets (14% private equity, 9% private venture equity, and 11% private real assets). This is in line with historical averages.

We are invested alongside smart money

In the two funds we explore in this issue, for which we have done extensive due diligence, we are invested alongside major institutions at the fund level. Additionally, both of these funds diversify further into institutional-only funds and subadvisers that themselves count pension funds, endowments, family offices, and ultra-high-net-worth individuals among their holders.

No Groucho Effect here. ■

Marks, not Marx

"The best opportunities are not in the public markets. The public markets are just too easy to access, it's just too easy for people to find out about and hop on the opportunities until they get fully priced. A great deal of what we are doing is in private investing, private lending, emerging markets or the things that are off the beaten path.

— Howard Marks, Chairman, Oaktree Capital Management $150B AUM, June 17, 2021

The Markets June 30, 2021	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	4297.50	8.51%	15.18%
International Stocks (Vanguard Index)	21.07	5.53%	9.69%
Emerging Markets Stocks (Vanguard Index)	34.36	5.10%	8.83%
Real Estate Stocks (Vanguard REIT Index)	33.82	11.64%	21.28%
Bonds (30 year US Treasury/Vanguard Index)	2.06%	6.54%	-7.54%
Dollar (US Dollar Index)	92.44	-0.85%	2.79%
Gold (London Afternoon Fix)	$1755.45	3.81%	-7.00%
Money Market Funds (Vanguard Cash Reserves Fed)	0.00%	0.00%	0.00%*

*change in yield

Portfolio Planning

Two funds for challenging times

With both mainstream stocks and bonds trading near all-time high valuations, and cash yielding virtually nothing, it's a tough time to source promising new investment ideas.

Public markets, subject as they are to investor fear and greed, are picked over clean today by retail investors who act as if they have no alternative. There's even an acronym for that: TINA (There is No Alternative).

But there *is* an alternative: The private markets. Given their inherent illiquidity, privately-held assets are not as liable to swing as wildly in value from year to year as their publicly traded counterparts. Private assets are less researched than public equities and hence likely to offer more bargains. And the private markets include investment categories and strategies not accessible on the exchanges.

We're particularly interested in private real assets and private lending (also known as alternative finance), where there still seems to be adequate, if not abundant, opportunity. The good news is that there are a small handful of publicly available mutual funds that invest in both categories. After a due diligence process, we have found two funds in these areas that we are adding to client portfolios — a mid-single-digit allocation to each.

Versus Real Assets (VCRRX)

Private farmland and private timberland have exhibited impressive long-term track records: Double-digit annualized returns, low volatility, solid inflation protection, and excellent portfolio diversification owing to their low correlation with other assets.

The issue until how has been access. These asset classes have largely been employed by large institutions (pension funds, insurance companies, endowments, and private equity firms) and by ultra-high net worth individuals. In the latter category, Bill and Melinda Gates have accumulated enough farmland through their investment vehicle, *Cascade,* that they are now the largest private farmland owners in the US (269,000 acres in 19 states).

Now there is a publicly-available mutual fund that invests a substantial portion of its portfolio in private farmland and private timberland, through selected best-in-class sub-advisers.

Staffed with experts on farm and timber management, *Versus Real Assets* has built a portfolio that allocates nearly half its assets to these areas, diversified by crop type and by softwoods and hardwoods, with interests in every major region (see map graphic). The remainder of the portfolio is invested in private infrastructure assets and private and public real estate equity and debt, which nicely

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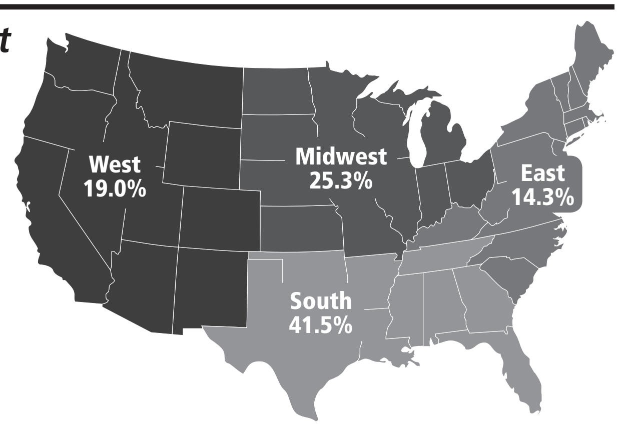
Broad footprint

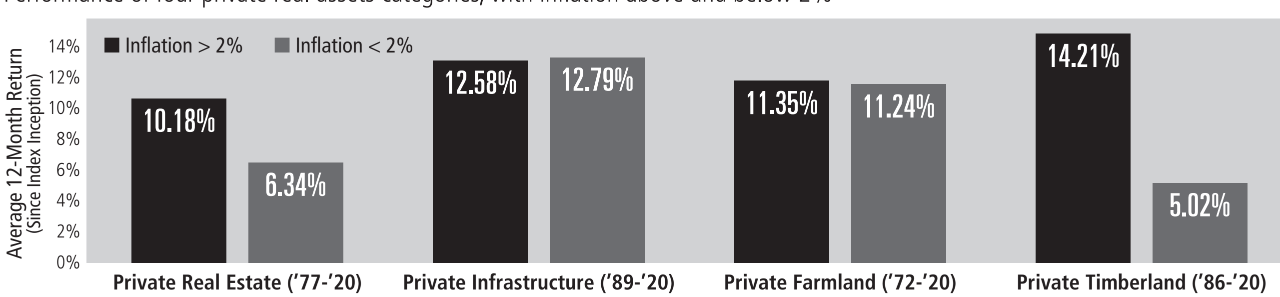
Versus Real Assets — Farmland & Timberland allocation, as of 4/30/21

