SALEM PARTNERS
WEALTH MANAGEMENT

Year-End 2021 Investment Letter by Erik Ridgley, CFA January 5, 2022

We wish all our clients and friends a Happy New Year! Below we provide a review of the markets in the 2nd half of 2021, and our thoughts for 2022. We are pleased to report our investment returns, net of fees, in 2021 of +20.65% Global Equities, +25.77% U.S. Large Cap Equities, and +2.81% Tax-Exempt Muni Bonds portfolios, and our annualized yearly returns since 12/31/2018, net of fees, of +21.38% Global Equities, +25.45% U.S. Large Cap Equities, and +4.92% Tax-Exempt Muni Bonds portfolios, for a subset of related client portfolios (see disclosures). We work hard on delivering superior long-term after-tax returns for each of our clients per their customized investment policy statements, and we are grateful for the trust and confidence our clients have placed in us.

Asset Class Benchmark Index Returns – 2021, 2020, and 2019

2021	2020	2019	Asset Class
2021: +18.54%	2020: +16.25%	2019: +26.60%	Global Equities: MSCI All Country World Index (ACWI)
2021: +1.52%	2020: +5.21%	2019: +7.54%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
2021: +10.03%	2020: +10.73%	2019: +17.07%	50/50 Blend Portfolio: 50% ACWI / 50% Muni Bond
2021: +28.71%	2020: +18.40%	2019: +31.49%	U.S. Large Cap Equities: S&P 500 Index
2021: +14.82%	2020: +19.96%	2019: +25.52%	U.S. Small Cap Equities: Russell 2000 Index
2021: +11.26%	2020: +7.82%	2019: +22.01%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
2021: -2.54%	2020: +8.31%	2019: +18.42%	Emerging Markets Equities: MSCI Emerging Markets Index
2021: +43.05%	2020: -7.52%	2019: +24.45%	Real Estate: S&P U.S. REIT Index
2021: +5.28%	2020: +7.11%	2019: +14.32%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
2021: -1.54%	2020: +7.51%	2019: +8.72%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

"What's Past Is Prologue" -*The Tempest*, by William Shakespeare

The Fed's approach to tightening monetary policy has been described as "keep raising rates until something breaks." In quainter times, when the Fed was arguably more concerned with squelching inflation than keeping Americans employed, Fed induced recessions were considered a healthy and natural way to "clear out the deadwood." The 2008 Great Financial Crisis (GFC) seems to have fundamentally changed the Fed's philosophy on recessions, after the 2008 GFC revealed that unsafe levels of leverage were being deployed by banks and non-bank lenders. The scope and scale of the leverage was sufficient to melt down the financial system in the absence of extraordinary government rescue measures such as quantitative easing (QE) and asset purchase programs (APP).

For this monetary tightening cycle, there is now a sense of urgency at the Fed due to consecutive >5.0% year-over-year consumer price index (CPI) monthly inflation reports since April 2021. The Fed is optimistically forecasting personal consumption expenditures (PCE) inflation to fall from 5.3% in 2021 to 2.6% in 2022 and 2.3% in 2023. It is counting on expiration of emergency government spending programs, restoration of supply chains, normalization of consumer spending habits, higher labor participation, increased immunity/vaccination rates, and higher prior-year comparisons to lead to lower inflation rates after the 1st quarter of 2022. Institutional investors are openly debating the unappealing optics of a 2Q22 with rapidly decelerating GDP and falling inflation just as the Fed will be raising interest

rates, but this is how these things get priced into markets. More importantly, institutional investors believe that the powerful disinflationary forces of the past two decades will stay for the next few decades, and that pandemic induced supply-side contractions of the past two years will be resolved with supply-side expansions by the private sector, because that is what the CEOs and CFOs they listen to are telling them.

