2nd Quarter 2021

CAZ Investments
Quarterly Letter

Key Takeaways from the 20-year history of CAZ Investments….AND why the 60/40 asset allocation model is "dead"

That is a much longer title than typically used for our quarterly letters, but this is a special letter as it is expected to be delivered on the very day of the 20th Anniversary of our Firm. We are honored to be one of the few companies to achieve this threshold as an independent business, and we are even more proud of what we have accomplished over the last two decades. That said, nearly every day we talk about how we want to think and behave like a startup because the opportunity set is enormous, and we feel we can make a massive difference in the lives of those that invest with us, our shareholders, and Team over the next 20 years.

The Unveiling of our BHAG

We will list the key takeaways later in this letter, but we wanted to share for the first time publicly the Big Hairy Audacious Goal ("BHAG") that has been selected by our Team. For those who have not read the book, *Good to Great*, a BHAG is a goal that drives the organization forward to achieve the most that it possibly can, while staying true to its values, and unifying all departments to a shared purpose. Over the last 20 years we have had many very good BHAGs, and achieved nearly all of them, but this past year we decided that our next 20 years should be defined differently, based on the value proposition that summarizes the reason for our existence. At the end of the day, if one tries to condense our highly unique business model into a simple statement, we exist to make money for our investors so they can utilize that increased capital base to make an impact on the world. As most everyone knows, we rarely charge management fees and typically only get paid if we make money for our investors, and then we share in the profits that we create. Ultimately, everything revolves around us making you money and everyone benefits the more money we make for you.

With that foundation, we wanted to create a BHAG that would motivate our Team in a uniform way that would ultimately drive us to find the very best investments we can and to get the maximum amount of capital deployed into those investments. That combination enables us to create the most significant quantity of profits that we can for our investors. It was an amazing exercise, and the end result illustrates the power of our ecosystem. Our Team kept moving the number higher and higher and ended up with an incredible Big, Hairy and Audacious Goal!! **We aspire as an organization to create $20,000,000,000 in profits for our investors over the next 20 years!** $20 Billion is a lot of zeros and it will be created by a Team that is dedicated to finding exclusive and unique alternatives and providing the opportunity for you, and those you know, to access those investments. Everyone wins when we accomplish this BHAG, and we look forward to updating everyone as we achieve various key thresholds over the next two decades!

It is too late to buy home insurance when the fire starts

Now that you know what our primary goal is as a business, let's transition to what we believe you must understand about the world today so that we can optimize how much money we can make for you. **We remain a 1 on the CAZ Scale and believe that the risk/reward from these valuation levels remains heavily tilted to the risk side of the equation.** This means that the number one thing we feel investors should be doing right now is determining how they can mitigate the risk that has built up in their portfolio. Make no mistake, the vast majority of investors really have no idea how much correlation and risk exists in their portfolio today, and they will have a rude awakening when the world turns and risk assets take a right cross to the chin…

As the header states, one cannot wait to buy home insurance until after the house is on fire. That is also true in the investment world. One must have a risk mitigation strategy in place before things start getting dislocated. This is precisely why we are approaching the current environment the same way that we did in 2006, in preparation for what we believed was a pending burst of the subprime mortgage bubble. We put in place a risk mitigation strategy that involved shorting subprime with John Paulson. Our objective was to profit from being correct on the bubble bursting, but to also protect the rest of our assets from the ripple effect that would likely occur in the stock market. We want to do the same thing right now and, as you will read below, we are taking action.

Yes, the 60/40 Allocation is "Dead"

With risk mitigation as our primary focus, what can investors do to protect themselves? For decades investors have been fortunate to have the ability to mitigate much of the risk in their portfolio by following a very simple asset allocation approach. The 60% stock/40% bond model has stood the test of time for very logical and statistically sound reasons. Simply stated, when one asset was "zigging" the other was "zagging," because an economic environment that was good for stocks was typically not great for bonds (but you still got paid a nice coupon of interest), and an economic environment that was good for bonds was typically bad for stocks. The end result normally allowed the volatility of the overall portfolio to be less and the returns to still be satisfactory.

Further, if the plan was followed as designed, it created the opportunity to rebalance the portfolio which allowed investors to sell their appreciated bonds and buy cheaper stocks, selling high and buying low. Therefore, the bonds would dampen the volatility, provide some current cash flow, even in a negative stock market environment, and provide a positive result for at least part of the portfolio when stocks were creating a lot of anxiety for investors. This allowed them to sleep better at night and be in a better frame of mind to ride out the storm.

When properly applied, this approach has been utilized to great success over the last 50+ years. So, if it works so well, then how can it be "dead?" Like anything, the answer is rarely absolute, and the debate as to the full progression of rigor mortis is well beyond the scope of this letter. What we can say is that it is virtually impossible for bonds to serve the same role that they have for the last 50 years. It is just math and the result of the exceedingly low levels of interest rates and very tight credit spreads. We are trading, at the time of this writing, at a 1.2% 10-year U.S. Treasury and less than 4% junk bond yield. People are willing to lock up their capital for a long time and, in the case of junk bonds, take very significant risk for very, very little return. When the next bear market comes, and it will come, bonds will not be able to function in the same way that they have in the past.

