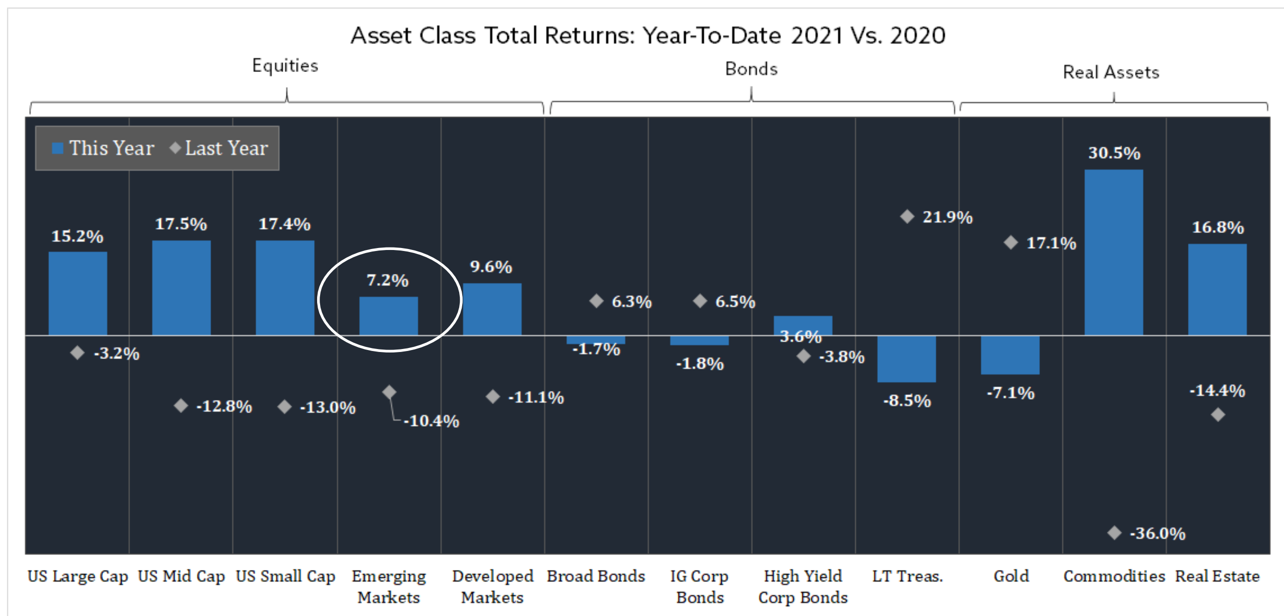
PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
2nd Quarter 2021 Investment Commentary
July 15, 2021

Strong economic growth and rising equity markets continued through the second quarter, as vaccines to Covid-19 became more widely available and social distancing protocols were relaxed. Looking ahead, we survey an economic landscape that has been fundamentally reshaped by the real-world stress-test it has endured over the last 18 months. We also highlight two positions from diversified client portfolios that illustrate what our team has gotten right (and wrong) about investors' response to economic and market developments so far this year. There is much to be optimistic about, but the question for investors is how much of that optimism remains to be priced into markets.

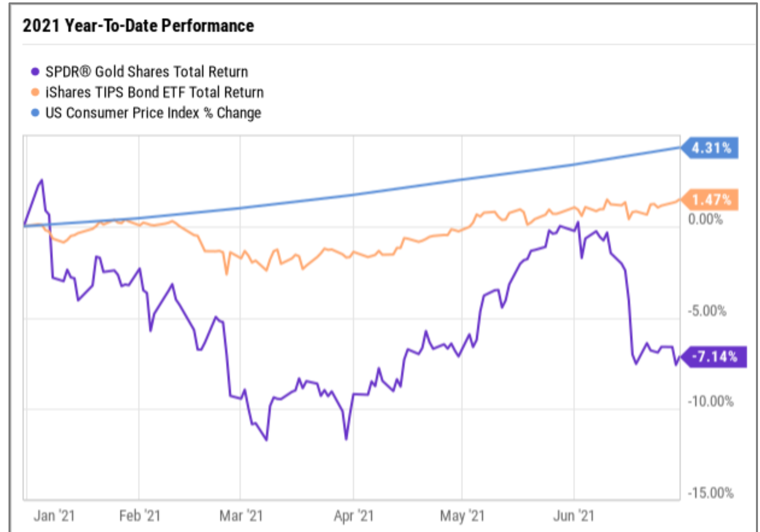
Markets: The poorest performing major stock market category year-to-date has been Emerging Markets stocks, with a return of 7.2%



