Madison INVESTMENTS

1Q 2021 Investment Strategy Letter - SMA

Mosaic represents Madison's global multi-asset product suite spanning the risk spectrum with 18 distinct portfolios across blended active/passive, ETF and Tax-Sensitive mandates. Madison's Multi-Asset Solutions team has deep experience monitoring worldwide macroeconomic trends and their associated investment implications. Risk management and a commitment to consistency are key components of our philosophy and process. We believe that efficient asset allocation and downside volatility mitigation will lead to increased long-term client investment success.

REVIEW – FIRST QUARTER 2021

Over the past three months, the U.S. has experienced an overwhelmingly positive uptake (in distribution, efficacy, and safety) of game-changing Covid-19 vaccines from Pfizer and Moderna. On que, stock investors were rewarded as equities posted solid returns. For the quarter, U.S. equities (Russell 3000 Index) advanced 6.35%, while foreign stocks (MSCI ACWI ex-US Index) returned 3.49%; meanwhile, US bonds (Bloomberg Barclays U.S. Aggregate Bond Index) declined 3.37% due to an accelerated rise in interest rates.

PERSPECTIVES / OUTLOOK

> *"If past history was all there was to the game, the richest people would be librarians."*
>
> \- Warren Buffett

We've previously stated that portfolio managers are essentially "not paid to forecast, but to adapt." It follows then, that our intended flexibility and timely adaptation to both economic and market realities are a critical aspect of our process and value add. In other words, it's arguably just as important to accept and embrace "what is" as opposed to rigidly obsessing over "what should be." Too much one-way-only discipline, in this context, could prove to be unhealthy. Once again, moderation wins.

But, what does this look like in practice? For starters, a flexible posture begins by first generating even more questions; quick, convenient, and "textbook" answers are reasonably viewed with healthy doses of skepticism. This has the effect of prolonging uncomfortable tensions and requires an uneasy, purgatory-like "acceptance" of challenging concepts like puzzling paradoxes and unwieldy juxtapostions. To the point, here are some of the questions we've recently been asking ourselves:

- Relative to history, how sophisticated and forward-looking are financial markets?
- To what degree has today's price-insensitive, passive, and institutionally complacent culture impacted overall financial market risk?
- Given the mission critical importance of elevated asset values to the Fed and global central banks, what are the effective limits to central bank intervention?
- With the fed funds rate at 0%, what is the economically optimal shape of the yield curve?
- What are the long-term implications of negative interest rates?

These are clearly "not your father's" ponderings. The inferred and underlying premise is that we are facing an unprecedented and extreme new investment paradigm. In many aspects, it is different this time. For example, even with the recent increase in interest rates, the total global market value of negative-yielding debt remains at over $14 trillion; $2.5 trillion, of which, is in corporate bonds! Prior to 2014, negative-yielding debt had never "existed".

The irony is that our low, no, or negative interest rate environment represents both cause for concern and opportunity. The necessity of maintaining historically low interest rates exposes the underlying fragility of many global economies; conversely, these same low rates can increase the relative (scarcity) value of those somewhat unique long duration risk assets that are deemed likely to continue generating proven and predictable long-term cash flows. In short, economic risks and (select) risk asset values have been, and are, rising concurrently. The question is, how long can this "particular paradox" continue? Unfortunately, we don't expect to get much of an answer from the librarians.

POSITIONING

Our most noteworthy tactical change over the past few quarters involved the decision to finally (and incrementally) shift away from our long running U.S. centric posture. Over the past ten years, U.S. equities (Russell 3000 Index) have outperformed foreign equities (MSCI ACWI ex-US Index) by over 8.5% annualized, a remarkable achievement. This degree of outperformance has resulted in elevated U.S. valuations relative to many other foreign countries. Not surprisingly then, we are opportunistically taking advantage of relatively attractive valuations in overseas equity markets. Our primary countries of focus are Japan, China, Korea, Taiwan, India, and the United Kingdom (UK). Our foreign underweights are the eurozone and Latin America.

Japan and emerging Asia are well-situated to capitalize on our increasingly digital and information-based global economy. Taiwan and Korea, to the point, are global leaders in the vital semiconductor industry and look well-positioned to maintain their enviable status for years to come. UK equities have underperformed since the 2016 Brexit referendum. The country offers compelling valuations, ranking highly in both dividend and free cash flow yield. In addition, the UK has had significant relative success in their rapid rollout of Covid-19 vaccines, trailing only Israel (among major economies) in initial (first-time) vaccination rates. Our recent contrarian-based UK investment represents our latest foray into international equities.

Our U.S. equity portfolios are emphasizing blue-chip stocks that are less susceptible to excessive leverage and economic cyclicality. Furthermore, our focus is on asset-lite and high free cash flow producing sectors; we also remain attracted to sectors with strong commitments to research and development. Our allocations to information technology and biotechnology are prime examples.

Our fixed income positioning reflects our view that current inflationary concerns are largely transitory. Unit labor costs (ULC) remain well-contained and show no signs of breaking out; historically, ULC's have had a much higher correlation with inflation than commodities. Due to commodity-related fears of higher inflation, Treasury-Inflation-Protected-Securities (TIPS) have significantly outperformed nominal bonds since last March; in the aftermath of TIPS strong performance over the past 12 months, we've recently trimmed our TIPS allocations.

SUMMARY

We are confident our portfolios remain well-positioned for a still stressed global economy. We also embrace our ongoing responsibility to insightfully differentiate between attractive and less attractive asset classes as we strive to deliver superior risk-adjusted returns. As we continue to work through these difficult times as a nation, we truly appreciate your confidence in partnering with us.

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. fixed income securities. The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors.

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