3D Report

Prett-ay, Prett-ay, Prett-ay Good

> **Dad: How are you?**
>
> **Larry David: Prett-ay, prett-ay, prett-ay good**

In a nod to the series finale of "Curb Your Enthusiasm," I thought we would start with the iconic catchphrase from the show. While the phrase—delivered in response to Larry's parents' innocuous question "How are you?"—is nothing special on its face, Larry's labored delivery is what makes it both funny and impactful.

Ryan Caldwell, Chief Investment Officer

Ryan Caldwell serves as Chief Investment Officer of FS Chiron funds. Prior to founding Chiron, Mr. Caldwell spent 14 years at Waddell & Reed, where he helped lead portfolio management decision-making for a suite of funds totaling $40 billion in assets under management, including Ivy Asset Strategy, W&R Asset Strategy and Ivy Funds/VIP Asset Strategy. Mr. Caldwell has over 20 years of portfolio management experience. In 2009 he was named one of Institutional Investor magazine's "Rising Stars of Mutual Funds," and in 2007 he was a finalist for Morningstar's Manager of the Year. He holds a BBA from Texas State University.

Co-authors:

Brian Cho, CFA, Head of Quantitative Research

Brian Cho is a Co-Portfolio Manager and Head of Quantitative Research for FS Chiron funds, where he drives the proprietary quantamental investment strategy. In 2002, Mr. Cho co-founded Empirical Research Partners LLC, an independent research boutique where he served as Partner and Director of Quantitative Research. Mr. Cho is a CFA charter holder and graduated from MIT.

Andrew Korz, CFA, Director, Investment Research

Andrew Korz is a Director on the Investment Research team at FS Investments, where he leads research efforts on equities and the U.S. commercial real estate market. Mr. Korz is a CFA charter holder, holds a BBA in Finance and Economics from Villanova University and has prior experience with structuring and pricing interest rate derivatives.

Scott Sullivan, Head of Fundamental Research

Scott Sullivan is a Portfolio Manager for FS Chiron Funds, where he drives the proprietary quantamental investment strategy as Head of Fundamental Research. Prior to joining Chiron, Mr. Sullivan spent 10 years at Ivy Investments. Mr. Sullivan earned a BA in Economics and Political Science from Tufts University and an MBA in Applied Security Analysis from the Wisconsin School of Business.

About the 3D Report

Each quarter, the team offers their insight on macroeconomic trends and potential impacts on global investment opportunities.

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A note to our new readers:

For those new to the Chiron Investment Management team our investment process combines rigorous quantitative modeling with deep fundamental research. Our quantitative work helps guide our fundamental research in asset selection (with two top-down models, Domain and Dispersion) and security selection (with two bottom-up models, Core and Dispute).

Our Domain model seeks to identify the factors that are being rewarded in a given region or market, with domains ranging from Deep Value to Full Growth. In this way we seek to gauge market sentiment, and therefore in this report we refer to Domain and Market Sentiment together. Our Dispersion model seeks to assess the relative valuation within regions, countries and sectors, and thus we refer to Dispersion and Valuation together.

Our Core model seeks to identify which factors and characteristics tend to outperform so that our fundamental work can identify the companies to go long, and so we refer to Core and Long together. Conversely, our Dispute model seeks to avoid the characteristics which tend to underperform so that we can construct our proprietary hedge, and so we refer to Dispute and Short together.