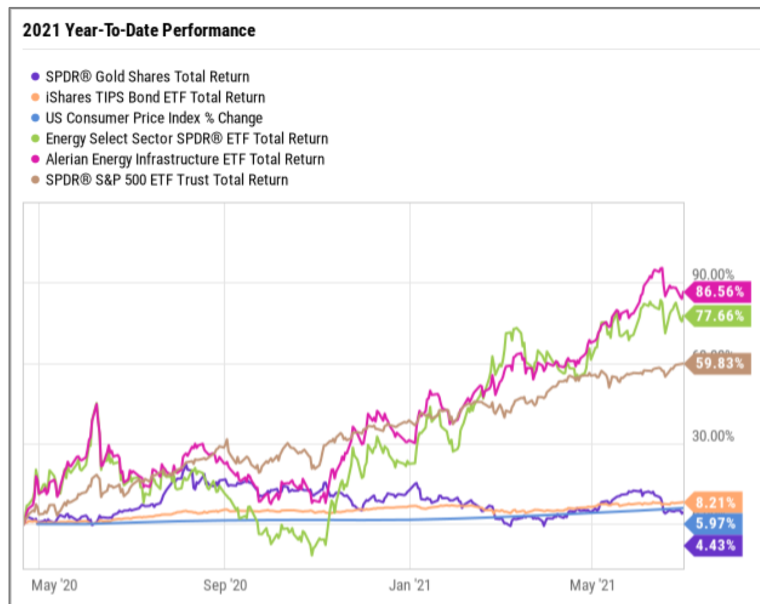
compared to 15.2% for US large cap stocks. Yet, 7.2% return looks great relative to 10-year annualized return of 3.6% for the same index through June 30th. All this to say, if the lowest performing category returns double its 10-year average in half a year, you can confidently say that markets are good. Meanwhile, bonds have delivered minor losses year-to-date as yield-focused investors digested stronger than expected inflation, and US and other countries' fiscal and monetary authorities continue to indicate that their money machines will be running at full capacity, indefinitely. These issues (continued economic strength, inflation, and stimulus) are still the most visible market drivers for both equities and fixed income, and we will be watching them closely for changes.

Room for Improvement: Diversified client portfolios have performed well against their objectives so far this year. While counting chickens is entertaining, we learn the most from examining our rotten eggs. We have learned not to underestimate investors' willingness to jump into markets priced at what we consider to be "nosebleed" valuations relative to the underlying fundamentals. We have also re-learned that sometimes we can have high conviction on long-term strategic portfolio changes that do not line up with short-term focused market views. For example, in the first quarter we discussed the importance of hedging portfolios against inflation, and we outlined why we believed gold was more appropriate than US Treasury Inflation-Protected Securities (TIPS) to do

that. Since that time, gold has significantly underperformed TIPS. While inflation has increased materially over the last 6 months, neither alternative has kept up with it. This highlights the ever-present possibility that investors can be "right" about the big picture, but "wrong" in how we incorporate that picture into portfolio positioning.



Satisfactory: On the other hand, we have found opportunities to not only preserve purchasing power, but also generate excess returns in other areas of the markets that have historically benefited from inflationary trends. For example, prices for commodities often absorb and anticipate inflation if conditions allow it. Because of a combination of strong inflation and strong current and anticipated economic strength, commodities and many of the companies that find, extract, refine, and distribute them have increased in price significantly since March of 2020. We began increasing exposure to the Energy sector in April of last year in diversified client portfolios and continued increasing that allocation through February of this year.



In-Progress: Most recently in diversified client portfolios, we reduced exposure to two sectors: Industrials and Financial Services. Heading into the end of the quarter, our Investment Committee concluded that those sectors currently face more headwinds than tailwinds. Additionally, given elevated valuation levels and investor sentiment, we concluded that the headwinds would likely result in greater downside than the upside that the tailwinds could provide. As a result, we exited positions in ETF's that track the performance of the entire sector and reinvested the proceeds in a minimum-volatility ETF that we have used in the past to protect portfolios from short-term declines while still maintaining overall exposure to equities. When conditions change, our preference will be to rotate back into high quality, undervalued companies within those sectors rather than owning the sector ETF.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

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