

To: Aequitas Client

From: Aequitas Investment Advisors

Re: Schrodinger’s Cat and the Paradox of Today’s Investment Markets

Dear Aequitas Client,

In 1935, the Austrian physicist, Erwin Schrodinger, presented a thought experiment to describe a quantum theory where two completely different realities exist at the same time. To illustrate his argument, Schrodinger presented the idea of a cat being placed inside a steel chamber for one hour along with a flask of poison connected to an atomic energy device. During the one-hour experiment, the device had a 50/50 chance of breaking the flask. Until the box was opened, Schrodinger posited, one could only assume the cat was both dead and alive at the same time (fortunately, Schrodinger did not use a real cat in his experiment). In a recent blog, J.P. Morgan’s Chief Global Strategist, Dr. David Kelly, drew on Schrodinger’s cat thought experiment to describe the current paradoxical state of the investment markets. On the one hand, the U.S. bond market is signaling an economic slowdown with growing anticipation the Federal Reserve may reduce interest rates to stave off a recession. The U.S. stock market, on the other hand, appears to view the prospect of lower interest rates as additional stimulus which could keep the economy growing along with corporate profits rising. Can both contrasting outlooks be right? According to Schrodinger’s thought experiment, the answer might be yes. We all know, of course, the box will be opened sooner or later.

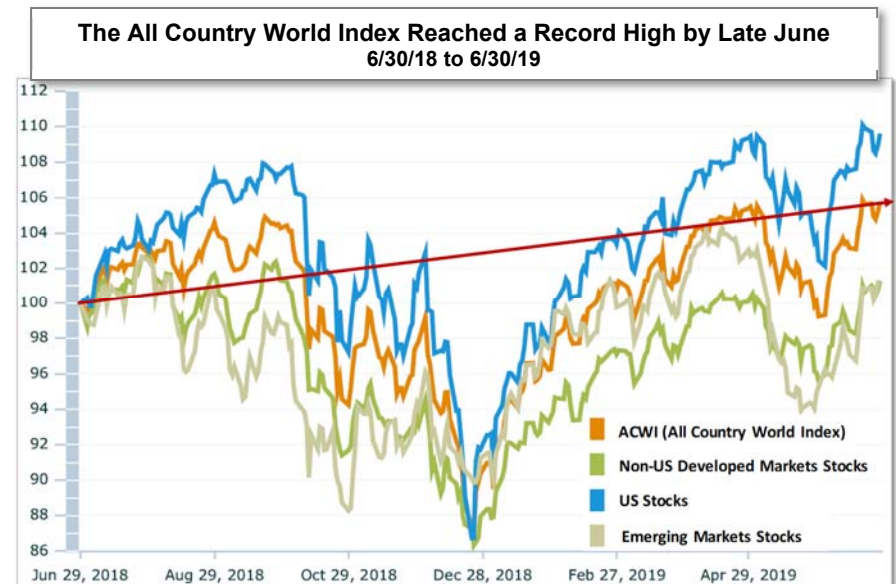
### What the Bond Market is Indicating

In early May, with indications of slowing economic growth and the unexpected failure of trade negotiations between the U.S. and China, a stock market sell-off began as investors became fearful of an impending recession. Typically, when the investor “fear gauge” rises (as measured by the Volatility Index, or VIX), investors shift money into bonds as a safe haven (be mindful that such market timing does not constitute a good investment strategy). As demand for bonds increased, bond prices rose, and interest rates fell as a result. Such a reaction by the bond market would normally be indicative of a slowdown in economic growth

which would also raise the odds that the Federal Reserve would lower interest rates. Fed Chairman Jerome Powell stated in his most recent testimony that various “.....crosscurrents, such as trade tensions and concerns about global growth, have been weighing on economic activity and the outlook.” Powell added that the Federal Reserve will “act as appropriate” to sustain economic growth (in other words, if conditions do not improve, a reduction in rates is on the table).

### What the Stock Market is Indicating

While bond investors interpreted the possibility of the Fed cutting rates as a sign of economic weakness (glass half empty), stock investors viewed the prospect of lower interest rates as additional fuel to keep the economy growing (glass half full). In early June, the stock market turned an about-face and reached a record high level later in the month. Favorable consumer sentiment and a surprisingly strong June jobs report also bolstered the stock market’s enthusiasm.