Understanding the Fed's Thinking as We Enter a New Tightening Cycle

The Fed in its December 2021 FOMC meeting explained its thinking behind the decision to taper its $120 billion monthly purchases of treasury bonds and mortgage-backed securities, which would then make its March FOMC meeting "live" for potentially announcing the first increase to the Fed Funds Rate for this monetary policy tightening cycle. Recall that after the 2008 Great Financial Crisis (GFC), during which Ben Bernanke lowered Fed Funds Rates to zero, Janet Yellen announced the first Fed Funds Rate hike in December 2015, and then a full year passed before the next rate hike was announced. This began a series of Fed Funds Rate hikes that peaked at 2.25%-2.50% in December 2018, which coincided with the S&P 500 stock market index selling off 20% in 4Q18 at the low on Christmas Eve. Jay Powell heard the message from the markets and signaled the end of rate hikes two weeks later.

Fed monetary policy is one of many important input factors for "financial conditions", which is a broad term associated with the ability for firms and individuals to obtain financing. It is critical to understand that for the most part the Fed does not determine financial conditions, rather it reacts to financial conditions. Of course, there are feedback loops, meaning that Fed decisions can impact markets, and vice versa. In today's economy, seemingly disparate corners of markets and commercial activities are highly interconnected, and the Fed has learned that it will inevitably become the buyer of last resort when there is a financial contagion.

Inflation results from demand for goods and services meaningfully exceeding supply, leading to undesirably high price increases year after year after year. The Fed has proven tools to defeat inflation, which unfortunately have been limited to raising interest rates until it causes a recession. However, Fed leadership now believes that recessions should be avoided if possible, since they lead to higher unemployment rates in the best cases and financial crises in the worst cases. This creates a natural tension due to these competing priorities. The Fed has made it clear that it will be "data dependent" in determining when and how high to hike the Fed Funds Rate, which should reduce the odds of a "policy error."

Congress Changed the Rules for Markets and The Fed

In response to the 2008 GFC, important bi-partisan legislation was passed that successfully restricted the ability for banks to wipe themselves out with unsafe levels of leverage, including Dodd-Frank and the Volcker Rule. However, human ingenuity being what it is, clever traders left the Wall Street broker-dealers in droves and relocated themselves at our country's hedge funds, some of which are so large that during the 2020 Pandemic Financial Crisis (PFC) they nearly melted down the financial system again, this time with highly leveraged trades in the Treasury repo markets. The Fed needed to inject a series of short-term loans into the system totaling $1.5 trillion in order to rescue these hedge funds, not because they favor hedge funds, but rather because it was the fastest way to stabilize the Treasury markets. Based on repurchase agreements between counter-parties, the "repo" markets are an important area of the U.S. financial system where firms trade trillions of dollars of debt for cash each day.

The Financial Services Regulatory Relief Act of 2006 authorized the Federal Reserve Banks to pay interest on reserves (IOR) held by or on behalf of depository institutions at Reserve Banks, which transformed the powers of the Fed when it became effective in the early days of the 2008 Great Financial Crisis (GFC), because it enabled the Fed to expand or contract its balance sheet without directly causing the Fed Funds Rate to decline or increase, respectively. Prior to Oct 1, 2008, the Fed's balance sheet was effectively required to be quite small. This legislation literally re-wrote the rules for central banking in the United States, and it explains how the Fed can purchase and hold $8.1 trillion of assets on their balance sheet while keeping the Fed Funds Rate at 0.00%-0.25% (or any other level it chooses).

Since 1977, the Federal Reserve has operated under a mandate from Congress to "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates" — what is now commonly referred to as the Fed's "dual mandate." It has expanded its price stability mandate to include "saving the world" during financial crises. A valid critique of the Fed is that it should do a better job with macro-prudential supervision to prevent financial entities from creating "systemic risks" with excessive leverage. Bank CEOs hate being subjected to the Fed's "stress tests", but it helped to keep them out of trouble in 2020, so maybe Congress should consider Fed "stress tests" for systemically important hedge funds and asset managers.

Review of 2nd Half of 2021: 3rd Qtr Earnings +38.8% (act.) and 4th Qtr Earnings +20.1% (est.)

