



PENDULUM
ASSET MANAGEMENT

July 11, 2024

Q2 2024 Commentary—Know Where the Pendulum is Swinging

Howard Marks is famous for co-founding Oaktree Capital Management, a credit investment firm specializing in distressed securities. Secondary to that, he is well known for his prescient memos on the market. Many of his memos discuss how the market acts as a pendulum, swinging from euphoria/overpriced to depression/underpriced, often spending much more time in the extremes versus the medium.

As simple as this seems, this analogy has always stuck with us and was the founding basis for the name of our firm, *Pendulum Asset Management*. The takeaway from this analogy is not so much that the market swings from one extreme to the other; that seems like a given. However, the real takeaway is that as investors, our job is to recognize where the “pendulum” is currently at, where it is swinging towards, and *assessing our associated risk management*, i.e. How do we manage capital based on this?

A Brief Primer on Pendulum Asset Management

Pendulum focuses on what we believe are high-yielding equity and preferred securities, predominately companies that are small-cap. We focus on this niche for a couple reasons:

1. Our view is that now, certain pockets of small-caps (mortgage REITs in particular) are fundamentally undervalued. At the same time, the broad market is overvalued and concentrated to a dangerous degree (see more below). In other words, the “pendulum” has swung to a dangerous extreme.
2. We expect volatility from this broad market concentration and other risks present, mainly inflation/stagflation and recession risk. Because of this, we believe that the income produced from invested securities may act as a hedge for future price volatility

Q2 Review: Concentration Risks Abound

Q2 2024 reinforced our view is that the “pendulum” is at the point where the market is at a concerning tipping point:

- Q2 returns for the S&P 500 were at ~3.9% **versus** -3.08% for the S&P 500 equal weighted index, or a difference of ~7%
- The S&P 500 is overly concentrated in the top 5 or so names, with NVDA contributing to ~1.6% of the S&P 500's quarterly return, or roughly a third
- Per Bloomberg, the Russell 2000 had one of its worst first half-year performances relative to the S&P 500 in history
- The 2-year/10-year treasury curve is still inverted since July 5th 2022, marking the longest stretch in which the curve has been inverted for
 - 2s/10s inversion is a key recessionary indicator

None of the risks mentioned above are surprising to institutional investors. Yet, this key data may illustrate that the market, at least the broad US equity market, is fundamentally broken. Given these economic trends, prudent investors may benefit from investing in alternative solutions.

Pendulum's Value Thesis

We view ourselves as that alternative solution.

The above risks, especially the concentration risk within the S&P 500 and stretched valuation in our opinion, make navigating the current market a clear challenge and in turn drive the value thesis of Pendulum's strategies. As an alternative allocator of capital, our goal is to not necessarily outperform the indices in the short-term, but rather:

1. Identify high-quality investments by conducting deep analysis on management strength, asset quality and business metrics
2. Constantly research and identify new investments with strong fundamentals that we can patiently acquire at attractive discounts

As mentioned above, we invest in small-cap equities and preferreds, many of which currently pay dividends/interest that we view as high-yield. Our goal is to acquire these assets at attractive valuations and earn investors good total return, both from price appreciation and income earned.

In good times, we strive to earn good total return, and in volatile times, we intend for the income to offset some of the price volatility of our holdings.

Thank you for your trust, and please reach out if you wish to learn more.

****Performance data for strategies will be included in future quarterly reviews**

US Indices	Price as of 3/31/24	Price as of 6/30/24	Change (%)
Dow Jones	39,807	39,123	-1.7%
S&P 500	5,254	5,460	3.9%
NASDAQ	16,379	17,732	8.3%
Russell 2000	2,125	2,048	-3.6%

Treasury Yields	Yield as of 3/31/24	Yield as of 6/30/24	Change (Bps)
2yr	4.61%	4.74%	0.13%
3yr	4.40%	4.54%	0.14%
5yr	4.18%	4.37%	0.19%
7yr	4.21%	4.37%	0.16%
10yr	4.20%	4.39%	0.19%
30yr	4.36%	4.56%	0.20%
2s10s	-0.41%	-0.35%	0.06%

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