Maintaining an Even Keel Through Volatile Conditions

Facing threats from multiple directions—geopolitical strife, persistent inflation and shifting central bank policy among them—financial markets staggered out of the gates in 2022.

Nearly all asset classes, sectors and geographies saw broad declines. Market volatility was elevated, and with the conditions that inspired it seemingly unlikely to abate soon, this may be the norm. That said, we do not view the short-term waxing and waning of portfolio values as the most serious risk facing investors; instead, we believe the possible permanent impairment of capital in real terms represents the most significant obstacle to long-term outcomes.

We seek to mitigate this risk and generate long-term absolute returns across market cycles through a selective, valuation-sensitive approach to equities, in many cases complemented by cash and cash equivalents as a form of deferred purchasing power and gold and gold-related securities as an important source of ballast. We look for companies we believe have the potential for persistent earnings by virtue of possessing a scarce, durable asset—a tangible or intangible factor that in our view provides it with a long-term operational advantage and is highly difficult for other businesses to replicate. We purchase these businesses only when available at a "margin of safety," or discount to our estimate of their "intrinsic value," a pursuit often facilitated by market volatility and the price distortions that may result. The end result is an eclectic mix of assets we believe has the potential to mitigate inflation's impact on real returns in the face of tumultuous markets.

KEY TAKEAWAYS

- There has been almost no place to hide thus far in 2022 as volatility spiked and markets sold off in the face of a multitude of threats.
- With inflation at multi-decade highs, it remains to be seen whether policymakers can achieve a "soft landing" for the economy or if a recession is the more likely outcome.
- First Eagle seeks to leverage the price disloca-tions that often accompany volatility to identify attractive entry points into businesses we view as resilient, including those we believe have the potential to mitigate the impacts of inflation on portfolio returns.
- While current market dynamics can be trying, strategies that attempt to mitigate the impact of down markets while participating in their upside may provide a more favorable outcome for investors, encouraging them to stay invested and providing the opportunity to compound gains over the long term.

Views expressed are as of May 31, 2022.