The S&P 500 index of stocks rallied +11.66% in the second half of 2021, including dividends, from 4,298 to 4,766. 10-year Treasury yields rose from 1.47% to 1.51%, after troughing at 1.13% on July 20th and Aug 4th, and peaking at 1.70% on October 21st. West Texas Intermediate (WTI) crude oil prices per barrel increased from $73 to $75, after troughing at $62 on Aug 20th, peaking at $85 on Oct 25th and Nov 10th, then troughing again at $62 on Dec 2nd. The US dollar currency index strengthened from 92.44 to 95.67, after peaking at 96.88 on Nov 24th. U.S. unemployment rates improved from 5.9% to 4.3%. 5-yr breakeven inflation rates increased from 2.46% to 2.86, after peaking at 3.17% on November 15th.

U.S. economic activity re-accelerated in the 4th quarter of 2021, after 3rd quarter growth slowed due to a summer surge in new daily Covid-19 deaths from the Delta variant (new daily U.S. deaths peaked on Jan 17, 2021). The U.S. economy (real GDP, QoQ% SAAR) grew +6.0% in 4Q21, +2.3% in 3Q21, +6.7% in 2Q21, and +6.3% in 1Q21.

Outlook for 2022: High Growth Decelerating Towards a "Normal" Year in 2023

Earnings growth is peaking, but earnings are not peaking. U.S. GDP growth is peaking, but U.S. GDP is not peaking. CPI inflation rates will peak in 1Q22, but consumer prices are not peaking. All three of these metrics will be correlated as the U.S. economy decelerates along a glide path to a normal 2023, if the Fed can successfully tamp down inflation without throwing the economy into recession.

Consensus estimates for S&P 500 EPS growth are +8.7% in 2022, after +49.9% in 2021 (up from +24.4% in Feb 2021, which explains the great year for S&P 500 returns), per I/B/E/S data by Refinitiv. 2021 EPS estimates are now +31.9% higher than 2019 EPS actuals. Year-over-year quarterly EPS estimates are +6.3% in 1Q22, +4.5% in 2Q22, +7.0% in 3Q22, and +14.2% in 4Q22.

S&P 500 revenues per share are forecasted to grow +7.5% in 2022, after +16.1% in 2021 (up from 8.7% in July), after falling -2.8% in 2020. Net profit margins are projected to expand to 13.2% in 2022 from 13.0% in 2021, after declining to 10.2% in 2020 from 11.5% in 2019, per I/B/E/S data by Refinitiv.

The highly respected UCLA Anderson Economic Forecast predicted in December that U.S. real GDP will grow by +5.6% in 2021, and +4.2% in 2022, and +2.7% in 2023. Wall Street's full year consensus forecast for 2021 U.S. real GDP is +5.6% in 2021, +3.9% in 2022, and +2.4% in 2023, and the quarterly forecasts are +4.0% in 1Q22, +3.6% in 2Q22, +3.1% in 3Q22, and +2.6% in 4Q22, per Bloomberg <ECFC>. Europe's economy is forecasted to grow +5.1% (up from +3.9% in Feb) in 2021, and +4.2% in 2022, and +2.9% in 2023 (per ECB), vs. its trend rate of +1% growth, and Japan's economy is forecasted to grow +2.7% (down from +4.1% in Feb) in 2021, and +3.0% (up from +1.7% in Feb) in 2022, and +1.3% in 2023 (per JCER), vs. its trend rate of +0.5% growth, after declining -5.6% in 2020.

Price/earnings (P/E) multiples are 21.4, 15.6, 15.6, and 11.8 for S&P 500 large cap, S&P 600 small cap, foreign developed, and emerging markets, respectively, where E is EPS on next four quarters (NFQ), per Bloomberg consensus. The long-term average for U.S. NFQ P/E multiples is 15 ½. Thus, U.S. large cap equity valuations are 38% above average, which in our view is the primary risk to stock markets, although most researchers would say that the lower interest rates we have today (and those forecasted for the future) should allow for higher P/E multiples, all else being equal. The counter argument to this would be that lower U.S. Treasury bond yields are signaling lower future GDP growth, which should dampen future EPS growth. We believe that actual 2022 EPS could end up being 10% higher than current estimates.