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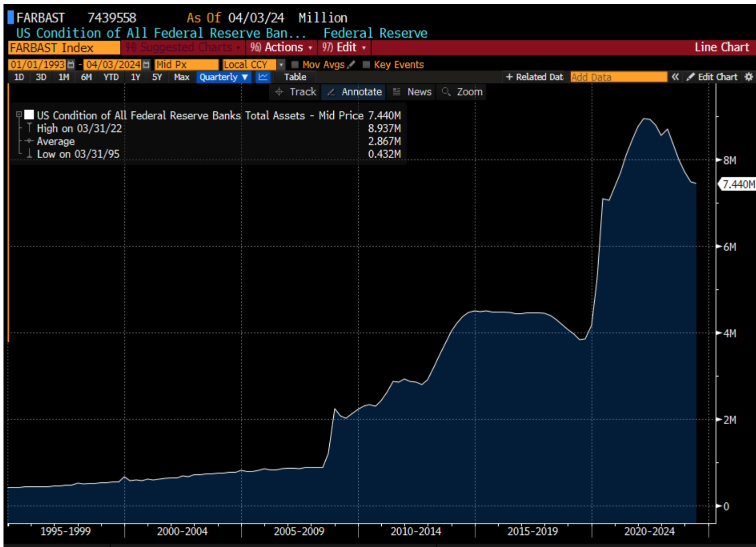
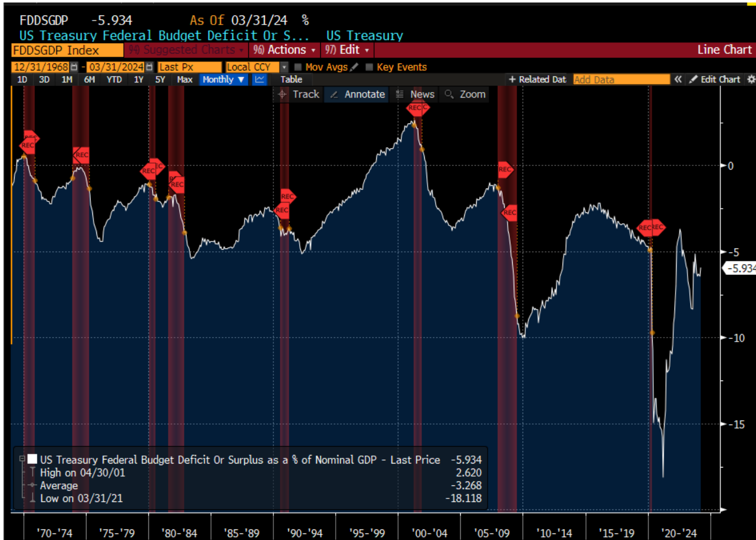
I imagine most investors would say they are feeling “prett-ay good.” Risk-free yields are high, equity multiples and earnings have expanded globally, and credit spreads have contracted. In all, a Goldilocks outcome for asset allocators. As we discussed in our last piece, this is not an environment many investors have experience with, particularly post-WWII. We have a tight monetary policy: Real rates are 150bps–200bps into positive territory and the Fed continues to reduce its balance sheet holdings, traditionally a headwind for risk assets. We also have exceptionally loose fiscal policy, with an estimated 6% budget deficit as a percent of GDP, an unprecedented number outside a crisis environment.



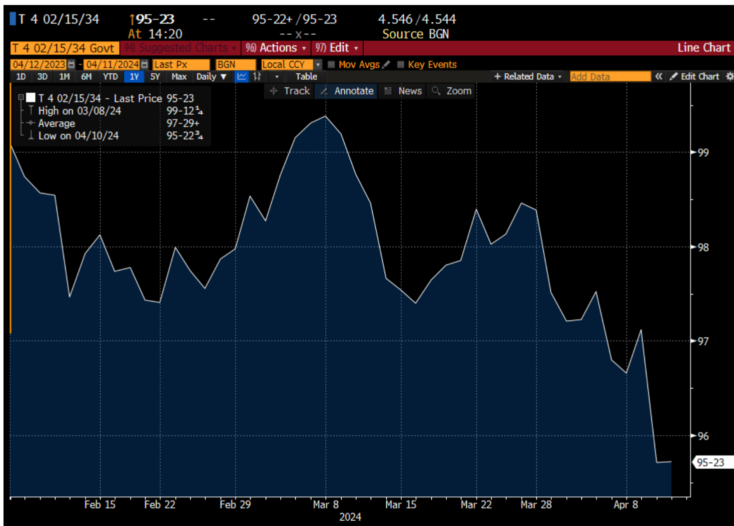
Source: Bloomberg Finance, L.P., as of of March 31, 2024.



