Fort Point Capital Partners LLC

Foundational Philosophy

Executive Summary

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» To maximize long-term, after-tax wealth, portfolios must be designed to optimize the trade-offs between risk, return, tax-efficiency, cost-efficiency, and liquidity.

» The most important objective in designing and managing portfolios is creating sustainable return asymmetry; that is, creating more upside than downside participation in rising and falling markets.

» Rather than spending time trying to find "winners" in the form of individual security selection, a manager's research process is best invested constantly seeking out assets and strategies that have a positive expected real return and low correlation to the manager's overall portfolio.

» Market timing – defined as being fully out of the market – is a very dangerous game. Investment strategies must be crafted to allow capital to remain invested in a manner that provides exposure to positive events, while actively reducing exposure to inevitable large negative events.

» For asset managers, small is beautiful. We are big believers in focusing on strategies that benefit from inefficiencies that exist because large pools of institutional capital cannot scale into certain markets that have limited liquidity.

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A Five-Dimensional Investment Framework To maximize long-term, after-tax wealth, portfolios must be designed to optimize the trade-offs between risk, return, tax-efficiency, cost-efficiency, and liquidity. This necessitates integrated portfolio structures that make use of both passive and absolute return strategies, employ risk-based design/ management principles and pursue active tax enhancement activities. [1]

Clarity of Investment Objective The most important objective in designing and managing portfolios is creating sustainable return asymmetry; that is, creating more upside than downside participation in rising and falling markets.

- Losses are linear, but the appreciation required to get back to even scales as losses increase. Since the turn of the millennium, investors have been subjected to two large drawdowns. The S&P's 44.7% decline from 2000 to 2002 required an 80.8% return to get back to even. The S&P 500's 51.0% decline from the October 2007 to March 2009 was even greater and required a 104.1% gain to get back to even.

- Over the last twenty years*, a portfolio that captured 70% of the return of the MSCI EAFE during positive days and 40% during negative days would have compounded at 37.73%, with 9.54% annual volatility and a worst drawdown of 13.41%. During this period, the MSCI EAFE compounded at 30.93% with 11.60% annual volatility and a worst drawdown of 7.06%.

All the virtues of successful investment management – from robust risk-adjusted performance statistics to attractive long-term returns – radiate from asymmetry. This foundational objective turns the conventional doctrine of investing on its head: structuring portfolios to be protective during adverse market periods is far more important than "beating the market/benchmark" during positive periods. Effective risk management applied with consistency trumps periodic return heroics.

Focus on Risk before Return The critical importance of reducing portfolio downside means that a money manager's pre-occupation should not be looking for hot stocks or big payoffs, but precisely the opposite. What are the big potential negative payoffs; where is risk/reward least favorable? Portfolios should be dynamically adjusted to reflect these views, underweighting assets with unfavorable risk/reward and redeploying capital into other assets with more favorable risk/reward. This is an ongoing, dynamic process. Diversification across many asset classes, geographies and strategies coupled with getting tactical tilts right on the margin, creates the ability to generate significant long-term outperformance relative to the market and other money managers.

Redefining "Winners" Rather than spending time trying to find "winners" in the form of individual security selection, a manager's research process is best invested constantly seeking out assets and strategies that have a positive expected real return and low correlation to the manager's overall portfolio. Introducing these assets and strategies creates incremental risk/return improvement to the overall portfolio in the form of decreased downside and reduced volatility, leading to enhanced long-term returns.

Total Portfolio Thinking It is the behavior of the portfolio in totality, and not just the individual assets in it, that matter most. This approach necessitates a totally integrated portfolio approach where all decisions are recognized as inter-related and made in the context of the composite portfolio. The goal is to achieve extensive diversification across many return sources influenced by different economic and market factors, with each portfolio component "big enough to matter, small enough not to hurt."

