October 12, 2020

Dear Fellow Investor,

Less than one month out from the election and most of the investment commentary these days is centered around who will win and what that means for the markets. While we will refrain from any prognostications on the election outcome and the impact on the general market, we do believe that our portfolios are poised for a strong fourth quarter no matter who wins the election as a result of the crystallizing events we anticipate for Fannie Mae and Freddie Mac in the post-election period.

Regardless of who wins the election, there remains a lot of heavy lifting to be done in Washington to get people and businesses back to work and the challenge at hand is not going to be easy. With interest rates at the zero bound and expected to stay there for years, the Federal Reserve is limited in what more it can do without having significant implications for the dollar and the financial system at large (see how negative rates worked for the banks in Europe). Something we learned the first day in Econ 101 is that there is no free lunch. Politicians and central bankers have been kicking the can down the road for years and eventually, there will be a price to pay. With the markets more and more dependent on fiscal and monetary intervention for a sugar high, investors should be prepared for greater bouts of volatility no matter the outcome in November.

Portfolio Update

The junior preferred shares of Fannie Mae and Freddie Mac (FNMAS/FMCKJ) remain our largest holding (we added during the quarter near current levels) and our conviction level is higher than ever that the train is about to leave the station.

On September 25th, the Financial Stability Oversight Council (FSOC) unanimously endorsed the proposed capital rule released by the FHFA (Federal Finance Housing Agency) in May 2020. In a released statement, FSOC had the following to say about the proposed capital rule:

"The proposed capital rule represents a significant step by FHFA to address the Council's recommendation in its 2019 Annual Report that FHFA continue to develop capital and other prudential requirements for the Enterprises.

Capital is a core component of the regulatory framework because capital absorbs unexpected losses and helps promote market discipline by aligning incentives and curtailing excessive risk taking. Moreover, significant private capital is the foundation for resilient national housing finance markets."

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This endorsement of the proposed capital rule by FSOC is another significant step on the path toward ending the conservatorships of Fannie and Freddie. The 10 voting members of FSOC include Treasury Secretary Steven Mnuchin, Federal Reserve Chairman Jerome Powell, and FHFA Director Mark Calabria as well as the head of the FDIC and the Comptroller of the Currency. Having the stamp of approval from FSOC, considering the councils membership, gives the FHFA cover to move forward with a final capital rule despite calls from industry groups and politicians for either delaying the process and/or lowering the final number. With the comment period concluded on August 31st and FSOC's recent endorsement, all signs point to a process that is moving forward full steam ahead and as such we expect the capital rule to be finalized in late October/early November.

Upon the publishing of the final capital rule, all eyes will turn to Treasury Secretary Mnuchin and FHFA Director Calabria. The consistent theme out of the FSOC meeting on September 25th, as well as the testimony of Director Calabria on September 16th during a hearing by the House Committee on Financial Services, was the need for Fannie and Freddie to continue to bolster their capital levels. With everyone in agreeance on the need for more capital, the only ways to fulfill this need are either retained earnings of ongoing profits and/or an infusion of additional capital. Both Secretary Mnuchin and Director Calabria have repeatedly expressed a need for a capital raise to help bridge the gap from the GSEs existing capital levels and the FHFA required levels. The Housing and Economic Recovery Act of 2008 (HERA) requires Director Calabria to request capital restoration plans from the entities which ultimately must be approved by the Director as a pre-condition for ending the conservatorships. JP Morgan and Morgan Stanley, financial advisors to the entities, cannot move forward with any plans until it is understood how Treasury is going to treat the senior preferred stock it presently holds. Further and widely understood by the major players involved, institutional investors are not going to invest the tens of billions ultimately needed until they know the treatment of the Treasury investment and what the status is of the ongoing litigation (which in most cases focuses on the Treasury preferred stock). Consequently, the process of ending the conservatorships that has been underway since last April and which is supported by the Treasury plan released last fall, cannot move forward without Treasury Secretary Mnuchin and Director Calabria amending the Preferred Stock Purchase Agreement (PSPA) to address Treasury's investment and give the prior consent of Treasury for the entities to raise capital.

As we have noted previously, in a December 2019 interview with *Housing Finance Strategies,* Craig Phillips, former counselor to the Treasury Secretary and who was instrumental in constructing Treasury's housing reform plan, outlined the importance of Treasury's treatment of the senior preferred stock to a successful capital raise. According to Phillips, "Treasury has received dividends totaling over $300 billion on its original capital infusion of $191 billion. Consequently, the liquidation preference of the senior preferred stock should be reduced to zero and the Treasury should be considered 'repaid.' These actions are aligned with the interest of the U.S. Government to move forward in recapitalizing the GSEs, namely in eliminating the current significantly negative worth of Fannie Mae and Freddie Mac and removing claims that negate the value of the very common stock that must be offered to the public to raise capital." The amendments needed to address Treasury's preferred stock are not subject to congressional approval and require the signatures of just Secretary Mnuchin and Director Calabria, both FSOC members that have endorsed the importance of greater capital levels at Fannie and Freddie. It is our expectation this amendment takes place in November or early December, regardless of the election outcome on November 3rd.