Source: Bloomberg Finance, L.P., as of of March 31, 2024.

What happens in theory when tight monetary policy meets lose fiscal policy? Almost exactly what has occurred in practice. The U.S. dollar has strengthened, equities as a pass-through vehicle for nominal growth have done well, credit has cooperated and even comoodities are now participating. As George Costanza and the bears would say, “Serenity Now.”

The big identifiable losers have been long-duration Treasuries. The bill is coming due in the form of issuance term premium as the U.S. has to pay for the deficit spending, and foreign currencies like the Japanese yen where carry has become incredibly attractive due to the wide rate differentials between the U.S. and the rest of the world.



Source: Bloomberg Finance, L.P., as of of March 31, 2024.

Source: Bloomberg Finance, L.P., as of of March 31, 2024.

The key macro debates heading into 2Q are: 1) How much—if at all—the Fed can cut this year with inflation remaining sticky (particularly house prices), and 2) whether liquidity and tightening financial conditions finally overwhelm fiscal policy. The string of recent CPI and PCE prints have created a narrative that inflation's descent has not only stallled, but may also accelerate due to global inventory cycles bottoming, a potential trough in China and high geopolticial risks in the price of oil. The global macro landscape continues to confound observers as risks remain extremely elevated but the economic data continues to give an all-clear signal. Unemployment still sits at rock bottom levels in the U.S. and even those weak manufacturing surveys are finally hooking upward, leading to positive earnings revisions for the first time in eight months. "Prett-ay Prett-ay Good."

What does this mean for global capital markets? Our conclusion is there are no fat tails nor big anomalies to exploit at the moment. This time very well may have been different insofar as traditional mean reversion just didn't materialize (we were big victims to this thought process) and trend following is, in fact, the order of the day. While nominal growth remains elevated, there is scant reason to think today's megatrends will not contnue to dominate.

In global equities, we are skepitcal of a big Value rotation, especially given Value performed well in Q1. While it took a month or two to get going, recent performance in sectors like Energy, Financials, Materials and even small caps indicate a broadening of participation as economic growth remains elevated. When we look at our Chiron Dispersion Spreads, we see few exploitable opportunities in cyclical value. China stands out in the data, but that opportunity clearly needs a sustainable catalyst. In Growth, we don't have much new to add. It has been a Growth/Quality market going on 12 months now. The megatrends in AI earnings, both in software and hardware, have been dominant. Q1 was another strong quarter of tech outperformance, particularly up market cap in things like Meta and Nvidia. Trend following is truly the order of the day, illustrated by the Momentum factor generating a 98th percentile performance in Q1.

So if Value isn't potent and Growth is extended, what is there to do? Our equity approach has been to tuck into the thematic trends that score well in our work and avoid portfolio over-management. We are also emphasizing our Dividend Discount Model Framework, or GARP (growth at a reasonable price) models to try and balance valuation (Free Cash Flow Yield) with profitablitiy (Free Cash Flow Margin). The playbook for a world of no spread centers on cash flow generation and capital return, traits we think will beat high beta. We found this to be true in Q1 and believe it likely to continue as long as monetary and fiscal are fighting each other.

Moving to fixed income, credit and rates have been on wildly different trajectories all year. Unlike last year, where rates drove prices lower via spread and term premium, spreads have tightened into higher rates, traditionally what one should expect. However, our rule of thumb has been when five-year High Yield CDX touches 300bps wide, as it did in Q1, forward returns to spread compression tend to stop. Another way of saying this: We are close to peak multiples in HY and IG credit. The belly of the credit curve is far more attractive privately than publicly, and we have seen the market respond to that realization with a heavy commitment to private debt financing to exploit the risk premiums in middle market lending.

Source: Bloomberg Finance, L.P., as of of March 31, 2024.

