Opportunity Zones: Think Long-Term, Diversify and Sell the Bounce

May 2019

Think Long-Term

Value versus growth investment strategies have long been a topic of spirited debate when attempting to analyze the optimal formula to outperform the market and maximize risk adjusted long-term returns. Two important inputs into that analysis include liquidity and the price volatility of the investment when calculating the appropriate term premium. In other words, when markets become overly risky, assets that are the most difficult to sell will go down further in price on a forced exit. Therefore, when comparing investments over long-term horizons, a less liquid, more volatile asset should compensate investors with a higher return to reflect the increased risks. Standard convention goes that increased liquidity dampens volatility and translates to increased financial safety.

On the surface, that theory makes complete financial and common sense, however, that's not always how reality plays out. Markets are controlled either directly or indirectly by humans who are inherently flawed and act on emotion. That's why many of the greatest investors of all-time have spent a tremendous amount of time analyzing market psychology, sentiment and behavioral finance when making their most important investment decisions. Buy low, sell high is the mantra of the sophisticated professional investor, while unfortunately retail investors often succumb to sell low, buy high when emotions come into play. Case in point, how many investors were overcome by heightened fear and sold equities without regard to fundamental valuations at the depths of the crisis in March of 2009 (S&P 500 sub 700) and never bought positions back until recently? This is not an uncommon story given the heightened level of stress throughout the financial crises which scarred a generation of equity investors. Liquidity is not always your friend.

As for valuing liquidity when investing for the long-term, reflect on the words of Warren Buffett, who is known as one of the greatest value investors of all-time:

"Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there — do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse." [1]

Warren Buffett is basically saying that decreasing liquidity when value investing for the long-term is not a bad game plan. Even though he's more famously known for investing in stocks/companies, it's telling that he is highlighting an asset that is typically considered illiquid like real estate since it protects investors from themselves. It's difficult to almost impossible to sell real estate with a click of a button and therefore it naturally provides a framework for value-based investing.

To be clear, this view is not that stocks are not valuable assets for long-term wealth creation. The key takeaway is that liquid markets can become unexpectedly dangerous to investors at the worst possible times, which increases the risk of the human element derailing the most perceived sound long-term investment strategies.

Diversify

Why is it prudent for investors to diversify? The simplistic answer is to minimize risk by investing across multiple uncorrelated assets to preserve principal and create wealth throughout a variety of market environments. In other words, achieving the same return on one asset is inferior to earning the same return spread out over multiple uncorrelated assets. The aggregate volatility of the latter portfolio will mathematically be lower, and thus will produce a superior risk-adjusted return.

Multiple factors are considered when constructing a diversified portfolio. As previously discussed, individual asset liquidity is a key factor, as is the asset's price volatility. Both are related, and liquidity is one of the most important inputs that directly affects the price volatility. Again, standard convention is that the most liquid assets are the safest and therefore are likely to have the lowest price volatility. While that theory makes common sense, the market does not always follow suit. For example, again looking back on the financial crisis in 2009, some of the most liquid markets exhibited the highest price volatilities when all asset classes were stressed in parallel, while fundamental valuations were ignored as chaos gripped the market. Over leveraged positions added fuel to the fire as margin calls forced leveraged unwinds and investors scrambled to raise cash to shore up losing trades. The result was that liquid markets were sold first as sellers took whatever liquidity was accessible to free up cash. Price action was evident given that stocks bottomed out in March 2009 while the most challenged illiquid sectors of the real estate market did not hit a bottom until 2010/2011. One key difference between real estate and financial assets utilizing leverage relates to the fact that real estate does not have a live daily real time prices which translates to margin calls when breached, forcing a sale of a financial position. This mechanism directly causes liquid markets to get oversold in the most stressed market environments as leveraged positions get unwound. In real estate, the only mechanism somewhat analogus to a "margin call" that exists requires a property to cover its debt service on a monthly basis. Foreclosing on real assets due to default is also not a fast process, either which can take months and sometimes years to remedy and thus limits short-term price volatility.