The yield curve is currently pricing in the Fed Funds Rate to rise to 1.00% one year from now, and 10-year Treasury yields of 1.93% at year-end 2022, per Bloomberg <FWCM>. More importantly, the yield curve is priced for 10-year Treasury yields to remain below 2.65% for the next 15 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind.

The yield curve is steep, but continued to flatten, with 10-year Treasury yields higher than 2-year Treasury yields by 88 basis points (bps), down from 113 bps in July. 10's to 2's steepness peaked at 155 bps near the end of the 1st quarter of 2021. Yield curve steepness is a reliable leading indicator of future economic growth.

High yield bond spreads (over Treasuries) peaked at 1100 bps (or 11%) in March 2020, and settled down to 271 bps since then (down from 334 bps in Feb, and up from 235 bps in July), indicating that credit markets have priced in a full recovery to better than pre-pandemic levels of low default rates.

Repeatable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g., >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good

judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because they can be used to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with prudent trust & estate planning, via step up in cost basis when wealth transfers from one generation to the next.

Long-Term Investing

To paraphrase Warren Buffett, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, in order to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets.

As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized planning and disciplined implementation.

Risk Management

Asset allocations should be based on well-designed investment policy statements to enable investors to get through bear markets without selling equities, by using fixed income or cash to draw upon until stock markets have recovered, which is common sense short-term risk management. However, comprehensive risk management should also account for the long-term shortfall risk of not achieving long-term portfolio growth objectives due to sub-optimal asset allocations and portfolio construction. Along the way, contingency risks (i.e., low probability and high impact) need to be efficiently managed with various tools including adequate liquidity, appropriate insurance protection (note: we do not sell insurance), coordination with clients' trusts & estate attorneys, and proactive tax planning with clients and their CPAs.

SALEM PARTNERS
WEALTH MANAGEMENT

Conclusions

We are optimistic that developed global economies will grow at high rates in 2022 due to pent-up demand, supply chain recoveries, low unemployment, and service sector re-openings. We believe this will lead to actual EPS continuing to significantly beat estimated EPS throughout 2022, thus driving up EPS estimates for 2023. Equity P/E multiples often look over-valued when earnings estimates are too low and will be revised upwards. We remain concerned about much higher-than-average large cap U.S. P/E multiples, however we note that S&P 600 U.S. small cap, foreign developed and emerging markets P/E multiples are reasonable. Recently bursting bubbles in some of the frothier areas of the markets are a healthy sign.

Markets have already transitioned from the early-stage to the mid-stage of the business cycle, even though global economies and stock markets are less than two years into their recoveries from a very severe recession and the steepest (not deepest) bear market >30% since 1929. In our early 2021 investment committee meetings, I hypothesized that 2013, a year when 10-year Treasury yields increased from 1.7% to 3.0% and S&P 500 index total returns were +32.39%, would be the best historical precedent for 2021. In both 2013 and 2021, the markets were reacting to faster than expected economic growth. 2022 will be trickier to forecast due to the wild card of elevated inflation.

Bond yields will rise in 2022, but an important factor weighing down much higher Treasury yields is that most institutional fixed income investment managers believe that the next recession will bring about another round-trip back down to 0% Fed Funds Rate and lower than 1% 10-year Treasury yields. Fortunately, we do not see evidence of the next recession any time soon. However, we do see the possibility of scenarios where new variants of coronavirus slow down the re-openings around the world, which would have the effect of extending the length of "lower for longer" interest rates policies.

We wish all of you a healthy and safe Winter. Please let us know if you have any questions. Thanks!