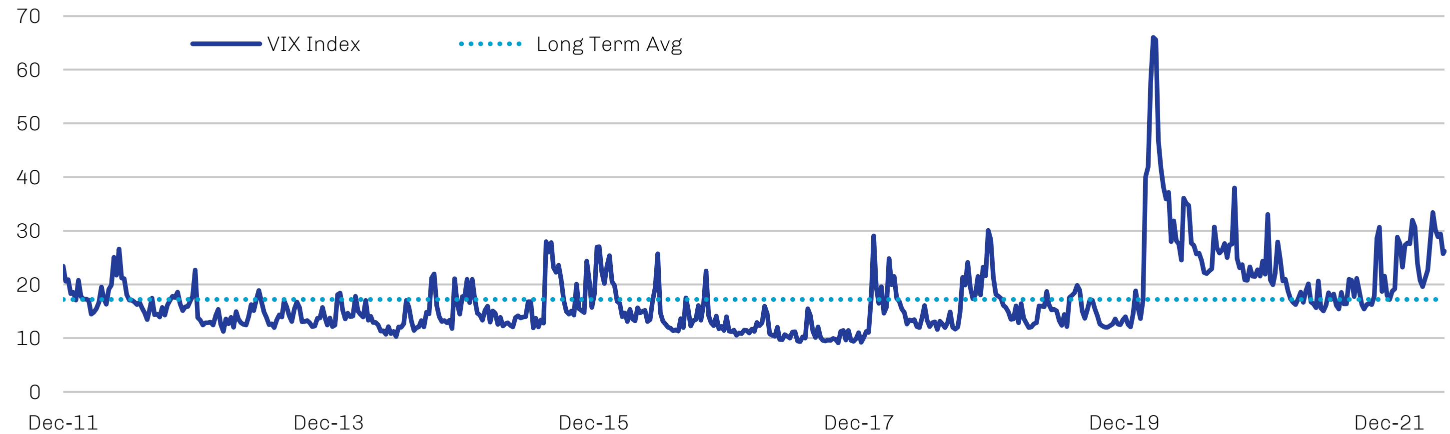
Nowhere to Hide from Volatility

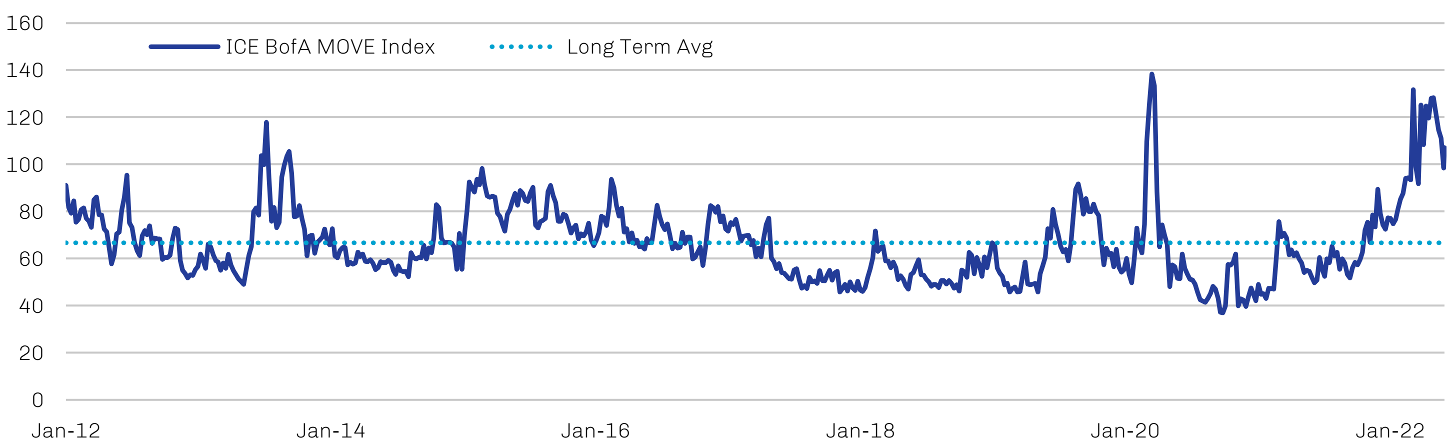
Markets, already on edge from incessant inflationary pressures and the aggressive policy tightening it was expected to inspire, were rattled further by new worries in early 2022, as Russia's invasion of Ukraine and a new round of Covid lockdowns in China had unwelcome implications for both global supply and demand. There has been almost no place to hide thus far in 2022; commodities were among the only assets to generate positive returns for the year to date through the middle of May.

Implied volatility across asset classes, which had been creeping higher since the fall, spiked in response to Russia's attack on Ukraine and has been biased higher since. Notably, fixed income volatility—as reflected by the ICE BofAML MOVE Index—approached highs not seen since the tumult of the March 2020 Covid-19 risk selloff.

Exhibit 1. Implied Volatility Spiked in Response to Russia's Invasion

January 1, 2012, through May 31, 2022





Source: Bloomberg; data as of May 31, 2022.