Overall, liquid markets are more likely to price at oversold levels faster, which increases volatility during times of stress and magnifies the potential for emotional errors. While almost all investment assets utilize leverage, liquid markets employ a higher degree of leverage, further amplifying the volatility during a tail-event. As the famous saying goes from renowned economist John Maynard Keyes, "Markets can remain irrational longer than you can remain solvent." We believe that traditional portfolio strategy comprised of the most liquid asset classes with weightings of 60/40 stocks/bonds is outdated and grossly neglects the previous points made in relation to liquidity and price volatility. More specifically, a moderate risk portfolio target allocation for alternatives/ real assets according to Charles Schwab is 4%, while stocks and bonds account for 91% of a suggest portfolio *(Figure 1).* The average retail investor who truly desires to achieve a long-term value-based portfolio should not focus on the asset allocation of money managers and hedge funds managers who are incentivized to trade on shorter term horizons driven by annual commissions and bonus payouts. The more logical comparison would be for retail investors to mirror the professionally managed portfolios of insurance companies, endowments and pension funds when strategizing on long-term allocations. These institutional investors fit the textbook definition of long-term value players and the percentage allocation to alternative investments (real estate, private equity, etc.) is approximately **30%** of their portfolio *(Figure 2).* Maybe the pros know something that the average retail investor does not?

Sell the Bounce

Over the past ten years, the resilience and staying power of the U.S. economy from the depths of the financial crisis has been remarkable. The inception of the economic expansion goes back to June 2009, and currently marks the second largest expansion in history. If the economy continues the run through the 10-year anniversary this coming June, it will mark the largest expansion in our nation's history. Equally impressive was the recent S&P 500 bounce of more than 25.2% off the Christmas Eve lows to the most recent all-times highs. Although the rally was from oversold valuations from the December sell off, the S&P 500 8.0% return for January alone marked the best January in over 30-years going back to 1987.[2]

Recent price action to the upside was mainly fueled off the change in rhetoric from Federal Reserve Chairman Powell, who walked back previous hawkish statements and substituted language stating that the "Committee will be patient" in determining the future course of direction of both the federal funds rate and quantitative easing. Following nine interest rates hikes in total off the zero bound, and four in 2018 alone, the market currently believes the Fed on hold rhetoric with a dovish bias as fed funds futures are pricing a 64% chance that there will be no hikes in 2019 and a 36% chance that fed funds which actually be lower by year end. Also, it's worth noting that 10-year TIPS break-evens have sold off ~60bps from the highs of Q4, which means the market is anticipating a slow-down in inflation, fostering further support for a Fed

