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Sitka Pacific

On Resiliency, and a Solution to the 60/40 Dilemma

Established excellence in global macro absolute return investing structured to take advantage of exceptional long-term opportunities in today's global market environment.

On Resiliency

In September 2013, we sent a letter to clients that began with a discussion of the Rim Fire, which had just begun blazing through the Sierra Nevada foothills in central California. The fire started when a lone hunter in a remote part of the forest above the Clavey River, several miles from the small town of Groveland (population: 601), lost control of a campfire when the wind picked up. The brush fire that ignited was only a few acres at first, but from that humble beginning it grew to 10,000 acres the following day, and by the fourth day it had exploded to 100,000 acres.

The Rim Fire caught national attention when part of the fire crossed into Yosemite National Park and threatened water quality in the Hetch Hetchy reservoir, which supplies 80% of the water for San Francisco — 160 miles to the west. At one point, more than 5000 firefighters were working to contain the flames. It ultimately consumed over 400 square miles of forestland, and due to the lack of rain that winter, it was not officially declared out until November of the following year, when the last of the smoldering logs had cooled. At the time, it was the third largest forest fire in California's history.

While attention focused on the hunter's errant campfire, less well known was the story of Dr. Scott Stevens, UC Berkeley's chief fire science expert. Dr. Stevens and his team happened to be in the area when the Rim Fire ignited, where they were measuring the density of trees in the forest. His measurements showed there were up to 400 trees per acre in 2013, while there had been just 40–90 trees per acre in 1911. In other words, just before the Rim Fire ignited, the mountains were covered in a densely packed forest with five times the number of trees that had been there a century earlier.

On Resiliency

Forests and forest fires have many parallels with the financial markets. Not long ago, a single fire scorching 400 square miles of land seemed almost beyond imagination. Yet since 2013, there have been seven firestorms in California which have exceeded 400 square miles — including one which burned over 1600 square miles.

These catastrophic firestorms were made possible, in part, due to a century of fire suppression, which allowed forests to grow unchecked by smaller fires. Many of the areas burned by the largest firestorms in recent years had not been burned by a natural fire in more than a century, and the catastrophic fires over the last decade have highlighted just how vulnerable forests are when they are overloaded with combustible material.

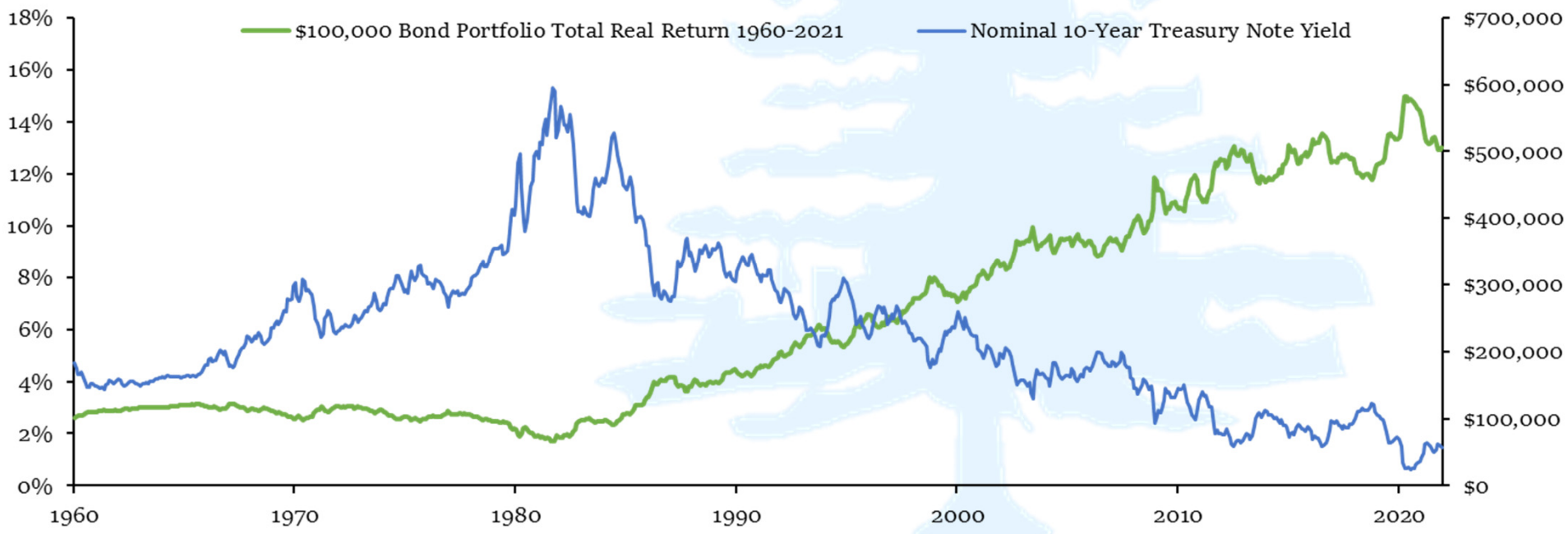
A lush, overgrown forest landscape may be beautiful and photogenic, but it also represents an elevated risk of fire when the right spark comes along.