[1] A dilemma investors must confront is that the items on the current investment menu – traditional active management, index strategies or hedge funds – are sub-optimal when considered on a standalone basis. The trade-offs are just too great. Traditional active management is, on balance, a losing proposition for investors due to costs and taxes. Conventional indexing is cost-efficient, but not as tax-efficient as it could be and, like active strategies, it exposes the investor to market risk that can erode principal. But risk management, in the form of hedge funds, is richly priced and often tax-inefficient. We are left with circular logic and tough trade-offs. No one approach wins. Many investors succumb to inertia and do nothing out of frustration or lack of obvious alternatives. Others constantly reconfigure their asset allocation and flip in and out of whatever seems to be working. The risk inherent in either response cannot be understated.

Source: Bloomberg
** Period ending 12/30/2022*

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Volatility Matters Many investors fail to understand how portfolio volatility influences long-term portfolio performance. Consider three portfolios all averaging a 10% return over twenty years, but with different levels of volatility:

- A portfolio averaging 10% annual returns with 8% volatility would have a cumulative return of 540%.

- A portfolio averaging 10% annual returns with 18% volatility would have a cumulative return of 403%.

- A portfolio averaging 10% annual returns with 30% volatility would have a cumulative return of 214%.

Widening volatility exposes portfolios to more frequent and deeper periods of negative returns, requiring greater amounts of positive portfolio performance to recover. Volatility control must be viewed as a core objective, not an abstract concept.

Unpredictability and a Spectrum of Scenarios Markets have many, unpredictable feedback loops and inter-related variables (e.g., investor psychology, exogenous events, etc.) influencing them and it is impossible to predict with confidence what any future period holds for returns in any given market. Accordingly, portfolio structures based on risk management must be predicated on the view that a wide range of outcomes are possible and therefore seek to avoid taking a concentrated bet on one outcome – win big in one outcome, lose big in others. Portfolios should be diversified across many assets, geographies and strategies and structured to generate acceptable risk and return across multiple potential outcomes, where no one result generates big losses. This approach has been foundational to the investment strategies of the most successful institutional investors. The successful manager must live with tension of opposing outcomes and be able to conceive scenarios across a spectrum with the apocalypse on one end and euphoria on the other.

Structured Contrarianism At certain points in time various assets become so objectively overvalued relative to others (e.g., Japan in the mid-80s, tech in 2000, credit leading up to the global financial crisis, etc.) that their risk/reward becomes highly negatively skewed. At points such as these, money managers must be disciplined in reducing weightings in these assets and redeploying capital into assets with more favorable risk/reward skew. While doing so creates the possibility of being "too early," managers can generate significant excess return when overvalued assets mean revert as they inevitably do.

Doing this successfully requires an objective, structured and systematic way of evaluating relative risk/reward to protect against emotional biases. Most investors and money managers do the opposite by clamoring in a herd for the most overvalued assets (those with the most favorable recent performance typically). The best time to reduce exposure is when an asset is expensive and risk seems low. The best time to increase exposure is when an asset is cheap and risk looms large. This is easy to say, yet hard to do in the absence of a structured, systematic, objective investment process.[2] Value tilts have historically been rewarded in many asset classes precisely because this is hard to do.

Recognizing and Dealing with Cognitive Fallibility All investors are susceptible to a host of cognitive mistakes: overconfidence, herding, extrapolation of recent experience, anchoring, loss aversion, and seeing false patterns. These behavioral biases – coupled with uncontrolled tax and implementation costs – are the primary reason most investors fail to achieve a market rate of return.[3]

Successful managers must humbly embrace their own fallibility and put in place a structured, objective and data-based investment process based on a valid set of assumptions about how markets work.

[2] In the paraphrased words of Jeremy Grantham of GMO, optimal investing is a mix of a few important judgmental overrides interspersed with long periods of cold, disciplined blocking and tackling around a well structured portfolio of assets.

[3] A study conducted in October 2011 examined returns derived by U.S. private investors during the 1982 to 2000 secular bull market. During this period the S&P 500 index returned 16.1% per annum; the average U.S. equity mutual fund returned 13.8% (not coincidentally, 2.3% represents an approximation of fees and costs involved in active equity strategies); the dollar-weighted return for the average U.S. equity mutual fund was 7.0%; inflation averaged 3.0% during this period and tax impact is estimated to reduce net returns by an additional 1.5%. In other words, the dollar-weighted, post-fee, post-cost, post-tax real compound return experienced by investors in U.S. equity mutual funds was approximately 2.5% versus a real return of 13.1% for the S&P 500 index.

