

Market Matters: 1st Quarter 2025

“Life is Poker, Not Chess” – Annie Duke, Thinking in Bets

- Uncertainty in the Markets is high, and trending higher.
- Government policy, lingering Fed ambiguity, and general negative sentiment are all fueling market swings.
- Volatility can be a source of opportunity, but is not a mandate to go to cash.
- Diversification is proving its worth in return stability.

Thinking in Bets¹: Investing in the Face of Uncertainty

Reintroducing Risk: We’re Playing Poker, Not Chess.

Since the rate hiking, Fed-fueled turmoil of 2022, investors have gotten accustomed to the market going up and recession risk going down. This relative comfort was uncomfortably broken when government policy changed on a dime starting after Inauguration Day. Everything from tariff policy, geopolitics, immigration, and tax cuts to the very government itself is on the table for dramatic changes. Some initiatives are in progress, some are held up in court, others are simply pending. Uncertainty abounds.



In a game of chess, the pieces are on the board for everyone to see. There is no hidden information, no appreciable impact of luck or chance. If you lose, it’s because you miscalculated: there were better moves laid out in front of you that you didn’t take. In cards, there is a multitude of hidden information and luck - the hand you are dealt, the (hidden)

hands that others are playing, along with uncertainty regarding the skill level and mistakes of the player(s) sitting across from you. **Deciding what to do next under a veil of incomplete information is a matter of finding a signal in the noise and playing the odds.** We don’t always respond to the right signals, and even if we made the best decision possible every time, we might still lose due to chance.



We are investors, not gamblers, but we are put in a similar position. We are faced with making decisions in the presence of profound doubt. We have little insight into what national governance decisions will

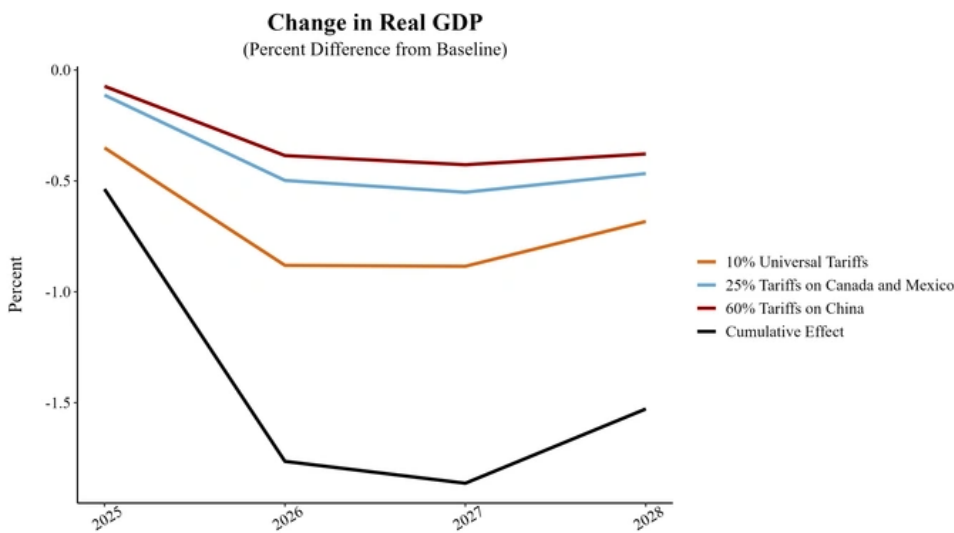
¹ With credit to the authorship of Annie Duke

materialize or their effects. Furthermore, the **rules of the game are changing faster than ever** as terms of trade and even the government itself morph into a different structure.

When valuations are high, corrections are more likely. It wouldn't have taken much to dampen the euphoria from the beginning of the year. But investors were quickly bombarded with *much* unsettling news – a shakeup in tariff policy, cuts to government staffing and agencies, uncertainty regarding government debt and budgets, and a laundry list of other changes. This comes at a time when the economy is slowing, the Fed has paused interest rate reductions, and bond yields have priced in higher inflation. We are reminded that we can't see all of the cards and we don't know what will be played next.