Putting pressure on Mnuchin to address the Treasury investment is the upcoming Supreme Court hearing scheduled for December 9th. As noted in our July update, the legal hopes of investors received a significant boost when the Supreme Court agreed to hear the APA and FHFA constitutional cases (Mnuchin v. Collins; Collins v. Mnuchin). The Seila Law, LLC v. CFPB ("*Seila*") ruling by the Supreme Court last term provides a clear path in our view for the plaintiffs to have the net worth sweep eventually vacated. The recent vacancy at the Supreme Court left by the passing of Justice Ginsberg further enhances the odds of a Supreme Court victory by the plaintiffs as it was more than likely that Justice Ginsberg would have been a vote against the plaintiffs in these cases. Should Amy Coney Barrett be confirmed prior to December 9th, the Court will have six conservative appointed Justices hearing the case. Therefore, it is without question that the plaintiffs' odds of winning are better today than they were in July when we provided an overview of *Seila* and its implications for Collins v. Mnuchin. In the event the vacancy is not filled prior to December 9th, five of the eight seats would be filled by conservative appointed Justices and in the event of a four to four tie, the lower court ruling (5th circuit en banc) would be upheld which was a win for plaintiffs and ultimately would lead to vacating the net worth sweep.

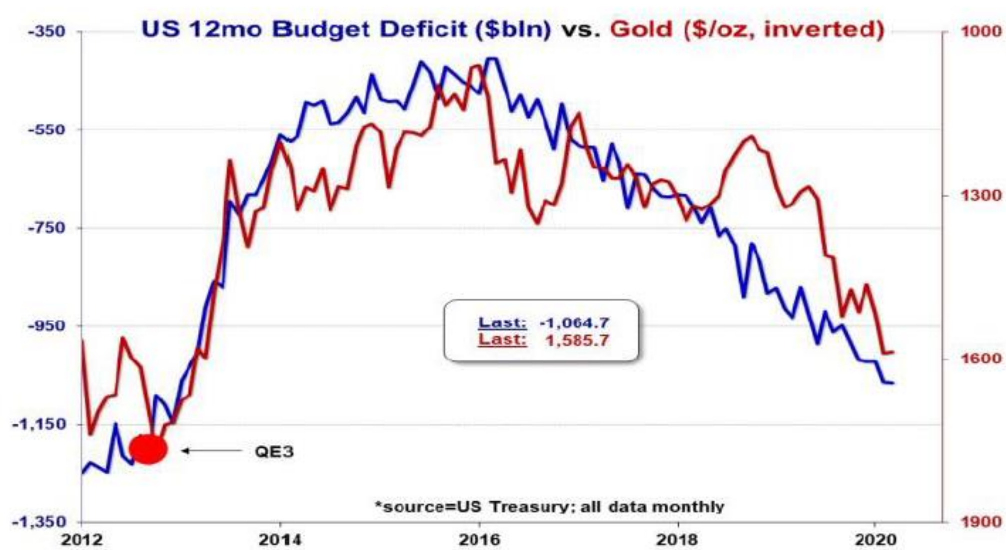
With the odds of a Supreme Court victory increasingly in favor of the plaintiffs, Mnuchin and the Department of Justice have a decision to make before December 9th. Amending the PSPA by eliminating the net worth sweep, writing down the Treasury senior preferred as prescribed by Craig Phillips, and addressing the excess payments to Treasury, are all necessary steps in order to facilitate a capital raise by Fannie and Freddie (something Mnuchin and Calabria repeatedly have stated would be needed). Such an amendment, if done properly, would also moot the APA case set to be heard by the Supreme Court. The Supreme Court is not the venue for floating trial balloons only to settle prior to an adverse final ruling and this is something that is well understood by the Solicitor General whose reputation and standing with the court could be tainted by such a strategy. Consequently, we believe the incentive is high for the government to settle with the plaintiffs either directly or indirectly by amending the PSPA and thus rendering the APA case moot. Allowing the APA case to proceed beyond December 9th introduces a host of risks for the government that could prove detrimental in advancing their policy initiatives. Should the government prevail, the task of raising what is likely to be the largest offering in history would be nearly impossible. Should the plaintiffs prevail, as we expect, the end result is the same as amending the PSPA before December 9th, yet the execution risk of a capital raise would be increased given the potential for a market downturn and/or economic deterioration while waiting for damages to be determined in the courts. As a result, we believe the next 60 days will represent a critical inflection point in this multi-year saga.