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It's All in the Tails The impact of large positive and negative market events dominates long-term investment performance. Distracted by significant noise and data around daily market moves, most investors spend their time thinking and acting solely in this realm (e.g., will Microsoft beat or miss estimated earnings by a penny this quarter?). It is the tail activity that, over time, drives long-term returns.

- From 2002 through the end of December 2022, the S&P 500's compound annual return excluding the best 10 days (.1% of all trading days) would have been 4.07%, a cumulative return of 131.10%.

- In this same period, the S&P 500's compound annual return excluding the 10 worst days would have been 12.07% representing a cumulative return of 992.98%.

The implications of this are that market timing – defined as being fully out of the market – is a very dangerous game. Investment strategies must be crafted to allow capital to remain invested in a manner that provides exposure to positive events, while actively reducing exposure to inevitable large negative events.

The Fallibility of Risk Models Assumptions of normal return distributions, stability of correlations, price continuity, liquidity and investor rationality cause risk models to chronically underestimate the frequency and magnitude of large moves in asset prices and markets. The increased use of quantitative investment strategies and risk management methodologies has magnified the risk of "computer herding." Portfolio risk must be assumed to be higher than any model's output implies.

Avoidance of Long-only Active Management The probability of long-only, individual security-selection strategies generating sustained excess post-tax, post-cost returns is exceedingly low. This is a logically sound conclusion looking at the zero sum nature of markets and the simple math of fees, trading costs and tax effects of active strategies. Without being pedantic, the rational investor seeking to maximize after-tax, after-cost wealth should dispassionately avoid the bulk of long-only active strategies.

Shaping the Return Distribution Portfolio risk can easily be reduced by introducing risk-free assets, but there is no value created by the manager. Many tools exist to generate reports that show pages full of numbers attempting to describe portfolio risk, but judgment and creativity is required to apply such information to enhance portfolio risk/return. Value-creating risk management seeks to "shape the curve" to extract maximum return per unit of risk taken. This means seeking ways to truncate left tail exposure, reduce portfolio volatility, increase positive skewness and create exposure to right tail events.

The One Certain Alpha Source Tax loss-harvesting is the one predictable and reliable source of "alpha" in portfolio management. It should be systematically pursued and is best executed in a portfolio employing an indexed approach to asset class exposure, where fungible replacement instruments are available to limit tracking error.

Small is Beautiful We are big believers in focusing on strategies that benefit from inefficiencies that exist because large pools of institutional capital cannot scale into certain markets that have limited liquidity. The reasons for this phenomenon are deceptively simple: massive allocators require massive capacity, thus ruling out economically compelling investment opportunities that are immune to scale.

For example, if a $10 billion asset manager (contextually small when compared to a Blackrock or Fidelity) believes that a $200 million market capitalization company is undervalued by 50% and they want to avoid insider restrictions, they would traditionally endeavor to own no more than 10% of said company or $20 million of economic exposure. Even if they are correct and invest at that 10% threshold, they stand to generate only +0.10% of positive attribution on their gross asset base. Thus an otherwise compelling investment opportunity is economically meaningless to the manager and avoided due to the impact of scale-driven incentives. Because of this scale quandary, the largest asset managers tend to gravitate upstream to where they can size their bets in more profound ways. Unfortunately, as one moves

Source: Bloomberg

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upstream the democratization of information also increases which erodes the benefits of proprietary insights. In short, size commoditizes opportunity.

This institutional imperative creates an opportunity for us as a small, nimble allocator who thrives on identifying and profiting from these inefficiencies.

Winning the Game of Inches Small differences in periodic returns make enormous differences over time. The ending wealth differential on an initial portfolio of $1 million compounding at 9% versus 8% over thirty years is $3.2 million. Efficiency must be sought relentlessly in both overt expenses (custodial fees, execution commissions, interest expenses, etc.) and hidden costs (market impact, bid/ask spread, opaque fees, etc.).

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