Source: Versus



Private real assets: Inflation-friendly

Performance of four private real assets categories, with inflation above and below 2%



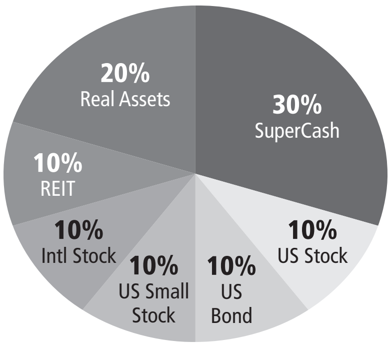
Two takeaways from this graph: 1) Private real assets have done well for decades, and 2) Real Estate and Timberland perform better when inflation is higher than when it's low, while Infrastructure and Farmland perform solidly regardless of inflation.

Sources: Real Estate – NCREIF Property Index; Infrastructure – JP Morgan OECD Core/Core+ Infrastructure Index; Farmland – NCREIF Farmland Index; Timberland – NCREIF Timberland Index

SuperDiversified Portfolios (SDPs)

Two new funds: Where do they fit?

SDP1 *Conservative*

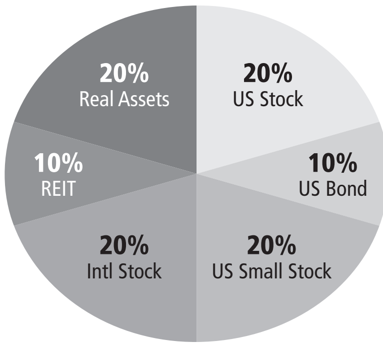


2nd Quarter ***6.95%***

Year-to-Date ***10.68%***

The easy one: *Versus Real Assets* (VCRRX). It will serve to broaden our Real Assets allocation, with interests in private farmland and private timberland that were not previously represented. Its private infrastructure allocation is also differentiated from the publicly listed infrastructure we hold.

SDP2 *Moderate*



2ne Quarter ***8.73%***

Year-to-Date ***14.49%***

The tougher one: *Variant Alternative Finance* (NICHX). Since its return comes nearly entirely from lending income, it would seem that it should fit in the Bond category. But its low duration, its very low volatility, and its non-correlation with fixed-income indices makes it a SuperCash addition.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Inflation: Transitory? The $64 trillion question

Asset Class	Mutual Fund	Performance 2nd Quarter '21	Performance Year-to-Date
SuperCash	PIMCO Instl Low Duration	0.00%	0.00%
	Merger	0.63%	1.49%
	Calamos Market Neutral	1.25%	2.55%
US Stock	Vanguard Index Trust 500	8.51%	15.18%
US Bond	Vanguard Long-Treasury	6.54%	-7.54%
US Small Stock	Vanguard Small-Cap Index	5.57%	16.33%
Intl Stock	Vanguard Intl Index	5.53%	9.69%
REIT	Vanguard REIT Index	11.64%	21.28%
Real Assets	PIMCO Commodity Real Return	14.93%	24.73%

Best
Worst

73 different models of used cars are now more expensive than their original sticker prices. Crazy times. Shortages and imbalances have helped generate the highest quarterly inflation in decades. We think that as the economy normalizes, we'll see a moderation in these numbers, perhaps a partial reversal.

But after these jiggles, it's likely inflation resets at a higher level post-pandemic, given the massive amount of capital that has been pumped into the system. A recent fund manager survey by BofA found 76% of managers considering the recent inflation transitory. We'll go with the minority.

Steady grower

US farmland has delivered only one quarter of negative returns since 1999. That's one quarter out of 86 quarters. The negative quarter was the first quarter of 2002, when the *NCREIF Farmland Index* declined 0.01%. Steady, solid gains have been the rule, with about one-half of the gain from appreciating land values and one-half from farm income.

Why such a solid track record?

Dwindling supply
The US loses more than an acre of farmland per minute to development and climate change.

Burgeoning demand
World population, currently 7.88 billion, will grow to 9 billion by 2050. And increasing incomes worldwide mean increasing need for high-quality crops.

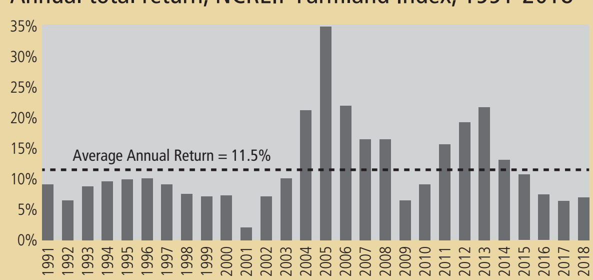
Improving technology
Key agricultural technologies will come into use in the next 10-20 years that should dramatically boost the productive capacity of farmland, raising both yields and land values.

