Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

February 5, 2021

2021 Investment Outlook

Executive Summary

- We continue to expect volatility ahead but anticipate that most assets will outperform cash long-term. Just like 2020, those returns will not come easy nor in a straight line and we should be prepared, as always, for our fair share of surprises.
- We still consider cash an unattractive investment on an absolute basis, but it is starting to look better than many high-grade taxable bonds. We are likely to hold some cash to capitalize on bouts of volatility, but generally prefer high-grade and high-yield municipals selected by active managers.
- It is becoming increasingly uncomfortable to hold US stocks; however, while recognizing the risks, we still assess that they are worth owning due to their yields well above cash and bonds. We are warming up more to international markets, which may benefit more from a global recovery.
- In alternative assets, we have cut our hedge fund manager count and overall exposure, but continue to look for great partners like the biotech managers we invested in during 2020. These funds not only delivered solid returns, but backed some of the vaccines seen in the news. We also continue to deploy capital selectively into private equity. While we do not expect runaway inflation, we have recently increased exposure to precious metals, as well as traditional and alternative energy plays.

Introduction

Any hopes that 2021 would quickly bring a return to normalcy for humanity and financial markets were quickly dashed in the first few weeks of the new year. While we certainly expected some volatility in January due to the US political situation and the vaccine rollout, we did not expect the main source of volatility to come from Reddit users trading GameStop. We do, however, expect the rest of 2021 to look a fair amount like January in many ways. As always, we do not change our views on assets with the flip of the calendar year and believe forecasting short-term returns is error prone.

In this update, we will discuss our long-term thoughts and plans across the various asset classes as we settle in for the rest of 2021. In brief, we are planning for volatility but expect most assets to outperform cash long-term. As we experienced in 2020, those returns will not come easy nor in a straight line and we should be prepared for a fair share of surprises.

Cash and Bonds

Our view on cash on an *absolute* basis remains mostly unchanged since we last wrote, but it is beginning to look more attractive than many bonds on a *relative* basis. Yields on cash, before even considering taxes or inflation, remain at historic lows. The Federal Reserve and its global central bank peers have flooded the world with cash. In fact, the increase in global liquidity over the last year is alone greater than the total amount of liquidity that existed before 2008. As Jerome Powell noted recently, “the time to raise rates is no time soon,” and we do not expect central bankers to tighten in the near term. While this expectation suggests that financial conditions will remain extremely accommodative for the foreseeable future, it also means that cash is over owned and unattractive on an absolute basis. We currently hold some excess cash in lieu of bonds and in anticipation of volatility, but we are constantly searching for better opportunities. We have also parked some of this excess cash in short-term municipals to pick up some additional yield.

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

Turning to bonds, our view is a bit bifurcated. The 10-Year US Treasury bond currently yields just over 1%. This is at a time when both political parties are willing to spend an additional $600 billion to $1.9 trillion in stimulus that will increase already unprecedented domestic debts. The Federal Reserve, as noted above, is on hold for the foreseeable future and would like to see inflation moving above 2%. This provides very little value to Treasuries to compensate investors for inflation, let alone taxes, and we find ourselves agreeing with others who deem the asset speculative or "reward-free risk." High-grade corporate bonds are not much better. If we strip out inflation – again, before even considering taxes – high-grade corporate bonds sport a negative yield, meaning we are essentially paying corporations to hold our capital for us. We expect to move toward the very low end of our strategic ranges in high-grade bonds and are considering other options, including mortgage debt.

As to municipals and high-yield debt, we are slightly more optimistic and expect to remain near long-term targets. In our core municipal fund, we can still find high-grade, tax-free bonds maturing over the next five to seven years yielding just about 1%. High-yield municipals are even more attractive, producing tax-free yields of 3-7%. The potential combination of higher taxes, infrastructure spending and aid to state and local municipalities from Congress are strong tailwinds for the sector. Retail investors who pulled record capital from the high-yield municipal market last year have recently been gingerly stepping back into this space, a trend that may accelerate. Finally, on high-yield taxable corporate bonds, we again see relatively slim pickings. The overall yield on the space is at its lowest levels in history. We still expect, however, that active managers can sort through a retail driven market for opportunities and fallen angels.

Public Equities

For many reasons, US equities are becoming increasingly more uncomfortable to hold, but we conclude that long-term investors should continue to strategically hold on and even add to US stocks on weakness. The list of concerns around US stocks is long and growing. Retail investors are increasingly bullish and participating through riskier leveraged bets. So far this quarter, companies who are beating their earnings guidance are significantly underperforming companies who missed earnings targets. Valuations are generally expensive based on most historical metrics. Large indices are increasingly dominated by a handful of names concentrated in certain sectors like information technology. All of these factors are reminiscent of bubbles we have experienced in the past.