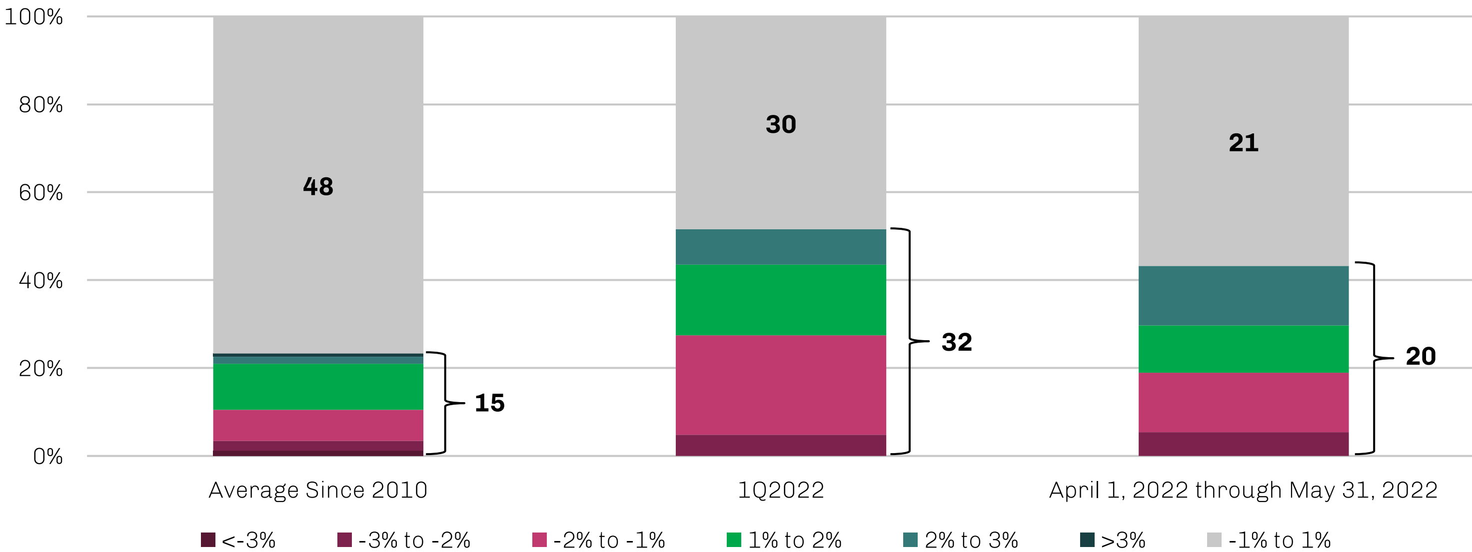
Realized volatility has also been significant. As shown in Exhibit 2, more than half of the S&P 500 Index's trading days in the first quarter saw absolute price moves in excess of 1%, well above the 23% average since 2010.[1] The second quarter to date is on a similar above-average trajectory. While volatility is often equated with sharp market pullbacks, in our experience such conditions have historically corresponded with periods of choppy returns that are muted but not catastrophic. For example, even though year-to-date equity returns have been poor, extreme volatility has been evident in both directions; of the 52 days the S&P 500 has closed more than +/- 1% of its open during 2022, 24 were gains.[2]

In our view, this observation highlights the futility of attempts at market timing and the importance of staying invested. While we acknowledge that large short-term losses can be difficult for investors to stomach, we also believe that maintaining exposure to resilient assets may best position investors to compound gains over the long term.

1. Source: Bloomberg; data as of May 31, 2022.
2. Source: Bloomberg; data as of May 31, 2022.

Exhibit 2. 2022 Has Seen Large Daily Movements—Positive and Negative—in Equities

Daily Percentage Change in Price of S&P 500 Index by Number of Occurrences, January 1, 2022, through May 31, 2022



Source: Bloomberg; data as of May 31, 2022.

Mixed Readings from the Tea Leaves

There are reasons to believe that elevated market volatility may be the norm for some time, as the conditions that inspired it appear unlikely to abate soon.

Realized inflation has hit a series of new multi-decade highs, sending short-term real yields into a swoon; after April's consumer price index print of 8.3%, the real federal funds policy rate stood at -7.3%.[3] However, measures of inflation expectations five years out and longer—like breakeven rates on US Treasury inflation-protected securities and five-year, five-year-forward inflation expectation rates—paint a more sanguine picture; though higher than they were to begin the year, these metrics continue to suggest that bond markets expect pricing pressures to ease back closer to the Fed's 2% target.[4]