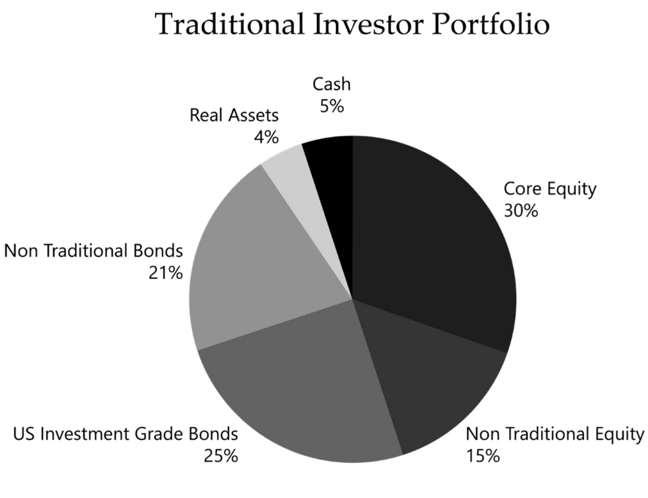

Figure 1

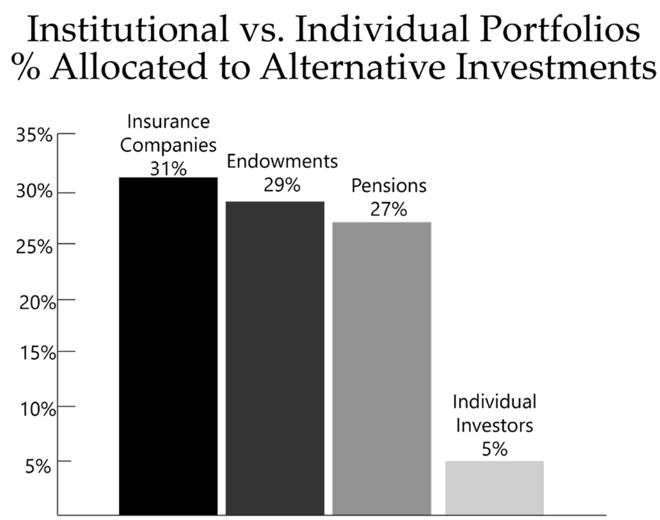

Figure 2

on hold view regardless of ongoing strong employment numbers and a historically low unemployment rate.

While the previously mentioned factors could allow for continued economic growth, albeit at a slowing rate environment in 2019, we believe that risk reward is not attractive at current levels given multiple reasons. The pick-up in volatility is notable given the whipsaw price action from December into January, which is a sign of stress in the system. Also, while growth in the economy is expanding it's occurring at a decelerating rate as Q2 GDP growth is currently forecasted to slow to 1.1% from a 3.2% print in Q1[2]. Yield curves in the bond markets remain at historically flat/negative levels with the latter being a leading indicator of a slowing economy. The treasury 2s5s yield curve is currently slightly negative at -2bps (2-year yields are greater than 5-year yields) while 2s10s is at +20bps, which is hovering around the lows going back to 2007 when the spread turned negative and foreshadowed signs of the recession a year in advance[3]. Geopolitical instability concerning U.S. and China relations, while improving, still remains an unknown. Ongoing friction will weigh on the global economy and specifically China, which currently is the second largest economy in the world, and will continue to lower the country's growth rate which is already approaching a 27-year low, dropping into the low 6% range.

With these risk factors in consideration when developing an investment strategy, we believe it's prudent for investors to utilize the Q1 relief rally to sell the bounce. To be specific, we are not taking a view on an investor's portfolio in aggregate with the recommendation that all stock holdings should be sold. However, we are recommending that now is an opportune time to sell positions with significant capital gains by leveraging the historic tax-incentive mechanism of the Opportunity Zone Program. We believe most strongly in this case for investors who have been fortunate enough to have been long the market over the past 5-10 years. Total returns earned on the S&P 500 going back to 2009 are impressive, clocking ~150.2%, with last 5 years responsible for 58.1% of that return *(Figure 3)*. The December sell-off was real and took many investors by surprise and it may foreshadow continued heightened volatility to come in 2019. As the old proverb goes, "Fool me once, shame on you. Fool me twice, shame on me."

Opportunity Zone Program: The Stars Align

Thinking long-term through a value-driven lens while also diversifying asset allocation in a tax-incentivized manner are direct unavoidable outcomes from leveraging the historic Opportunity Zone Program. As a reference, we wrote in depth on the Opportunity Zone Program's creation, mechanics, tax incentives and overall historic investment potential in the most recent *Saxum Insights* titled *Opportunity Zones: A Historic Tax-Efficient Mechanism to Leverage Real Estate*[4].

To summarize, the newly created federal program is historic given that it creates an exchange vehicle mechanism that allows investors to unlock capital gains from any asset class to achieve significant tax incentives through reinvesting in new investments located in designated Opportunity Zones. Investors may reinvest capital gains upfront and tax-deferred[5] from the sale of any existing investments (stocks, bonds, real estate, operating businesses, art, collectables, etc.) into an Opportunity Zone Fund ("OZ Fund")[6]. In addition to deferring upfront capital gains, investors can potentially reduce the deferred capital gains taxes based on the holding period of the new investment. For example, after the new exchange investment is held for 5 years, investors can achieve a 10% reduction on the capital gains taxes from the original investment, and after 7 years, investors can receive a 15% reduction. While deferred taxes from the original investment are reduced, they are still due to the government by 12/31/2026.[7] We believe that while deferring and reducing taxes is meaningful, what is most significant about the program is that **after 10-years,**