However, there are still several strong mitigating factors that motivate us to stay invested. Unlike our two previous major bubbles in 2000 and 2008 when the Federal Reserve was hiking rates to combat inflation and exuberance, the Fed is and will remain extremely accommodative at this time. While fundamentals and technical factors are not great, liquidity is and will remain abundant. Second, relative to both cash and bonds, the earnings yield on stocks is still attractive. Third, despite the IPO boom, the number of publicly listed companies continues to shrink while demand for US equities remains solid. Finally, companies have locked in historically low borrowing rates and are poised to grow earnings at potentially record rates in 2021. We are maintaining a near neutral stance to US stocks for now with our eyes wide open to the risks.

We are similarly remaining near neutral to our targets in international equities. International stocks remain relatively cheap compared to their US peers and their own historical averages. We have noted in the past that there are often good reasons why this is the case, but we do think some of these reasons may begin to fade somewhat. First, international stocks tend to be less concentrated in information technology and more exposed to cyclical sectors like financials and energy. While this attribute has been one driver of international underperformance over the last ten years, it may turn to a solid tailwind as the global economy eventually recovers and these cyclical industries rebound. We have also been skeptical of the idea that Europe is anything like the union we have in the US with one political system and a largely homogenous

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

society. While the Europe Union still has its long list of issues and a long road ahead, it has finally put Brexit largely behind it and made strides toward fiscal unity. Finally, we remain bullish on China and the overall Asia region, which has weathered the COVID storm better than global peers. We expect US-China tensions to remain heated, but do still want exposure to China's massive and ascendant middle class.

Alternative Assets

In terms of alternative asset classes, our views remain mixed. We have significantly reduced both our hedge fund exposure and the number of hedge fund managers we utilize across the portfolio. We continue to believe that hedge funds are not a true asset class, but purely a structure of partnership. The overwhelming preponderance of these partnerships are not worth the fees or illiquidity they offer. We do, however, believe in partnering with a handful of managers who have exceptional skill within their well-defined circle of competence. In 2020, we sold many more hedge funds than we added, favoring new partners with strong, sustainable competitive advantages. Our largest additions, for example, were to biotech specialists who not only delivered solid returns, but also helped support COVID vaccine development. We expect to add more to partners like them in 2021.

Contrary to the hedge fund space, we continue to believe that private equity serves a useful purpose and that the asset class is generally worth its fees and illiquidity. New companies are scaling faster than ever before, but require both capital to grow and guidance on how to manage that growth. The potential for increased public market regulation suggests that even more companies may stay, or become, private. We continue to deploy capital into private markets very selectively, while also benefitting from the recent boom in IPOs. In Q4, we re-committed with one manager who delivered an 83X return to us on an IPO in a previous fund. We backed another manager who helps scale new firms through its in-house lab.

Finally, in real assets and real estate, our views are divided. We do believe there will be some diamonds in the commercial real estate rough and, as a result, recently committed to a fund looking for small, distressed properties. However, we remain quite skeptical that traditional office space and hotels will completely return to their former glory. We continue to expect that non-traditional real estate, such as single-family rentals, cell towers and industrial warehouses geared to e-commerce, will be the long-term secular winners, even post-COVID. As we wrote in an investment update last July, we remain unconcerned with the risk of runaway inflation any time soon, but we do assess that there could be some very surprising transitory inflation prints. We reason that liquid, traditional energy equities, precious metals and alternative energy plays are all good hedges against this risk and we will likely continue using a combination of these defensive positions within the asset class.

As always, we appreciate your trust in us and take our jobs as stewards of your wealth very seriously. We think the road ahead will continue to be rocky and volatile, but that we can capitalize on resulting opportunities due to our long-term time horizon. We wish you a happy 2021 and hope to see you in person later this year.

This material is published solely for the interests of clients and friends of Sentinel Trust Company, L.B.A. The opinions expressed are those of Sentinel Trust Company management and are current as of the date appearing on this material. The material is not intended to be used as investment advice, nor should it be construed or relied upon, as a solicitation, recommendation, or any offer to buy or sell any securities or products. Any offer may only be made in the current offering memorandum of a fund, provided only to qualified offerees and in accordance with applicable laws. Each type of investment is unique. This material does not list, and does not purport to list, the risk factors associated with investment decisions. There can be no assurance that any specific investment or investment strategy will be profitable. Before making any investment decision, you should carefully review offering materials and related information for specific risk and other important information regarding an investment in that type of fund.