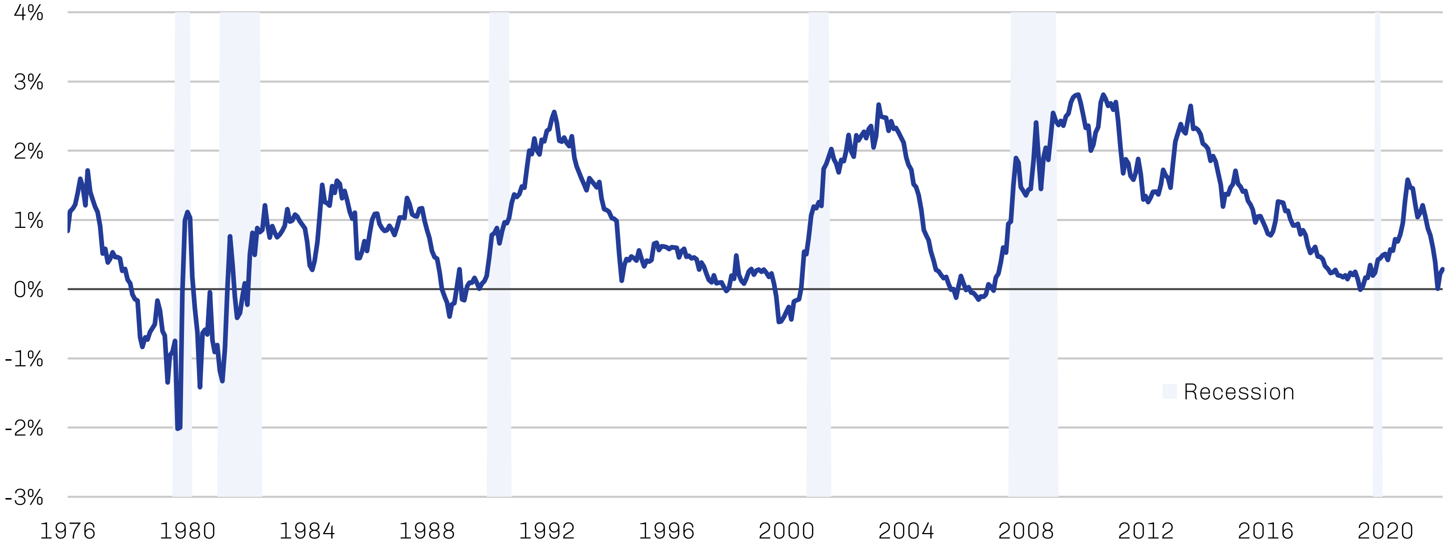
One interpretation of this dichotomy between near- and long-term inflation expectations is that markets believe the Fed will be successful in engineering a "soft landing" for the economy; another is that the Fed, already behind the curve, will be forced to act aggressively to tame inflation and snuff out economic growth in the process. Whichever side one believes, it's clear the Fed is walking a tightrope; Fed Chair Powell himself expressed optimism of a "soft-ish" landing. At its most recent meeting in early May, the central bank raised the fed funds target rate by 50 basis points, to 0.75–1.00%, and signaled that hikes of such magnitude may be the norm for the next few meetings; markets are pricing in a rate of 2.75–3.00% by year end.[5]

The yield curve appears to be biased toward a "hard landing" given its brief inversion in March, shown in Exhibit 3. An inverted yield curve suggests that investors see greater risk—and thus demand greater compensation in the form of yield—in the near term relative to the long term, and is often a precursor to recession. In fact, the difference between 10-year and two-year Treasury rates has turned negative before seven of the last eight recessions in the US.[6]

3. Source: Bureau of Labor Statistics; data as of May 11, 2022.
4. Source: Federal Reserve Bank of St. Louis; data as of April 29, 2022.
5. Source: CME Group; data as of May 13, 2022.
6. Source: *Barron's*, BCA Research; as of April 5, 2022.

Exhibit 3. Recessions Often Have Been Preceded by an Inversion of the Yield Curve

10-Year US Treasury Yield Minus Two-Year US Treasury Yield, June 1976 through May 2022



Source: Bloomberg; data as of May 31, 2022.