Best Regards, Erik

Erik Ridgley, CFA
CEO & Chief Investment Officer
Salem Partners Wealth Management
(310) 806-4200 main
(310) 806-4217 direct
(310) 497-0776 mobile
eridgley@salempartners.com
www.SalemPartners.com/Wealth-Management (PDF version of investment letter available via this link)

- Fiduciary and fee-only registered investment adviser firm always, established 2004
- Institutional investment management expertise combined with personalized financial planning and customized portfolios to drive superior long-term after-tax outcomes
- Assets under management custodied at $1.8 trillion Charles Schwab (NYSE: SCHW) platform in segregated accounts under clients' names
- Welcoming new clients with over $10 million to invest with us

Selected to Los Angeles Business Journal's List of Most Influential Wealth Managers in 2021, 2020 & 2019

Disclosures

- **Past performance is not a guarantee of future results. Investments can lose money.**
- This analysis is not a guarantee, prediction, or projection of any particular result and your actual results may vary materially from those presented herein.
- Our firm's investment returns reported in this letter are average total returns, net of all fees, of a subset of related client portfolios, from client reports generated by Black Diamond, our third-party client performance reporting software application, which utilizes securities pricing and income data provided by Schwab Advisor Services, our third-party custodian.
- The subset is comprised of the same related client portfolios during the entire performance reporting period portrayed. The investment policies, objectives, and strategies of the subset were consistent during the entire performance reporting period portrayed and are consistent with the type of advisory services currently offered by Salem Partners Wealth Management. The criteria for selection of the subset of related client portfolios are substantially similar investment policies, objectives, and strategies, in addition to an absence of material account specific constraints, which could cause returns to be materially different from those accounts not included in the subset.
- U.S. Large Cap Equities reflect total returns for all large cap U.S. equities in the subset, and Global Equities portfolio returns reflect total returns for all equities in the subset, excluding up to two concentrated holdings with account specific constraints. Muni Bonds portfolios reflect total returns for all bonds in the subset, and Muni Bonds portfolios can hold up to 10% allocation to corporate bonds as permitted by clients' investment policy statements.
- Total return is the industry standard and our method of measuring investment performance in client reports. Total return is the investment income received or accrued plus the change in market value over a specified period divided by the market value at the beginning of the period.
- All total account performance returns in client reports are time-weighted total returns, displayed as net of all fees.
- Recognizing that past performance does not guarantee future results and that indices differ from actual portfolios, the data presented are based on the historical performance of their respective asset classes. When necessary, indices are used as proxies for the asset classes. The indices are not managed, not subject to fees nor transaction costs, nor available for direct investment. In certain instances, assumed rates of return or inflation are incorporated as part of the presentation. However, there is no guarantee that these assumptions will be realized in the future and they shall not be deemed as a guarantee of future results.
- Investment returns portrayed are subject to the effect of material market or economic conditions during the specified time periods.
- Investment returns of indexes reflect the reinvestment of dividends and interest income.
- Investment returns of indexes do not reflect the effect of any fees or expenses since they do not ever pay any fees or expenses. You cannot invest directly in an index.
- Investments portrayed can generate profits but they can also incur losses.
- Equity (stocks), fixed income (bonds), and other investments do not always gain or lose value at the same time. Historically, volatility has been reduced over time by holding multiple non-correlated asset classes in a portfolio.
- Diversification within an asset class is important because it can eliminate idiosyncratic (i.e., individual security) risk within an asset class, but it cannot eliminate systemic (i.e., market) risk of an asset class. No investment strategy or allocation can eliminate risk or guarantee investment returns.

- Although single-asset class diversification is an important tool in the toolbox of investing, relying on it alone might cause an investor to forego the benefits of other non-correlated asset classes that may help them achieve their long-term goals. Asset allocation differs from single-asset class diversification because it involves being diversified across multiple diversifying asset classes.
- Assets are broken out by market cap and style using data supplied from S&P, MSCI, Bloomberg, Morningstar, Inc. and other sources.
- This presentation does not constitute an offer to sell or a solicitation to buy any securities or an offer of any investment advisory services.
- Please see our website at www.SalemPartners.com/Wealth-Management and our Form ADV, Form ADV 2, and Form ADV 3/CRS at www.sec.gov for additional disclosures.

IMPORTANT:
The projections or other information shown in this presentation regarding the likelihood of various investment outcomes are based on publicly available information, or our opinions, and are not guarantees of future results.