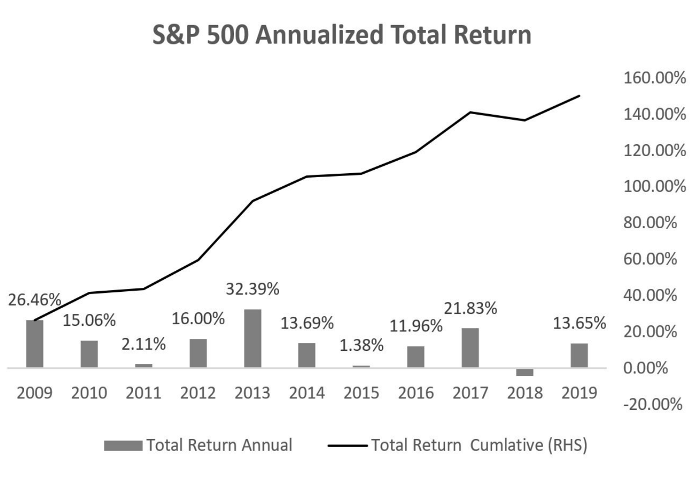

Figure 3

Assuming a 7% annualized return in both scenarios, an OZ Fund outperforms a Standard Portfolio by $441,281 for every $1,000,000 reinvested over a 10 year horizon due to tax-incentives alone [(1)]

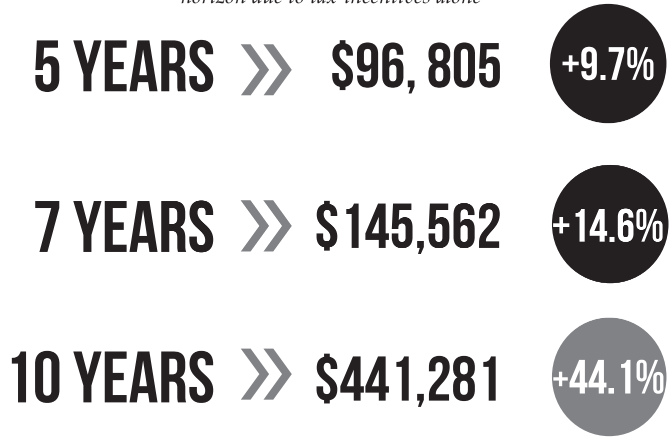

Figure 4

investors pay zero federal taxes on the new gains earned through the OZ Fund investment, which is extremely attractive to any investor with a longer-term time horizon.[8]

The OZ Program forces investors to think long-term, diversify, and sell appreciated liquid assets at what we believe to be an ideal time in the present market cycle. Diversifying away from paper assets is a structural view of ours, favoring quality, income-producing hard assets in our portfolio for the long-term for a variety of fundamental, technical and macro reasons. The debate for portfolio asset allocation of traditional assets versus alternatives is not a new one, but we would argue that the game recently has changed dramatically. Prior to the OZ Program we would still have recommended the **25-30**% retail investor allocations to alternatives which is in line with similar minded long-term institutional investors that include insurance companies, endowments and pensions funds. While we are holding our suggested **25-30**% weighting in the post-OZ announcement world, one could argue that those targets are now on the low side for an investor with sizable capital gains given how substantial the OZ tax incentives are with returns outpacing a traditional taxed investment by **40-80**% on an after-tax basis.