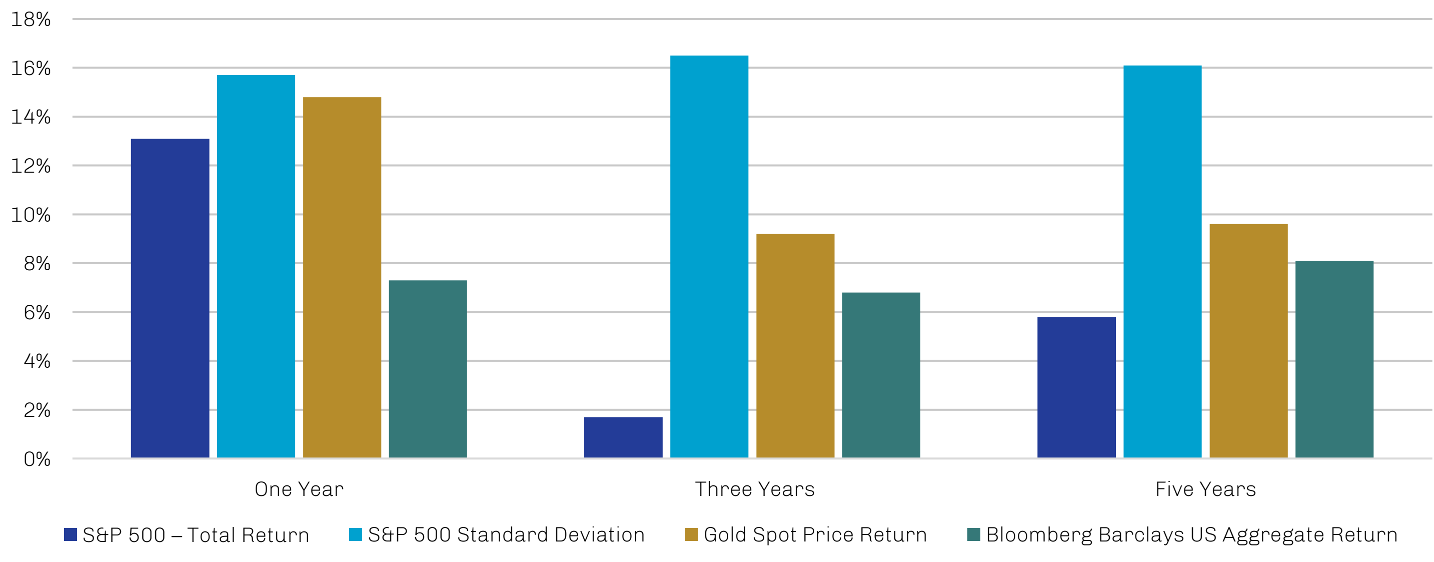
Caution Ahead

While we won't hazard a guess as to what the future holds for inflation or interest rates or markets, there are a couple of observations we can make based on historical data. In short, conditions such as those we are experiencing today are not necessarily the death knell for equity investment—but there are certain nuances to be aware of.

As shown in Exhibit 4, periods following yield curve inversions have been characterized by lower—but not necessarily negative—returns from financial assets alongside pronounced market volatility and strength in the gold price. While such an environment can be trying, strategies that attempt to mitigate the impact of down markets while participating in their upside may provide a more favorable outcome for investors and encourage them to stay invested.

Exhibit 4. High Equity Market Volatility Has Followed Yield Curve Inversions

Average Performance Following Yield Curve Inversion, August 1978 through March 2022

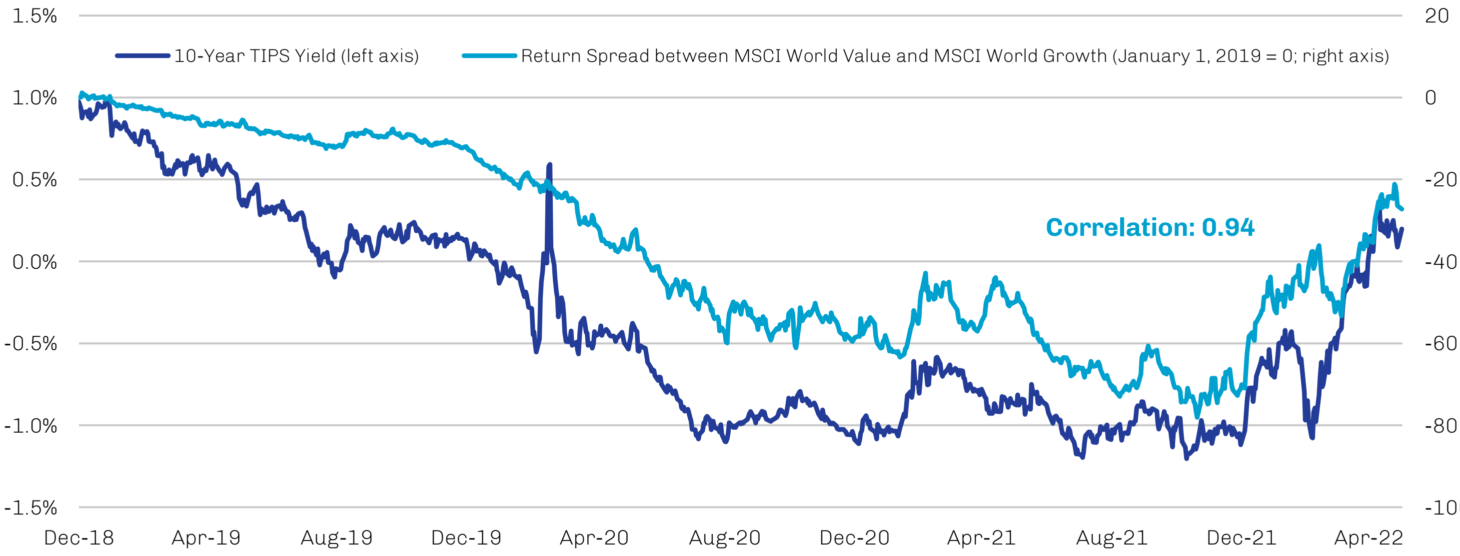


Source: Bloomberg; data as of March 31, 2022.