Yosemite Valley, Back When Smaller Fires Checked Overgrowth (left), and Now (right):

On Resiliency

Over the last forty years, investors have experienced a truly remarkable era of nearly uninterrupted growth in U.S. financial markets, and the images of portfolio growth during those years are as beautiful as a lush forest. For investors in long-term bonds, the performance of their portfolio since 1981 has resulted in a more than fivefold increase in real value. This growth was fueled by a more or less unchecked downward trend in short-term interest rates and long-term bond yields from the high levels of the early 1980s, with the 10-Year Treasury yield falling to just 0.4% in 2020.

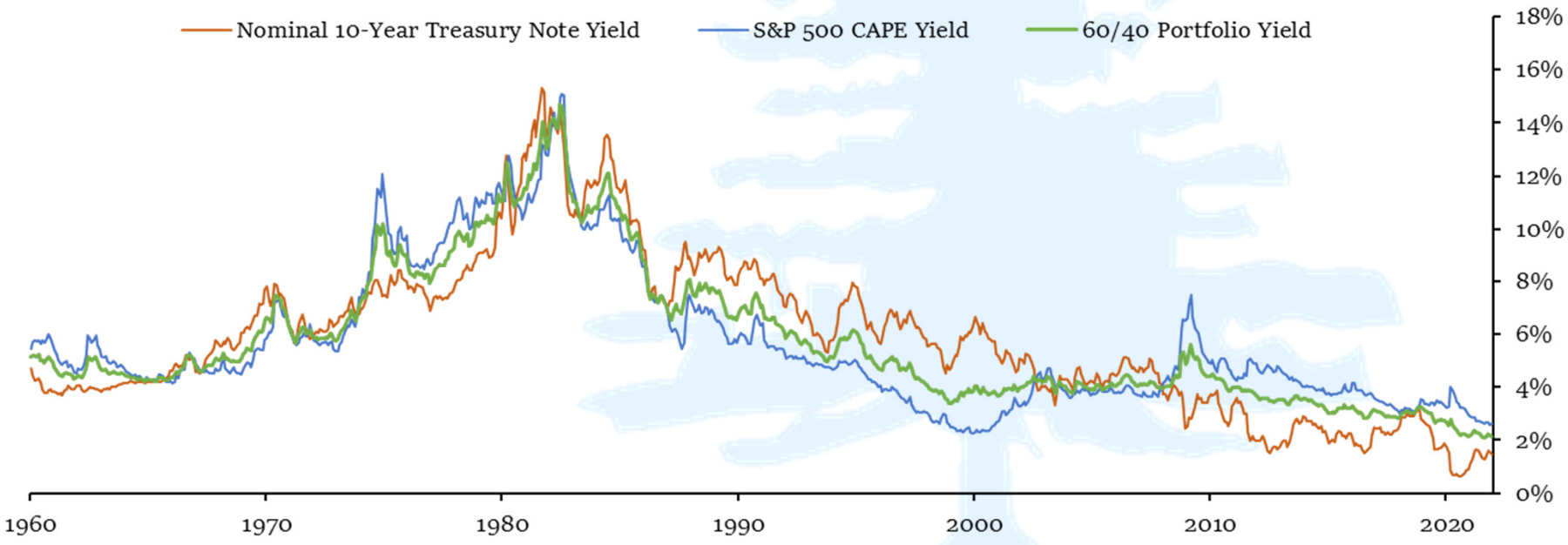
Investors in bonds who reinvested interest payments over the past forty years have done exceptionally well, yet with yields having fallen to the lowest levels in history, the investment landscape has now fundamentally shifted. Instead of simply admiring the lush returns over the past forty years, investors should now be considering the risks that are embedded in these past epochs of portfolio growth.



The 60/40 Dilemma

The high bond yields of the early 1980s enabled the high bond portfolio returns over the past forty years, and bond investors were not alone in benefiting from a tailwind of falling yields: investors in stocks also benefited. An investment in the S&P 500 received an earnings yield of 13% in 1981, and a downward trend in earnings yield since then coincided with a forty-year expansion in valuations.