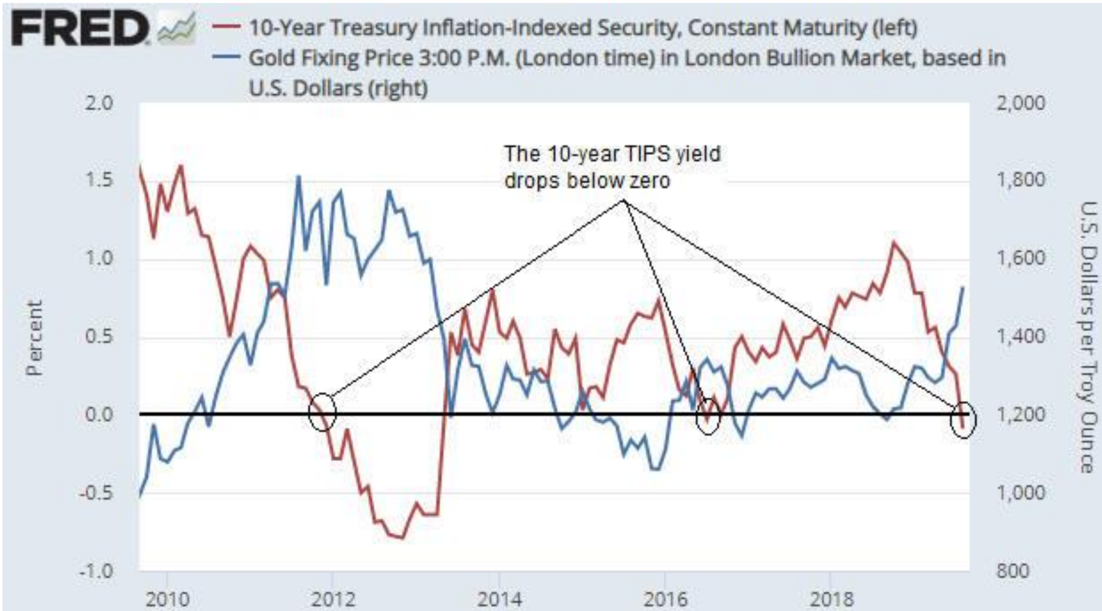
The expected amendment to the PSPA will serve as a crystallization event for the capital structure that should lead to a substantial repricing of the junior preferred shares of Fannie and Freddie. With the Treasury senior preferred declared repaid, Fannie and Freddie would be approximately a quarter away from having a book equity in excess of the $33.2 billion par value; implying the shares should be worth at least stated par value ($25 per share in the case of FNMAS and FMCKJ) adjusting for the time value of money and an appropriate discount rate. Around $9 a share today, we expect the clarity provided by a PSPA amendment to lead to a material appreciation in the shares and in turn portfolios.

What if former Vice President Joe Biden wins the election in November? Regardless of who wins the election, housing needs to be strong for the economy to grow. The more capital Fannie and Freddie have, the greater their ability to absorb losses and in turn support mortgage affordability and the economy. Once an amendment is completed between Secretary Mnuchin and Director Calabria (again not subject to congressional approval), the Biden administration would have few options available to them to reverse the course and it is unlikely they would want to spend their political capital fighting to reverse a recapitalization of Fannie and Freddie given bigger policy priorities such as tax reform, infrastructure, health care and additional stimulus to address the economic damage from the pandemic (assuming something isn't passed before the election). Furthermore, in the event of a Biden victory, Director Calabria would remain an independent director until the second quarter of 2021 at least, as it would take a Supreme Court ruling on the constitutionality of the FHFA before he could be replaced at will by the President. In the event the cases slated for December 9th are mooted, the process to remove Calabria could take much longer. Lastly, as detailed in our July update, we expect the FHFA to utilize a consent decree in the event of a Biden win to further cement the actions taken to date and make permanent the recapitalization process underway.