Past performance is no guarantee of future results.

Meanwhile, periods of rising interest rates have tended to favor value stocks over growth stocks, as shown in Exhibit 5. Years of historically low interest rates heightened the appeal of long-duration growth stocks and their promise of future cash flows, fueling massive outperformance relative to value names. Higher discount rates may limit the appeal of such stocks, especially given valuations that remain high despite the recent pullback; though it has underperformed the MSCI World Value Index by about 1,500 basis points year-to-date, the MSCI World Growth Index's trailing price-to-earnings ratio is nearly double.[7]

Exhibit 5. Rising Rates Historically Have Favored Value over Growth



Source: Bloomberg; data as of May 31, 2022.

Volatility Expands the Small Cap Opportunity Set

Small cap stocks represent a particularly volatile and inefficiently priced segment of the US equity market. First Eagle's Small Cap team believes that these dynamics can create opportunities for disciplined active investment managers to identify undervalued small cap names in an effort to generate attractive returns for investors over the long term through diversified portfolios.

Inflation, tightening financial conditions and the potential threat of slowing growth represent risks to corporate earnings in general. Small cap companies are often perceived as more vulnerable to price pressures and the reduced liquidity conditions that often accompany them. But, in our view, financial resilience isn't solely defined by market capitalization, and the recent re-rating of equity markets has created price dislocations and provided new opportunities for investment, especially as shrinking market capitalizations push once-larger companies into our investment universe. Thoughtful navigation of difficult market periods, with an eye toward company-specific catalysts that may drive a normalization of valuation, may serve as a potential tailwind when market conditions improve.

7. Source: MSCI; data as of May 31, 2022.

Maintaining a Focus on Selective Diversification

While the volatility we have experienced of late can make for a white-knuckle ride, we believe that the most serious investment risk is not the short-term waxing and waning of portfolio values but the possibility of permanent impairment of capital. We seek to minimize this risk by building diversified portfolios of quality businesses trading at what we believe to be a discount to our estimate of their intrinsic value. The price dislocations that often accompany volatility can help support this process.

The Global Value team's approach remains unchanged amid the current market and macroeconomic turbulence. We continue to seek attractively priced companies we believe have the potential for persistent earnings by virtue of possessing a scarce, durable asset—a tangible or intangible factor—that in our view provides it with a long-term operational advantage and is highly difficult for other businesses to replicate. One byproduct of this focus has been ownership of an eclectic mix of resilient businesses we believe have the potential to mitigate the impacts of inflation on portfolio returns—that is, "inflation beta." In this context, such holdings can be bucketed into four broad categories.

> The price dislocations that often accompany volatility can create opportunities to uncover quality businesses trading at a discount to our estimate of their "intrinsic values."

Scarce tangible assets. We seek companies with physical resources that are well-located relative to their competition—as manifest in the ability either to have consistently generated strong revenues or kept costs low—and that have a long natural duration. That is to say, assets we expect to earn a spread relative to the average asset in the same industry. This generally has resulted in a higher exposure to commodities, which has been one of the only bright spots in this turbulent market, and premium urban real estate, the price of which can be adjusted relatively quickly in an inflationary environment.

Scarce intangible assets. Companies with scarce intangible assets often have an advantaged market position and can be difficult to unseat, resulting in long duration in the form of customer loyalty, strong pricing power and steady cash flow. Luxury brands tend to have an element of inelasticity to demand for their highly sought-after goods, for example, while the products of many consumer staples giants are ubiquitous throughout the world. Meanwhile, a number of high-performing information technology companies have strong retention rates among the users of their critical business applications.

Middlemen. We think that potential opportunities may be uncovered along the value chain between businesses and their end consumers; these include a variety of "middlemen" that earn commissions or fees for providing services ranging from logistics to transaction processing. Inflationary environments may offer these intermediaries an opportunity to capture a portion of rising transaction values in the industries they service without major increases to their own input and asset-carrying costs.

Float Businesses. Lastly, we also own a number of financial businesses able to generate interest or capital returns on their liabilities. This includes regional banks whose interest income on their lending activity exceeds the interest cost on deposits, for example, and niche insurers who generate investment income on their reserves.