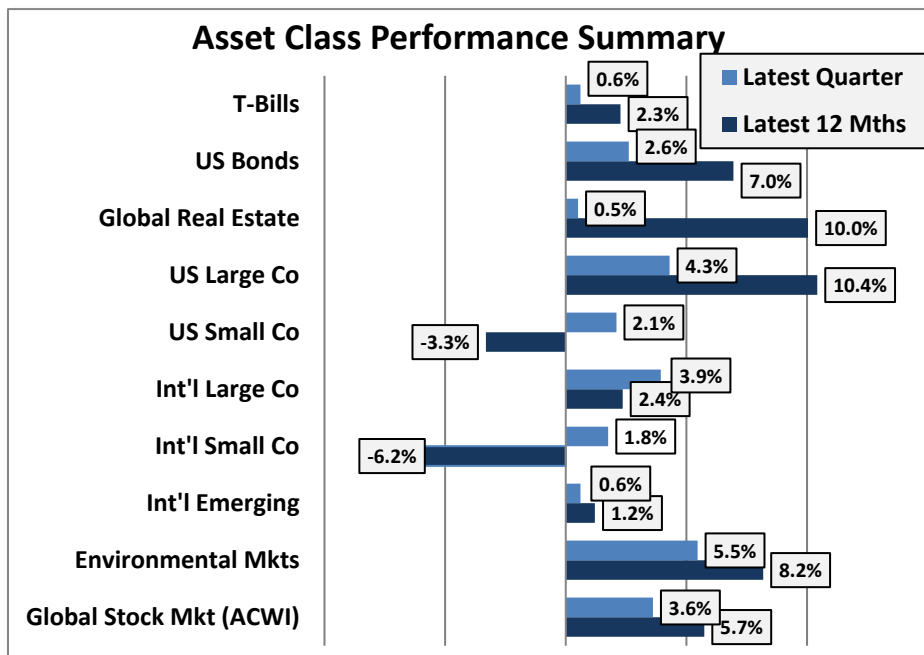
### How to Interpret Opposing Indicators?

With the bond and stock markets indicating opposing views, how should investors be positioned? Or, do the contrasting views suggest we’re in a “Goldilocks Economy” which is characterized by an economy which is neither too hot,

causing inflation, nor too cold, causing a recession. If that's the case, then Schrodinger's cat paradox may linger a while longer and the box opening may be delayed. Until we know, however, we believe investing with both possible outcomes in mind is the most practical and prudent course of action (i.e., maintain an appropriately constructed *balanced* portfolio with a level of risk commensurate with each investor's unique time horizon).

### Asset Class Performance Review

During the latest quarter, every major asset class posted a positive return ranging from a low of 0.6% (US T-Bills and Emerging Markets) to a high of 5.5% (Environmental Markets). The downturn in May was more than made up for with the strong finish to the quarter in June. The All Country World Index (ACWI) rose by 3.6% for the period. Once again, investors seemed to shrug off the prospect of a slowing economy, although the sell-off in May was a reminder of the stock market's inherent volatility.

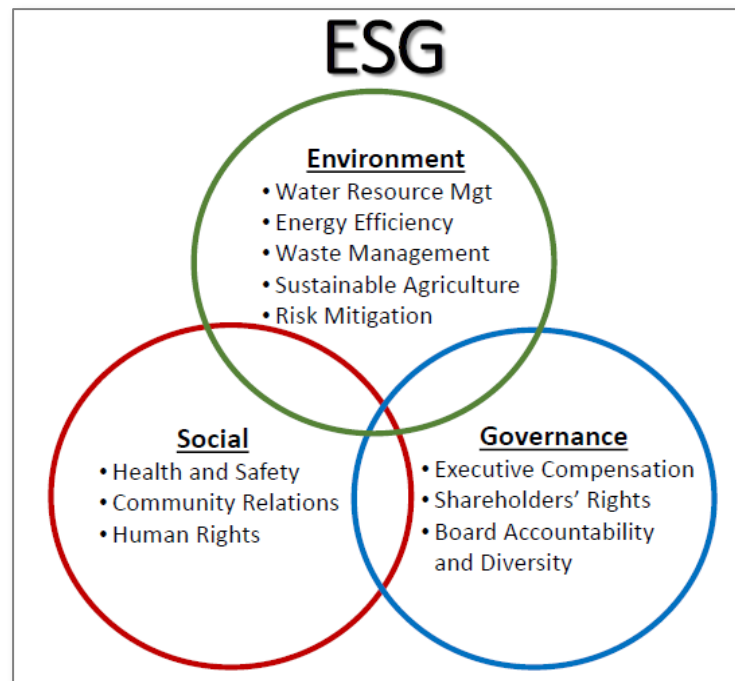


Over the trailing 12 months, only US and International Small Cap stocks landed in negative territory with respective losses of 3.3% and 6.2%. Interestingly, these two asset classes have been the top performers over the past twenty years. Often, asset classes which perform the best over the long term are those which are also the most volatile in the short term (Risk and Reward are highly correlated). The best performing asset classes for the past 12 months were US Large Caps

(+10.4%), Global Real Estate (+10.0%), Environmental Markets (8.2%) and US Bonds (7.0%). Bonds did particularly well given the drop in interest rates. Next in line were International Large Caps (+2.4%), T-Bills (+2.3%) and Emerging Markets (+1.2%). The All Country World Index was up 5.7% for the period which is a figure close to the expected average annual return for stocks globally over the next ten years.