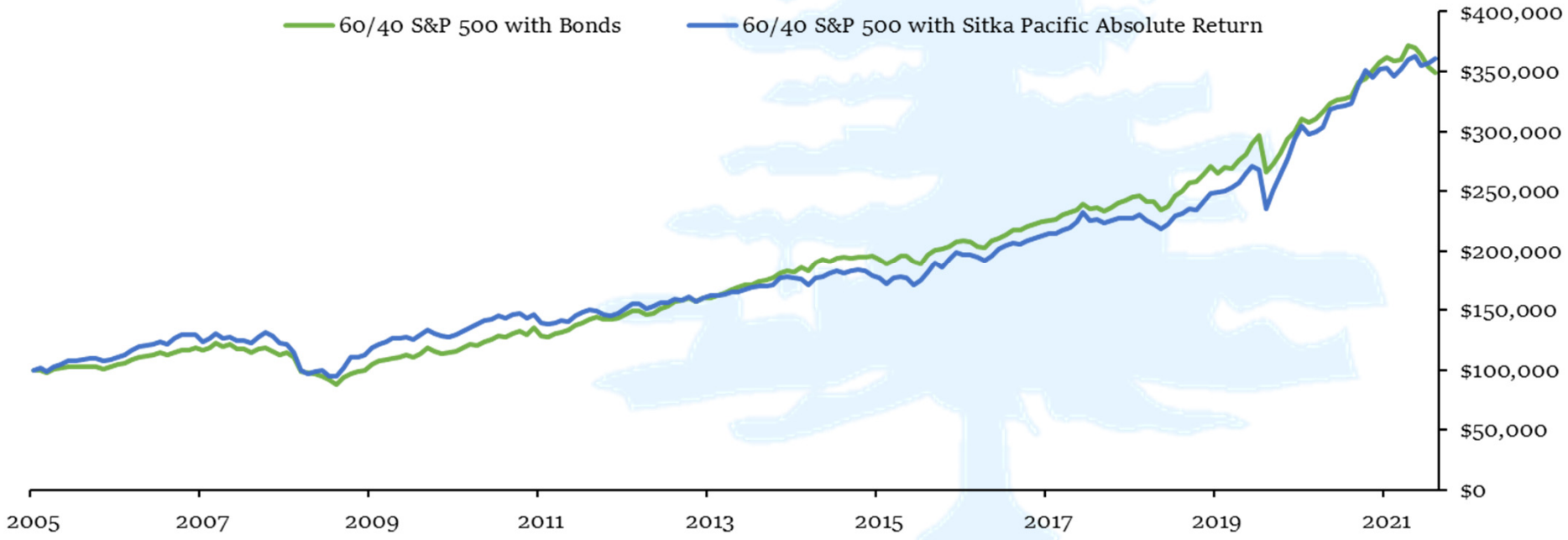
In contrast to the early 1980s, the S&P 500 recently offered an earnings yield of less than 3%. **With such ultra-low yields in stocks and bonds, the risk/reward environment today is the opposite of the early 1980s, and this poses a particularly acute dilemma for investors in the U.S.** On the one hand, the benign conditions of the last forty years produced beautiful buy-and-hold returns in a standard 60/40 portfolio of stocks and bonds, but on the other hand those conditions have resulted in a severely overgrown market environment.