The markets were betting that President Trump would make good on deregulation and tax cuts, but that when it came to trade, he was bluffing. Chance would have it that *both* of these bets were losers. Instead of systematic deregulation, government agencies are in turmoil and legal challenges leave confusion in their wake. **An absence of order is an increase in risk without an increase in reward.** Tariffs are

being assessed with a heavy hand, but at times without resolute parameters. Retaliatory tariffs are being laid onto U.S. goods. Higher prices of goods in the U.S. due to importation taxes, in conjunction with lost revenue from retaliation, will have a negative impact on growth, increase job losses and add inflationary pressures.²



The problem was assuming that Trump 2.0 was going to resemble Trump 1.0. This flowed easily from thought patterns that normal humans follow. We form sticky beliefs from our earliest experience. We believe what is easiest, but not what is most likely. Now, we need to re-evaluate.

Historically, Equity and 60/40 Portfolios Do Best in Environments of Real Growth Acceleration and Inflation Deceleration

Median 60/40 Portfolio Returns by Macro Regime
60/40 U.S. Equity & Bond Portfolio

REGIME	REAL GROWTH ACCELERATION	REAL GROWTH DECELERATION
INFLATION ACCELERATION	9.7	5.5
INFLATION DECELERATION	14.9	10.8

At left, it seems we are likely to have real growth deceleration. A slowing business cycle will be slowed more if the announced tariff policy is fully implemented. While inflation has decelerated, this seems to have stalled and could reverse as prices

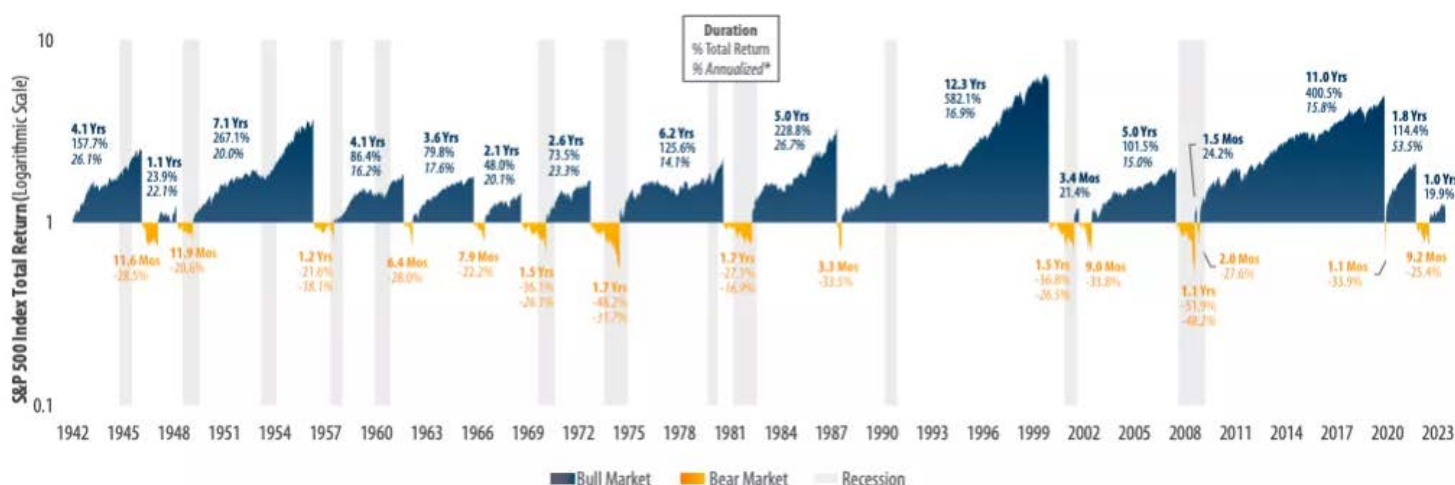
² Graphic from the Council on Foreign Relations

adjust to tariff policy. This points us to the upper right hand column (red), with lower average returns.³

In a bad case, we have an inflation uptick and negative growth triggered by a global trade war (and possibly a full-on recession). This would likely cause a more prolonged drawdown with a longer recovery. In what currently looks like the best case, tariff policy is moderated, retaliation is modest, and we have limited inflation and low but positive real growth, where portfolios can see modest real return. In between the bad and the best cases, a lot could happen. A non-transitory pickup in inflation with low-to-no or negative growth (a stagflation scenario) could lead equities into a bear market, leaving credit and bonds to pull off positive returns.

A Double Dip on the Horizon?