Investors have benefitted from the stock market trading to new highs this year and they absolutely must find another way to mitigate the risk that they have in their portfolio. The question every person must ask themselves is what are they going to experience when the correction does come? How did they feel in March of 2020, March of 2009, or the fall of 2002? No one likes to remember those traumatic times but, as the famous quote goes, "those who forget the past are doomed to repeat it."

Stocks are the most expensive they have ever been, the frothy behavior of the retail investor has never been more extreme, and the solutions available for investors have never been so limited. If we cannot buy bonds to mitigate our risk, where do we go? We could go to cash, but yields are still near zero and, after inflation, generate negative real returns. From there, nearly every other choice has a measure of risk that must be accepted. Thereby, investors are really "stuck" and must find a new design. In a perfect world, that solution would provide a way to generate higher cash flow than plain vanilla bonds, while also possessing a built-in way to mitigate the losses created from the world going into "risk off" mode, triggering declining stock markets and asset prices. As our existing investors learned last week, we have spent the last six months working to create such a solution and we would strongly encourage everyone to take the time to understand what we are doing, and how it can replace the simplistic 60/40 model.

From 2001 to 2021 – An Amazing Journey!

The great thing about the investment arena is that the battle is always changing. There is never a shortage of interesting things to analyze, fascinating people with whom to interact, and opportunities to learn and grow. The last twenty years in our business have provided an endless set of opportunities and have been everything one could have hoped for. There have been countless learning opportunities, mistakes, and disappointments, but there have been many more triumphs and celebrations. We have been incredibly blessed and want to do everything we can to stay hungry, remain humble, continue to learn and develop our skills, while at the same time creating raving fans of our investors.

The key takeaways below are only a small sampling of what could be listed but we hope that you find them interesting and helpful. They are not listed in any particular order, and some are directed more at our Team and others are directed more at you as the investor. We will let you decide which is which!

There will be several key announcements this fall related to new innovations at the firm, and we are excited to share those with you. We appreciate the confidence you have placed in us. We look forward to maximizing the profits that we can make for you and hope that you will be a large portion of the $20 Billion in profits we will make for investors over the next 20 years!!

All our very best!

The CAZ Investments Team

Key Takeaways from the Last Twenty Years

- Alignment is everything and without proper alignment the conflicts of interest will drive the decisions, but if everyone is aligned, from the investor to the shareholder to the Team, all decisions will be driven by what should deliver the best outcome
- Stocks always go down faster than they go up
- A smoother ride, with less volatility, is so much easier to stomach for investors, which allows them to stay the course and not let emotions drive their decisions
- Hire slowly, fire quickly
- Sell when you can, not when you have to
- Never, ever, stop improving as a person, a department or a firm
- Cash flow is, and always will be, king
- The focus should always start with the premise that we absolutely abhor losing money, we will take risk, but we want asymmetric payoffs in return for that risk
- Correlations converge to 1 in market stress events, so it is critical to have assets that are truly uncorrelated, in addition to negatively correlated return streams
- Assumptions about what people understand, believe, and find valuable can lead to really bad outcomes
- It is critical to plan for the end of the partnership, before the partnership begins
- The vast majority of investment decisions are driven by only two factors, cash that investors feel they have to deploy and career risk, which is the fear of either getting fired or feeling unwise
- Never, ever, assume in what an investor wants to invest; rather, provide them with the opportunity and let them decide what they want to do
- Trust is the driver of the investment decision much more than most people will admit
- As much as most investors say they will not allow emotions to drive their investment decisions…. they do
- The worst enemy of most investors is usually themselves… they pass on the investments they should do, they do too much of certain investments when they should not, and not enough of the investments that they should do more of – ultimately, most investors do not have a plan but allow emotion, cash, and career risk to drive their decisions
- Tell investors what you believe they need to know, not what they want to hear… they will benefit from your counsel and appreciate the honesty…. usually, and if they do not it is still our job to tell them
- Life is too short to work with investors that are hard to work with; there are more than enough people that are fun to work with and appreciate all the effort that goes into making them money
- Hard work and attention to detail are the two factors that differentiate top performers from average
- The vast majority of investors will refer us to their ecosystem, IF they feel there is proper alignment and that their referrals will be well taken care of
- People are generally decent and honest, but there are bad apples out there and they must be rooted out quickly
- Investors understand risk, and if they are given the right information, they can make well-informed decisions
- Our firmwide adage has stood the test of time: *If you can live with the worst-case scenario, the upside will take care of itself*
- When our firm places the investors' needs first and above its own, the investors feel it and they are immensely more loyal as a result