Rates markets have been dominated by the sticky inflation narrative of Q1 as well as the realization that the issuance calendar in the second half of the year will be more heavily skewed toward coupon issuance (i.e., bank reserves) versus bill issuance. Q1 was a boon for the Treasury Department as money market assets continued to rise north of $6 trillion, allowing the Treasury ample room to passively fund the budget deficits. This was been a big liquidity bonus for markets in the first half of the year.

Source: Bloomberg Finance, L.P., as of of March 31, 2024.

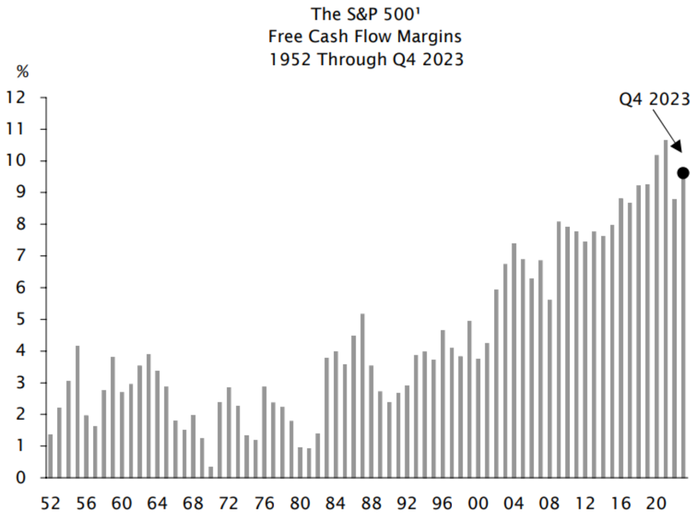
Relatedly, the Fed's balance sheet has largely drained passively, given the decline in the overnight Reverse Repo Facility. Effectively this is passive quantitative tightening (QT) as bank reserves are unaffected by this drawdown of repo reserves.

The bearish narrative, which could have real teeth, is the reality that the passive rundown of the balance sheet is about over, and any further contraction is likely to drain bank reserves. The Fed is already talking about the QT taper starting midyear and as the market has been predicting all year, the Fed is desperate to move off of what it deems as "highly restrictive" monetary policy to something less restrictive.

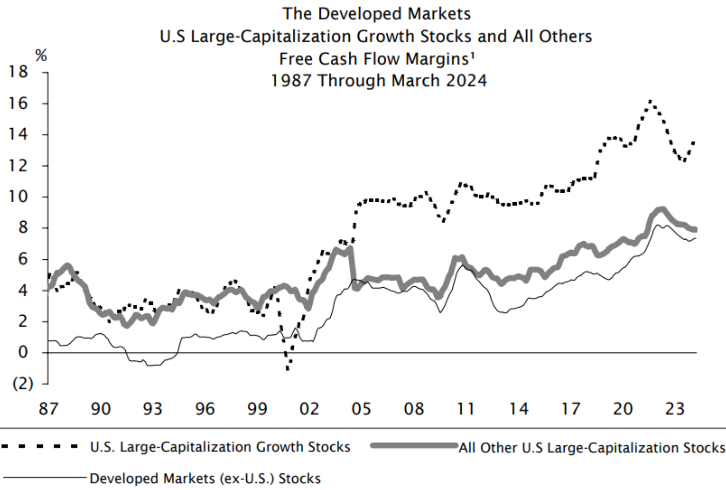
How this delicate balance plays out in an election year is likely to be the source of whatever volatility we get this year. Can the Fed effectively become less restrictive if GDP is accelerating along with the price of oil? One can easily speculate that geopolitics are going to be at play here, given oil's impact on inflation and real rates. In our view, this is the combination of factors most likely to knock us out of the current "prett-ay, prett-ay good" environment.

It is also important to comment on Q1 earnings growth. As we called out to start the year, the **"Really Big Thing"** in U.S. and global markets is the margin power in U.S. large-cap companies.

Source: Bloomberg Finance, L.P., as of of March 31, 2024.



Source: Corporate Reports, Empirical Research Partners Analysis.
[1] Excluding financials and REITs; prior to 1976, the large-cap universe is used.