Meanwhile, gold and gold-related securities continue to be an important source of ballast in many of the portfolios managed by the Global Value team as well as a source of deferred purchasing power in the face of ongoing fiat currency debasement. We hold gold for two primary reasons: to mitigate the short-term impacts of extreme events (such as war) and to serve as a long-term potential hedge against monetary debasement, inflation and other currency issues. Thus far in the current challenging environment, gold's reputation has been validated on both fronts. While the price of gold faces a headwind in the form interest rates that appear biased higher, we maintain our faith in the value of a strategic allocation to gold and gold-related securities as potential hedge and continue to implement our strategy with a focus on resilience.

Floating-Rate Assets May Provide Some Relief

Inflation packs a one-two punch against traditional fixed-rate bonds, eroding the purchasing power of their coupon payments and often presaging higher interest rates—both of which weigh on market prices. This dynamic has been clearly evident in 2022, as the Bloomberg US Aggregate Bond Index has shed 9% year to date, and interest-rate sensitivity combined with slim yield cushions suggest an unfavorably asymmetric risk-return profile for core bond assets going forward.[1]

Loans—both broadly syndicated and directly originated—may hold greater appeal. In exchange for additional credit and liquidity risk, these noninvestment-grade assets typically offer higher yields than investment grade debt, helping to mitigate the deleterious effects of inflation, while their floating-rate structure provides a degree of protection against the impact of rising interest rates.

The diversity of borrowers in the loan market suggests that current conditions may prompt a bit of separation across industries and among individual business models. Identifying the investment opportunities that may emerge from this is incumbent upon strong underwriting and rigorous investment discipline alongside scale that facilitates effective and efficient deployment of investor capital. First Eagle Alternative Credit's investment teams represent an uncommon blend of experience and continuity in what is still a relatively incipient corner of the capital markets, in many cases having worked side-by-side to hone their processes and philosophies over multiple decades and across multiple market cycles. The team takes an intensive, research-driven approach to allocating assets across the alternative credit spectrum—including both public investments and proprietary private market deal flow—to build differentiated investment opportunities for clients, with the potential for downside mitigation a key consideration.

1. Source: Bloomberg; data as of May 31, 2022.

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Past performance is not indicative of future results.

Risk Disclosures

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and micro-size companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade. A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented. There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations. All investments involve the risk of loss of principal.

Investment in gold and gold-related investments present certain risks and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market for interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements; and
- Below investment-grade loans which may default and adversely affect returns.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Standard deviation is a statistical measure of the distance a quantity is likely to be from its average value. It is applied to the annual rate of return to measure volatility.

"Intrinsic value" is based on our judgment of what a prudent and rational business buyer would pay in cash for all of the company in normal markets.

First Eagle defines "margin of safety" as the difference between a company's market price and our estimate of its intrinsic value. An investment made with a margin of safety is no guarantee against loss.

Volatility is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

Inflation Beta is calculated as the covariance of each security's daily returns to the daily percent change in the US 10Y Breakeven Rate divided by the variance of the daily percent change in the US 10Y breakeven rate. The beta calculation is taken over the trailing 1-year period (31-Mar-2021-31-Mar-2022). A beta > 0 indicates a security exhibited a positive return when the 10Y Breakeven increased, while a beta < 0 would indicate a negative return for a security when the 10Y breakeven increased. A higher magnitude beta indicates a higher expected sensitivity of the security's return to an increase in the Breakeven Rate.

Bloomberg Barclays US Aggregate Bond Index is an unmanaged broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS and is not available for purchase.

CBOE Volatility Index is a measure of the 30-day expected volatility of the US stock market. It is based on the prices of options on the S&P 500 Index and is calculated by aggregated weighted prices of the index's call and put options over a wide range of strike prices.

Consumer Price Index For All Urban Consumers (CPI-U) measures the changes in the price of a basket of goods and services purchased by urban consumers.

ICE BofA MOVE Index is a measure of US interest rate volatility. It is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.

MSCI World Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 23 developed markets. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI World Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 23 developed markets. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

Standard & Poor's 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the Standard & Poor's 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

Treasury Inflation-Protected Securities (TIPS) are a type of US Treasury security whose principal value is indexed to the rate of inflation. TIPS provide investors with protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Bureau of Labor Statistics Consumer Price Index for All Urban Consumers (CPI-U).

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses

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