Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: The Barbell Bet

Date: 6/15/2020

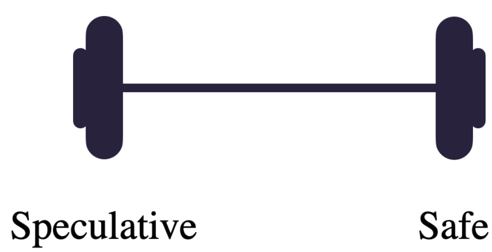
In last month's memo we discussed the intricacies of placing a valuation on the overall broader market. According to our calculation, it appears the broader market is relatively expensive when placed in a historical context. However, as I mentioned the combination of interest rates and fiscal stimulus distorts valuation levels when utilizing historical data, making overall approximations to the markets intrinsic value that much more difficult. In this month's memo I'm going to share with you a concept called the "Barbell Strategy" and why I think it has more or less played a role in the overall recovery of the current market.

The Barbell Strategy

The barbell strategy originated as a bond trading approach. For traders, they could execute the barbell strategy by holding short-term duration bonds along with long-term duration bonds while simultaneously forgoing any exposure to intermediate term bonds. The strategy was further popularized by Nassim Taleb due to the success in which he deployed it during the 2007 – 2008 financial crises. Taleb articulated the barbell strategy as a way to capitalize on extremely risky and speculative bets while making sure a large portion of your holdings were kept in the absolute safest assets. According to Taleb, the underlying principles of the barbell strategy work well for the following reason:

"If you know that you are vulnerable to prediction errors, and accept that most risk measures are flawed, then your strategy is to be as hyper-conservative and hyper-aggressive as you can be, instead of being mildly aggressive or conservative."

Overall the strategy can be summed up as a design to help downside risk while maintaining exposure to higher return opportunities.



As It Relates To Today

So how does the barbell strategy relate to what we are seeing today? Let's consider the reactions we've witnessed since the 2020 lows in late March.

Reaction 1) Capital Fled to Technology Stocks – The market rally was led heavily by technology stocks. It's not hard to decipher why so much capital fled to these companies. The conditions set forth by COVID-19 accelerated the world's need to adapt market ready technology solutions. Retail was closed but ecommerce was open. Work from home forced businesses to adopt the cloud in order to continue operations. Consumer entertainment was limited to at home options.

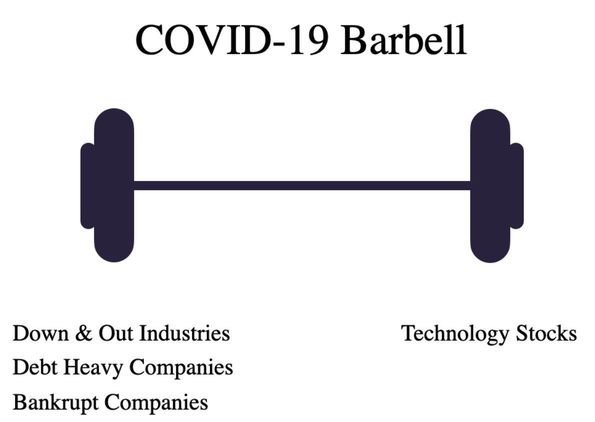
The fact is actual demand for technology services flooded the economy and technology companies were there with the solutions. As most companies across the world were wrestling with how to survive, technology companies were wrestling with how to fulfill. For investors, technology companies became the corner of the world that was a pretty safe bet.

Reaction 2) Capital Fled to Speculative Bets – Simultaneously, while technology companies thrived the deterioration of many large non-technology companies began to unfold. The oil price war put energy companies on the ropes overnight. The ban on travel placed a historical shot on the chin for the entire industry (airlines, car rentals, hotels, cruise lines) and their suppliers (part manufacturers, third party solution providers, etc). The restriction of in-person gatherings delivered what could become known as the final blow to an already down and out retail industry. It appeared by just assessing the reality of the fundamentals, many of these companies would fail to exist altogether.

What happened next is quite interesting. As the dust began to settle, the stock of companies in these industries began to rally. Unlike technology companies, the rally of these companies had no influx of demand for their products and services. Furthermore, the deterioration of their operations forced many of these companies to load up on ever more debt in order to survive. In theory, all of this should have made their equity even less attractive. Some of these companies are solid operators that saw their value dragged down by the selloff of their entire industry. The price recovery of their equity is well justified. However for companies with deteriorating fundamentals and imminent reshuffling capital structures the rally seems to be more of a speculative bet.

Over the last few weeks this trend has only accelerated. As recent as Monday of last week (June 8, 2020), companies such as Hertz, Whiting Petroleum, Pier 1, J.C. Penny, Chesapeake Energy and California Resources have seen their shares skyrocket despite already filing for bankruptcy or largely considering to file for bankruptcy. Soon to be worthless positions, skyrocketing! The speculative bet is so popular, Hertz is issuing $1 billion in new shares to meet demand (all while essentially saying they fully expect common shareholders to lose all their money).

Two reactions - one a flee to safety (technology stocks), the other a speculative bet. Together these reactions have fueled the rally and formed a barbell strategy among market participants.



<u>What Happens Next</u>

As we enter the last two weeks of Q2, it will be interesting to see if this barbell rally continues. COVID-19 cases have begun to spike in parts of the country. Many businesses will soon run out of their PPP. The extra $600 weekly in Pandemic Unemployment Compensation runs out for consumers at the end of July. All this while companies will begin reporting actual Q2 earnings. From my perspective the rally in technology stocks was justified but now needs a little time to let the fundamentals catch up with the valuation. Should the economic recovery hold, I anticipate capital to rollover to industries and assets previously left on the sidelines during the rally. Financials and industrials typically due well coming out of this phase of a recovery and it would not surprise me to see institutions rotating capital into these positions.

As it relates to the speculative bet, it's anyone's guess. In the meantime, we'll keep looking for good businesses at fair prices.

Until next time,

M. Carter Johnson