### Environmental Markets

As the July sun starts to turn up the heat on summer, and in the early days of hurricane season, we thought we'd review our approach to environmental sustainability and portfolio diversification under the broader umbrella of ESG investing (Environmental, Social and Governance investment criteria). In the past, Socially Responsible Investing (SRI) pursued the dual goals of achieving social ends while attempting to optimize investment returns, yet it seemed that pursuing one of these goals was at the expense of the other. Over the years, SRI investing evolved into a broader set of investment criteria including Environment, Social and Governance. The benefit of this expanded set of investment considerations, rather than just Social, has resulted in a larger universe of potential investment opportunities. Furthermore, with growing interest in ESG, fund management fees and expenses have fallen to much more competitive levels. Lastly, there are many even lower-cost index and passively managed ESG fund options today which were unavailable just a few years ago.



Given the growing impact of climate change on the environment as well as resource scarcity resulting from population growth, there are many opportunities to invest in companies which are involved in the transition to a more sustainable global economy. In this regard, we believe the dual goals of satisfying social ends and optimizing investment returns can be achieved simultaneously. A great example is the Pax Global Environmental Markets Fund which is a core holding in our recommended model portfolios. The fund invests in Energy Efficiency, Water Infrastructure, Pollution Control, Food and Agriculture, and Waste Management. Not only do these investment areas offer diversification benefits, they also offer the potential for capital appreciation. For the year-to-date period through June 30<sup>th</sup>, Pax Global Environmental Markets Fund gained an impressive 20.2% which compares favorably to the 16.2% gain for the All Country World Index (ACWI). Over the trailing 3-year period, the fund posted an average annualized gain of 11.7%.

Waste management presents a major investment opportunity for the Pax Global Environmental Markets Fund. In China, more than twenty-five years ago, Zhang Yin started a paper recycling company called Nine Dragons and she would later become China's first female billionaire. China wanted scrap paper and plastic to recycle into more products and Yin seized the market. One of the Pax Global Environmental Markets Fund holdings is China Everbright International Limited (CEI) which has become an industry leader along with Nine Dragons. As a subsidiary of the parent China Everbright (a State-Owned Enterprise, or SOE), CEI has become a leading player in China's waste industry with a focus on waste-to-energy as well as hazardous, medical and food waste treatment. As a result, CEI is in a strong position to continue benefiting from the waste processing capacity build-out and market consolidation while performing waste sorting, environmental sanitation and wastewater treatment. CEI has locations in 21 of 23 Chinese provinces and is a strategic partner in the Chinese government's Silk Road Initiative, which is an ambitious infrastructure project for land and maritime route expansions to promote trade and economic growth.

Investing in the Environmental Markets can also provide a modest "hedge" against adverse environmental outcomes while also potentially lowering the cost of capital for companies which are helping the environment – in other words, doing well by doing good. As part of our ongoing investment management process and as a result of growing client interest, we have designed an additional model portfolio which emphasizes ESG criteria in most of the other major asset classes. (If this is an area of interest, please let us know.)

## Closing Comment – Navigating Through the Fog

As a sailor speaking from personal experience, one of the more unsettling events at sea is when a thick fog bank rolls in unexpectedly. One immediately loses sight of land, other boats and any nearby navigational buoys. It's not unusual under such conditions for sailors to lose their sense of direction and veer off course (possibly toward another boat or even the rocks!). This is when advance planning really pays off. Prepared sailors will have their course plotted on a chart, will regularly keep track of the boat's position and will rely on a compass, and other navigational aids, for direction. With such prudence, the helmsman can more confidently sail toward the desired destination.



Perhaps today's paradoxical market is analogous to sailing in the fog. There is no clear view of which way the economy will head. Is a recession on the horizon, or are economic conditions favorable enough to sustain growth for the foreseeable future (perhaps with a little help from the Fed)? What we do know is that without a plotted course (i.e., a financial plan) or regular recordings of one's position on the chart (i.e., updates to the plan and progress reviews), one might veer off course and lose ground toward achieving one's financial goals. At Acqitas we're here at the helm to help our clients navigate into the future and improve the odds of a successful journey.

In closing, we hope you have an enjoyable summer until we meet again!



**AEQUITAS INVESTMENT ADVISORS, LLC**  
**FINANCIAL PLANNING AND PORTFOLIO MANAGEMENT FOR LIFE'S JOURNEY**