Add to these:

Broadening investor demand
Funds like the one we profile this quarter are likely to become more numerous, increasing retail investor participation in private farmland and timberland and thereby supporting valuations.

All good

Annual total return, NCREIF Farmland Index, 1991-2018



Farmland as an asset class has risen every year since 1991, an average 11.5% per year, with about half of the gain coming from crop income, and half from a general increase in land values.

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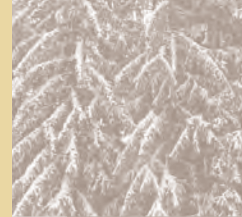

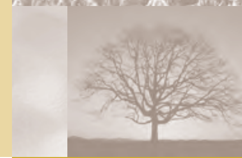

Two funds for challenging times

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balance the farmland/timberland allocation, resulting in what has been very low volatility since the fund's inception in 2017. Returns have been modest thus far, slightly above 4% annually, partly a function of the fund taking a while to get fully invested and partly mediocre returns during a period of US dollar strength and commodity weakness. With the fund now fully invested, we expect more robust returns in the next ten years as the dollar moderates and inflation rises.

Variant Alternative Income (NICHX)

If we eliminate sole proprietorships (like mine) and mom-and-pop businesses, there remain at least ten times as many small-and-mid-sized private businesses in the US as their publicly traded counterparts. And all these businesses need capital to run. Many however, have complex or esoteric credit needs that make it difficult or impossible to borrow from conventional lenders. Business development companies (BDCs) fill part of that lending gap. But much need still flies under the BDC radar.

These borrowers are not bad credits, just unconventional credits. That's where *Variant* comes in. Three examples:

Take microloans. They have an astonishingly high performance rate, upwards of 98%. Roughly 8% of *Variant's* portfolio comprises loans to fintech companies that in turn make these loans to tiny businesses in Africa and Developing Asia. Current accrual rate: 12.3%.

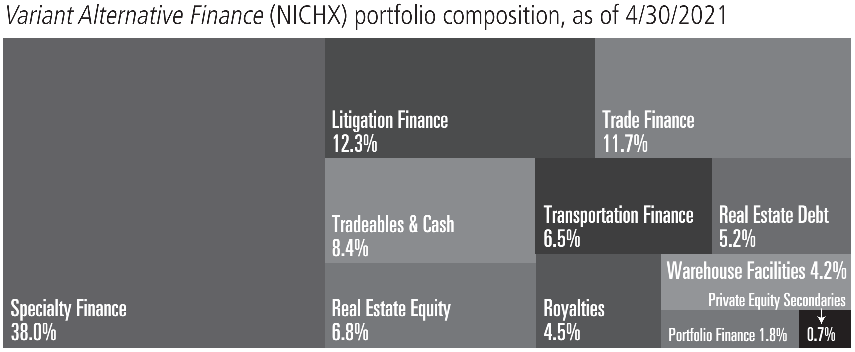
Next, consider *AppAcademy*. The coding school makes deferred tuition and income-sharing arrangements (ISAs) with its students so they do not have to pay up front, yet get training that ultimately more than doubles their incomes within months. *Variant* loans money (0.3% of its portfolio today) to *AppAcademy* for operating capital, and it's repaid from revenues from these ISAs. *Variant* underwrites loans like these very conservatively, analyzing employment rates and income numbers, estimating the worst-case scenario, then pulling back 25% from there. And the loan is well-collateralized. Current accrual rate: 12%.

Finally, consider litigation finance. Law firms' income is lumpy, coming only when they win cases. Through a subadvisor, *B. E. Blank Equal Access Justice Fund, Variant* lends to smaller law firms in need of capital as they await verdicts. The focus is on lending against a whole portfolio of firms' current and future dockets. Again, the fund analyzes past success rates and awards, estimates a worst-case scenario, and pulls back 25% from that figure. That's currently a 0.7% allocation, but litigation finance, both directly and through other subadvisors, makes up 12.3% of *Variant's* portfolio, as of April 30, 2021. Current accrual rate of above subadvisor's loans: 14%.

Overall, *Variant* holds 51 separate positions in 11 different types of lending (see graphic), and most loans are laddered short-term, with more than 80% of capital coming due within the next 36 months. After the occasional non-performing loan and substantial fund expenses, investors have received 8.5% per year with only two down months, both fractional losses recorded at the beginning of the 2020 lockdown. ■

Alternative finance indeed

Variant Alternative Finance (NICHX) portfolio composition, as of 4/30/2021



Variant's (NICHX) portfolio ranges far and wide into niches (hence its ticker) that are unserved or underserved by conventional lenders. As of April 30, the fund totaled $847 million — large enough to be a dominant niche lender but small enough to allocate nimbly within and among these sectors.