At the close of Q1, the S&P 500 was down ~8% from its peak in February. The market was effectively skating a correction, after previously touching -10% declines in both mid- and late March. On April 2nd, President Trump's tariff announcement sent markets reeling into a full correction, with the S&P 500 sliding ~10% in the remaining two trading days of the week. It doesn't look like prior bear markets yet (below), which may be evidence that **a recession isn't fully priced in**. Heightened uncertainty has reduced valuations and encouraged risk-off investing. Having more answers in the future could help, hurt, or breed even more uncertainty. When the economy and market valuations are at a peak, even a modestly elevated chance of a worse economic outcome could trigger another selloff.⁴



A Healthy Remix from Higher Volatility: Diversification in Three Dimensions⁵

Public Markets: Fixed Income and Equities

Fixed income markets have been volatile, but there is real yield to be found with built-in protection in BDC bonds and high grade CLO's or other securitized floating rate instruments. Lower duration cushions

³ Morgan Stanley

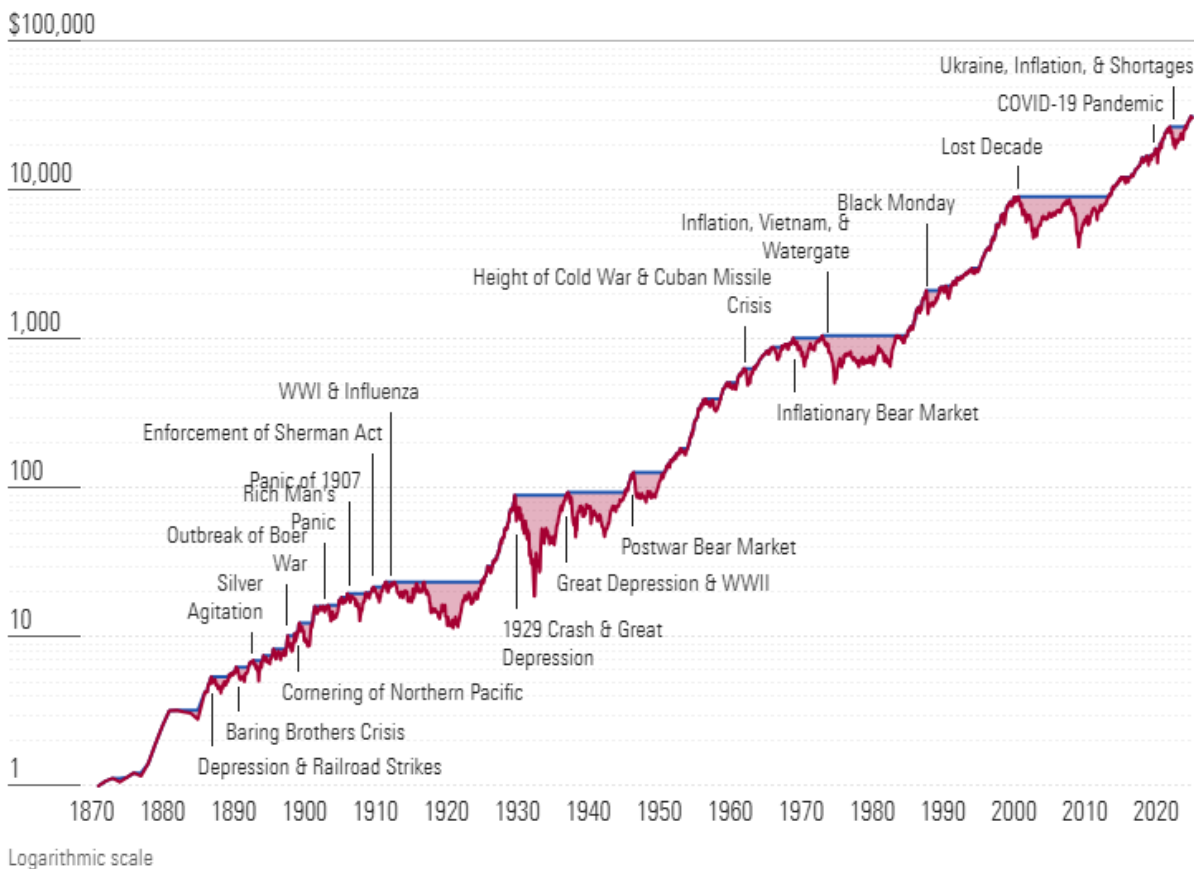
⁴ Graphic from Investopedia

⁵ Credit to Dr. David Kelly, JP Morgan

investors from yield shocks caused by changing inflation expectations or possible Fed rate surprises, while supplying decent real yield.