An Active Solution to a Passive Dilemma

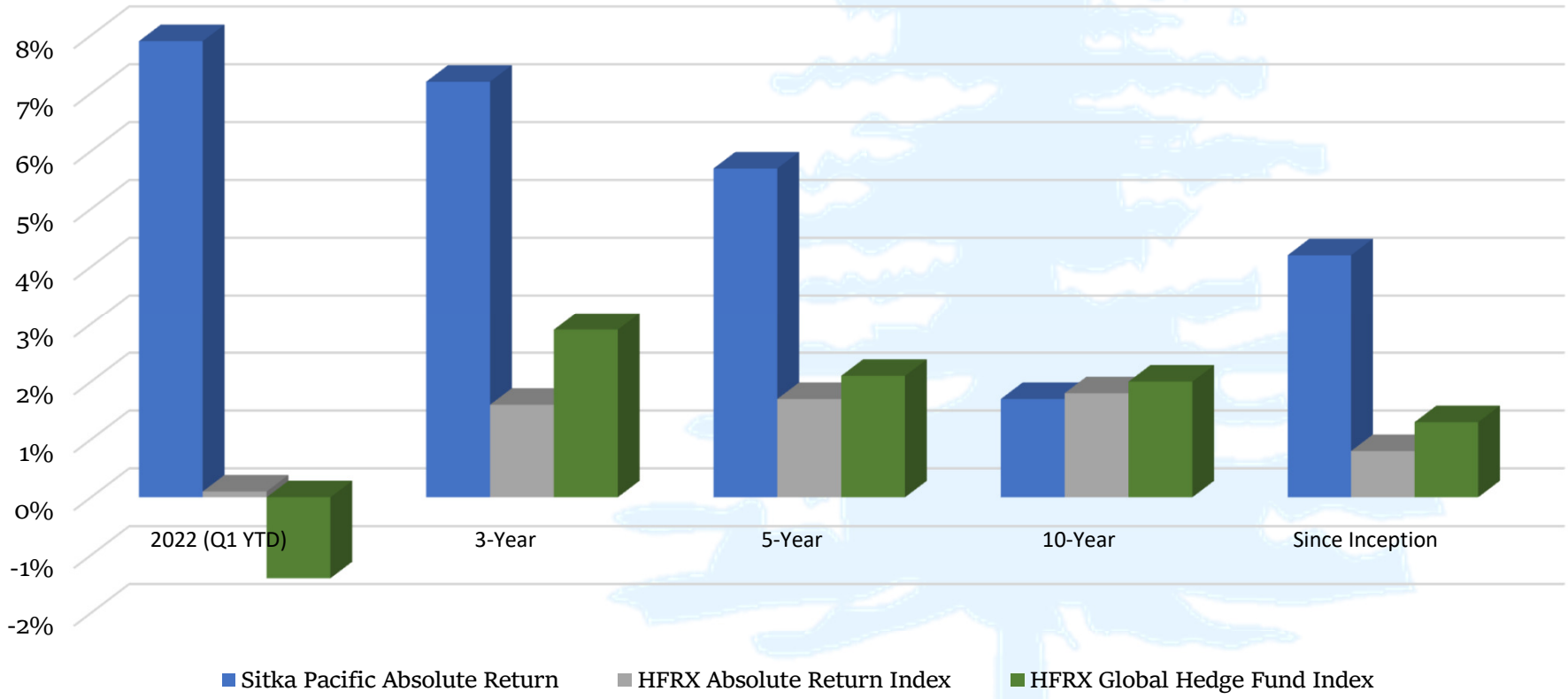
The prospect of low or negative returns from passively holding stocks and bonds represents a dilemma similar to overgrown forests: the vast growth in recent decades resulted in a beautiful landscape, but there are now significant risks which were not present before. **Fortunately, there is a way to address these risks: it involves a move away from the passive 60/40 portfolio of U.S. stocks and bonds to a more active, global search for investment value.** This active search for investment value is the process which underlies our Absolute Return approach.

Since 2005, our Absolute Return approach has provided an effective alternative to a passive bond allocation in a standard 60/40 portfolio. Our active, absolute-value based approach to global equities, bonds, commodities and currencies has historically been uncorrelated to the S&P 500 and is ideally suited for investors seeking a more broadly diversified strategy to counterbalance risk asset exposure.



Historical Performance Summary

	2022 (Q1 YTD)	3-Year	5-Year	10-Year	Since Inception	Sharpe Ratio	Correlation to S&P 500
Sitka Pacific Absolute Return	**7.90%**	**7.20%**	**5.70%**	**1.70%**	**4.20%**	**31.25%**	**-0.02**
HFRX Absolute Return Index	0.10%	1.60%	1.70%	1.80%	0.80%	-4.65%	0.68
HFRX Global Hedge Fund Index	-1.40%	2.90%	2.10%	2.00%	1.30%	5.70%	0.89



June 2021
(Updated April 2022)

Blended Portfolio Performance Summary

Since Inception	S&P 500	**60/40 S&P 500/Absolute Return**	**60/20/20 S&P 500/Absolute Return/Bonds**	60/40 S&P 500/Bonds
Annualized Return	9.0%	**8.3%**	**8.2%**	8.1%
Annual Standard Deviation	16.6%	**10.7%**	**9.7%**	9.2%
Maximum Annual Gain	30.0%	**27.1%**	**21.2%**	20.1%
Maximum Annual Loss	-39.3%	**-19.9%**	**-18.8%**	-17.7%
Sharpe Ratio	58.3%	**66.2%**	**72.0%**	74.5%
2022 Q1 YTD	-6.1%	**-0.5%**	**-3.0%**	-5.6%
3-Year Annualized	12.1%	**10.2%**	**8.8%**	7.4%
5-Year Annualized	10.5%	**8.7%**	**8.1%**	7.5%
10-Year Annualized	9.4%	**6.9%**	**6.9%**	6.9%
Monthly Average Return	0.9%	**0.7%**	**0.7%**	0.7%
Monthly Standard Deviation	3.7%	**2.6%**	**2.3%**	2.2%
Maximum Monthly Gain	12.3%	**8.5%**	**7.1%**	6.3%
Maximum Monthly Loss	-20.2%	**-13.2%**	**-12.1%**	-11.1%