The financial math for the OZ Program is undeniable and shocking given that we calculate that the tax-incentives alone result in a $441,281 (44.1%) outperformance on a $1 million capital gain invested in an OZ Fund earning the same 7% annualized return as a taxable Standard Portfolio. Returns explode to the upside when factoring in actual real estate projected OZ returns which outperforms the taxed Standard Portfolio earning 7% annually by ~**50-80%**. Finally, when considering a tax break-even when quantifying the power of the tax-deferment incentive, it takes approximately 5-years earning 7% annually for the taxable Standard Portfolio to recoup the capital gains taxes paid upfront to grow proceeds back to the initial $1 million in capital gains *(Figure 4).*

Recommendation
The time is now for investors to get serious and get educated on the Opportunity Zone Program due to the impact that the historic incentives can have on long-term wealth creation. In this day of age, it's not common practice for the federal government to create a bi-partisan supported plan that is mutually beneficial for the government, investors and local economies who are primed for the injection of investment capital. Timing is everything, and we believe that there is a notable first mover advantage for investors who act early and deploy capital. This is especially true given that the 8,762 OZ tracts are already designated and will only get more competitive as the rush for the most attractive deals ensues. It's also critical to note that while OZ tax incentives are substantial, we believe that prudent risk managers must respect that the OZ Program will not make a bad deal successful. Our goal is to provide investors with investment opportunities that are fundamentally and technically sound on a standalone basis without tax incentives. As the deals perform, the OZ tax incentives will then provide additional alpha and substantial upside on the back end on an after-tax basis. We applaud the federal government for creating a mechanism to focus and incentivize investors to take a serious look at their portfolios and take gains on assets that are held for tax-basis reasons alone as opposed to fundamental investment views.

The Roman philosopher Seneca once said, "Luck is where preparation meets opportunity." We believe this thought is a great one to live by as preparation and hard work do pay off when people put themselves in a more likely position to be lucky. However, if Seneca was alive now, we believe that he might admit that sometimes true blind luck does exist in a world of randomness. We agree when reflecting on the OZ Program and the daily reoccurring conversations that we have with investors drawing the response that, "This sounds too go to be true. What an amazing stroke of luck." In our view, it does sound too good to be true, but lucky for us, it happens to be a reality.

Chad DeBolt
Director of Investments
Saxum Real Estate

Sources

[1] "Warren Buffett's Annual Letter: What you can learn from my real estate investments."
[2] Atlanta Federal Reserve GDP Now
[3] St. Louis Federal Reserve: FRED
[4] Opportunity Zones: A Historic Tax-Efficient Mechanism to Leverage Real Estate
[5] OZ Program gains tax incentives relate to federal taxes only
[6] Only partnerships or corporations are eligible for OZ Program investments
[7] Phantom taxes in 5 to 7 years can be alleviated by prudent fund managers who build reserves or refinance a portion of the portfolio to pay forward tax liabilities
[8] Note that only the gains portion of the investment exchange receive the program's tax incentives
[9] Assumes all-in 23.8% capital gains rate; $1 million in capital gains = $762,000 invested tax incentives
[7] Bureau of Labor Statistics
[8] Note that this simple analysis assumes a liquid market with minimal transaction costs

Appendix

Figure 1: Charles Schwab, "A Modern Approach to Asset Allocation and Portfolio Construction," 2014; Total Return Model Portfolio with Moderate Risk
Figure 2: Money Management Institute, " Distribution of Alternatives Investments through Wirehouses," 2015
Global Pension Asset Study 2016
NACUBO 2015 Study 2015
Preqin, "Insurance Companies Investing in Alternative Assets," 2015, Total Alternative Assets Allocation as % of Total Portfolio, Insurance Companies with 5bln or less AUM
Figure 3: CitiVELOCITY: S&P 500 Annualized Total Return
Figure 4: Tax Incentives Gains Outperformance: OZ Fund vs Standard Portfolio

Our Saxum team has a broad range of experiences, and we believe that analyzing real estate through a variety of lenses brings multiple perspectives to focus which fit an asset class that is in itself so inherently complex. No individual real estate deal is the same given the multiple levers that can be pulled throughout numerous stages of an asset's life cycle. Saxum Insights covers a wide range of topics from extremely technical and analytical in nature, to simple thought driven concepts based on sentiment and anecdotal observations. Sometimes the most thought-provoking ideas are simple concepts which are misunderstood or overlooked. Feedback and thoughts are always appreciated.