Diversification in equities created a drag on return when Mega-Caps were surging, but it is helping as these stocks tumble and lower risk stocks maintain their pricing. Value investors and quality tilts underperformed by an annualized 5% over rolling 1, 3, and 5 year basis by some measures. Now, the tides seem to have turned. The Russell 1000 Value is outpacing the Russell 1000 by 6.4%, posting +1.6% YTD as of 3/31 while the base index is down -4.8%. Minimum volatility funds like those from Vanguard and iShares are even more divergent, with positive returns in the range of ~+5.4% YTD, against the S&P 500's -4.6%, **a 10% return advantage for investors who bet on diversification**. High volatility also creates opportunities, and buying in when valuations are discounted has historically been a good bet.

Though we can't see what might be coming next, **a diversified portfolio of U.S. equities has always recovered** in the past, with the longest stock bear market in modern history lasting from 2000 to 2009,⁶ but the average lasting about 10 months. 88% of rolling 5 year periods have produced positive returns⁷.



Source: Kaplan et al. (2009); Ibbotson (2023); Morningstar Direct; Goetzmann, Ibbotson, and Peng (2000); Pierce (1982); www.econ.yale.edu/~shiller/data.htm, Ibbotson Associated SBBI US Large-Cap Stock Inflation Adjusted Total Return Extended Index, S&P 500 (Bureau of Labor Statistics, Non-Seasonally Adjusted Consumer Price Index (2025). Data as of Feb. 28, 2025.

⁶ Graphic from Morningstar

⁷ Capital Group, Curvo

For a 60/40 portfolio, drawdowns have been less painful, with **positive returns 100% of the time for any length of time over 5 years**. Depending on portfolio composition, 5 year rolling returns were positive 99% of the time and 1 year returns ~80% of the time. **Up the ante on your time horizon. Time in the market heals all wounds.**

Returns of the 60/40 portfolio over time



Private Markets: Alternatives (the Third Dimension)

Private Markets were also less appealing when stocks were in a bull run. Large Cap indexes outpaced average private equity returns, due in part to small companies in the lower middle market not seeing a comparable increase in multiples as the Mag 7. With the markets at a reset point, Alternatives provide investors with through-the-cycle investments that can add both diversification and return.

Private credit offers higher yields and cushions against market declines when loans are senior secured with adequate ratios and covenants. Higher-for-longer rates have helped the private credit universe pay investors generous yields, but even in a lower rate environment, a core allocation to high quality credit is beneficial. Both private credit and private equity offer benefits in terms of lowering portfolio correlation to traditional stocks and bonds *while* increasing return (in purple, below).⁹

Private Equity has the advantage of being able to implement multiple levers of value creation, though less favorable economic conditions can lead to longer hold periods and less liquidity for investors. Lower interest rates are a tail wind for PE, which may help if and when the Fed decides to cut rates. Private Equity is an inherent diversifier compared to the public markets, which only represent 15% of investable companies. PE offers exposure to the other 85% companies across sectors and geographies at times when they are most opportune.