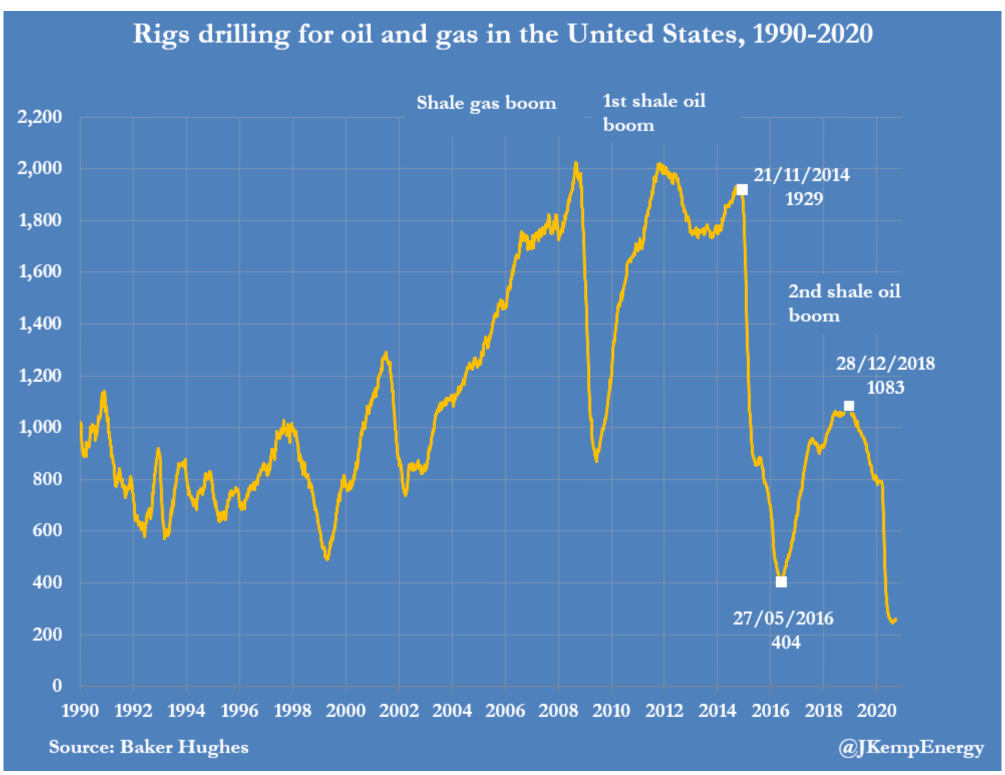
The fog of the upcoming election and lack of clarity on the Treasury preferred investment are what have the shares trading for less than 40% of par value despite clear signs over the past few months that the train is about ready to leave the station. For those that have been following closely, the destination is clear. Once this fog has lifted, the destination will finally become clear to all. When it does, those not already on board will have to pay considerably more for their seats!

Our second largest portfolio exposures remain in the World Gold Trust ETF (GLDM), and Barrick Gold and Agnico Mines. Shares of Barrick popped in mid-August when it was disclosed that Berkshire Hathaway made an investment in the large cap gold miner. With massive deficits likely as far as the eye can see (regardless of who wins in November) and the Federal Reserve committed to keeping rates low for years, the set up for gold is ideal (see below; negative real rates, deficits and gold). Institutional investors are increasingly coming around to the idea that a weighting of 5% in gold and/or commodities can be a good portfolio diversifier and we expect that trend to accelerate given expected future fiscal and monetary policy.





At less than 3% of the S&P 500 today, the energy sector has never been more unloved. The combination of poor capital returns and a push toward green energy has left the industry starved for capital. However, just as gold has proven a valuable diversifier in portfolios over the years, we believe energy can and will play an important role in the next few years. According to an update by Goehring & Rozencwajg, "as recently as March 13th, there were 680 rigs drilling for oil in the United States. In less than four months, the US oil directed rig count fell by 75% to 180 – the lowest level on record. There is at least a two-month lag between drilling a well and first production, suggesting hardly any of the drilling slowdown impact has shown up in production data yet." In the commodity business, the cure for low prices is always low prices.



Eventually, the lack of activity will show up in production and we suspect it will be right around the time that demand starts to come back; potentially setting up a dangerous scenario where prices of oil and gas increase substantially. This type of move has the potential to cause inflation expectations to rise and in turn multiples for growth-oriented stocks to come down, just as was seen in 2016. Unlike in 2016, many energy balance sheets today are strained, and the capital markets are mostly closed to the sector. As a result, it is likely to take much higher prices this time around to incentivize growth in production and the paltry 3% weighting in the index will not capture such a move. We do not have any intention of adding to our exposure, but believe the worst is well in the rearview mirror.

Remaining portfolio holdings consist of high quality "essential" businesses such as payments (Mastercard and Visa) and wireless communication infrastructure (American Tower). The changes in behavior brought about by the COVID-19 virus have served to strengthen these businesses and in our view the future tailwinds remain favorable. Lastly, portfolios maintain adequate liquidity to take advantage of opportunities afforded by expected volatility during the upcoming election season and potential fall/winter spike in COVID-19 cases.

Summary

As we head into the final months of the year, the BARGAIN light on Fannie and Freddie is flashing green. In the words of Warren Buffett, "opportunities come infrequently. When it is raining gold, put out the bucket, not the thimble." We have done just that and expect our patience to be rewarded soon!

Sincerely,

Brian F. Boyle

Brian F. Boyle, CFA

The S&P 500 is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The index is used for comparative purposes because it approximates what an investor could earn from a passive investment in the general securities market.