June 2021
(Updated April 2022)

The Goals of Our Absolute Return Approach

The tailwind powering bond returns has been strong for forty years. However, in light of the decline in yields to near zero in 2020, investors should ask themselves whether bonds will be able to fulfill their traditional role of counterbalancing risk assets going forward. For bonds, it has been a long time since the last fire. When investors receive ultra-low yields from bond allocations, total returns are guaranteed to be low, and can turn negative if yields rise — exacerbating portfolio volatility, instead of dampening it. This unfavorable range of outcomes represents a fragility similar to a severely overgrown forest: a beautiful landscape embedded with hidden risks of loss.

Absolute return investing is an approach which seeks to earn a positive return over time, regardless of whether markets are going up, down or sideways — and to do so with less volatility than stocks. By ignoring conventional benchmarks and instead striving for positive absolute returns, absolute return strategies can offer a number of potential benefits to a broadly diversified equity portfolio:

- Reduce Overall Portfolio Volatility
- Limit Losses During Market Declines
- Provide Valuable Strategy Diversification
- Broaden Sources of Returns Beyond Stocks and Bonds
- Improve Overall Portfolio's Risk-Adjusted Return

Our Absolute Return approach serves as an effective counterbalance to risk assets using an active, absolute-value based asset allocation approach which is not dedicated to any single asset class or region. As a result, since inception our approach has had a near zero annual correlation with the S&P 500, which has helped to provide durable, long-term portfolio resilience.

Getting Started

Sitka Pacific provides asset management focused on delivering an absolute return that is independent of the markets over time. We believe it is crucial for every investor to have a portion of their assets dedicated to an actively managed absolute return strategy as part of their overall portfolio, as it can provide stability and diversification when it is needed most.

Before opening an account, we will review your current investments, your goals and tolerance for volatility and risk, along with any questions you may have. We'll then discuss how we invest and whether or not our approach is right for you. Investment management is available to accredited investors. If you are not an accredited investor, ask your current investment advisor to contact us for more information.

Sitka Pacific also provides portfolio assessment and strategic guidance for individuals and institutions. **If you would like to schedule a review of your portfolio, or you would like to receive a more detailed portfolio summary, visit** www.sitkapacific.com/investing/getting-started/ **or send us an email at** investing@sitkapacific.com.

Investment Advisors and Wealth Managers

If you are interested in adding our absolute return strategy to the investment options available to your clients, email us at investing@sitkapacific.com for more information.

We are glad to help you achieve your client's goals through better diversification.

Our Absolute Return strategy is listed in the InformaIS PSN database, in the Global/International Balanced category.

About Sitka Pacific

- Founded in 2005
- Based in Edmonds, Washington, 15 miles north of Seattle
- Principle Manager: Brian McAuley
  - Founder of Sitka Pacific
  - 17 Years Industry Experience

- Client funds are segregated in separately managed accounts (SMAs)
- Available Custodians: Interactive Brokers, Charles Schwab
- Complete transparency
- Complete liquidity

Disclosures

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Sitka Pacific Capital Management, LLC is a Registered Investment Advisor (RIA) based in Edmonds, Washington. Investment management services are available to Accredited investors.

Sitka Pacific Capital Management, LLC is an independent investment advisor, which allows us to offer completely objective advice to our clients.

Visit www.sitkapacific.com for more information.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance may not be indicative of future results. Regular internal reviews will, from time-to-time, result in changes in composite construction and thus changes in composite characteristics for various historical periods.

HFRX Index Source: Hedge Fund Research, Inc. www.hedgefundresearch.com, Please contact us for the most up to date version of this document.

The U.S. Dollar is the currency used to express performance. Returns are presented gross of management fees and trading costs and include the reinvestment of all income. Net of fee performance was calculated using actual management fees. Bundled fee accounts pay a fee based on a percentage of assets under management. Other than brokerage commissions this fee includes investment management, portfolio monitoring, consulting services, and in some cases, custodial services.

The investment management fee is 1.75% of assets under management, or 1% of assets under advisement, assessed periodically at an annualized rate. Actual investment management fees incurred by clients over time may vary. One-time portfolio evaluation fee is 0.5% of advised assets.