⁸ Graphic from Vanguard

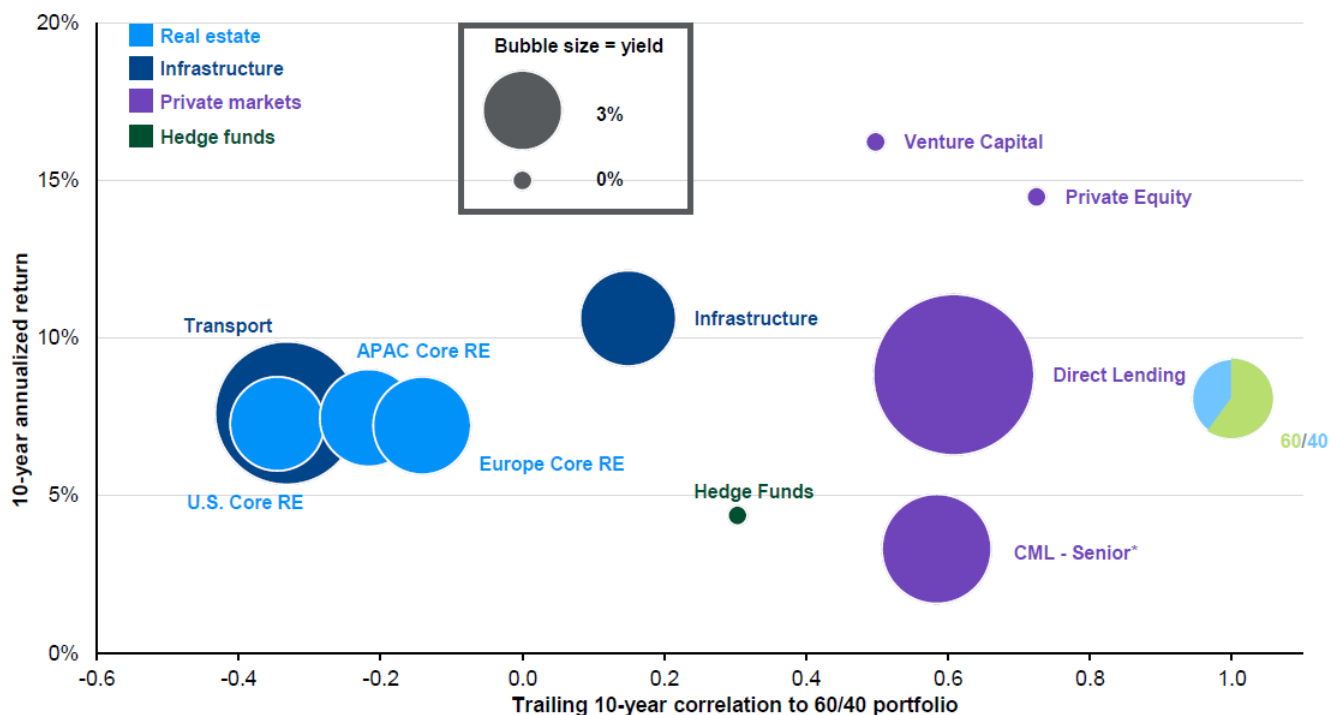
⁹ Graphic from JP Morgan

Private Real Estate is an even better diversifier, offering investors more customized exposure to sectors and geographies, opportunistic themes, and lower volatility than publicly traded REITs. Real estate also functions well as inflation hedge, with low correlations to traded markets (in light blue).

Private Infrastructure likewise has a low correlation to other asset classes (dark blue), and private markets offer infrastructure opportunities for which there are virtually no investable proxies in the public universe. The good news for investors who are looking to diversify is that there are now more options for high net worth investors (not just institutional buyers) to invest in quality private infrastructure funds.

Correlations, returns and yields

10-year correlations and 10-year annualized total returns, 4Q14 – 3Q24



The price paid for lower volatility (and arguably the reason for it) is **illiquidity**. Investors should not make bets on liquidity in the private markets and must be diligent not to overextend their illiquidity budget due to return of capital expectations. Even evergreen funds that do offer redemptions typically have fund and/or investor level liquidity limits or lockups. **Don't bet too much on liquidity** provisions, which should be taken with a proverbial grain of salt.

Final Thoughts

Investors are better off thinking in bets, not acting on sentiment. Tactical rebalancing allows investors to **lean in when the odds are in your favor, and lean out when the odds are against you, keeping in mind that no one should make a bet they can't afford to lose.**

Most investors are like amateur poker players sitting at a table with professionals, playing against the smart money, which gets in ahead and gets out before them. Herding behavior encourages following

trades and trends rather than target and tactical allocations. Though even geniuses make some pretty big mistakes, deep pockets can afford them more easily than most investors. The smart money has usually already won the trading game, so stick to your own established playbook (i.e., your long-term asset allocation). Rebalance in accordance with long-term targets or tactical ranges, over-rebalance if your risk tolerance has genuinely changed, but do not retreat to cash.

"Resulting", or changing strategy because it didn't work out well in the short run, is a common instinct. But a drawdown should not be confused with the failure of a long-term portfolio allocation. The best decision making may have poor short-term results due to bad luck, but over the long term, staying the course is a more successful strategy than wholesale changes every time the market tides turn. **The only thing more difficult than *deciding what to invest in* is *deciding when to invest later*** if you opted to sit on the sidelines. We evaluate the information we have and make decisions that we think will maximize wealth over the span of an investor's time horizon.

We need to adapt to our current uncertain and unpredictable environment. In doing so, investors will be well served to make bets backed by the best assessment of the entire spectrum of investment opportunities, the most candid appraisal of our economic environment, and the odds of long-term success.

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