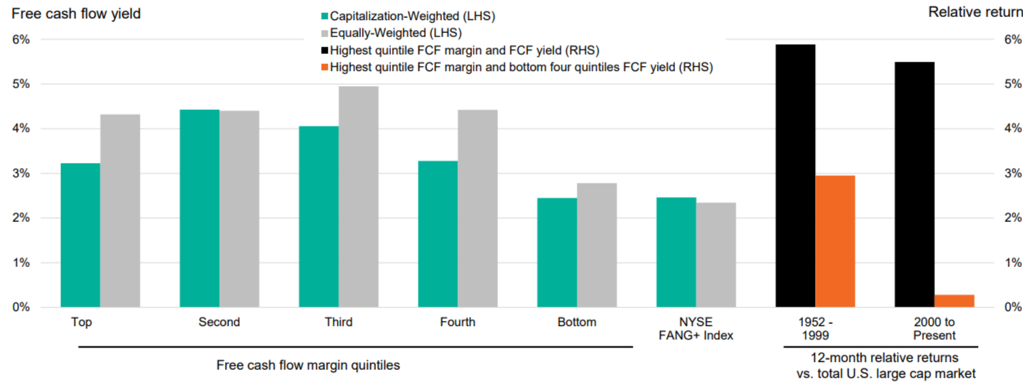


Source: Empirical Research Partners Analysis.
[1]Measured in aggregate terms; data smoothed on a trailing three-month basis.

We continue to see this story as good till canceled, but the market remains somewhat skeptical. We are not. We think the top decile of free cash flow margin with a 3% Free Cash Flow Yield is exploitable and compoundable, and this is a key aspect of what we are doing in our funds globally.

Earnings power of tech stocks in perspective

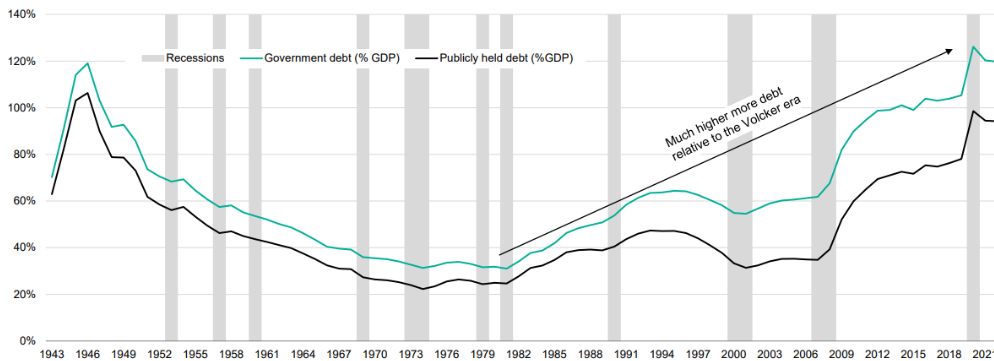
U.S. large cap stocks free cash flow (FCF) yields by quintile of free cash flow margins



Source: Bloomberg Finance L.P., as of February 29, 2024. Excludes financials, REITs, utilities and energy. NYSE FANG+ index includes Meta, Apple, Amazon, Netflix, Microsoft, Google, Tesla, NVIDIA, Snowflake and Broadcom Inc.

Lastly, I want to comment on precious metals, gold and silver. We do think gold is a large beneficiary of the tight monetary/loose fiscal policy combination. The market is pricing real rates falling by hook or by crook: Either growth slows, inflation falls and the Fed cuts, or growth accelerates, and the Fed doesn't hike rates. We think this is a fascinating discussion but likely misses the plot. We think the reason gold and other scarce assets are accelerating revolves around the deficits, as funding them will likely lead to long-term currency pressure. Other global central banks are stockpiling gold in anticipation of trading oil and other commodities in gold. We have anchor positions in the barbarous metals in both our strategies and we think the cycle timing for gold is now.

Government debt (federal, state and local) as a % of GDP



Source: Macrobond, FS Investments, as of December 31, 2022.

–Ryan Caldwell, CIO

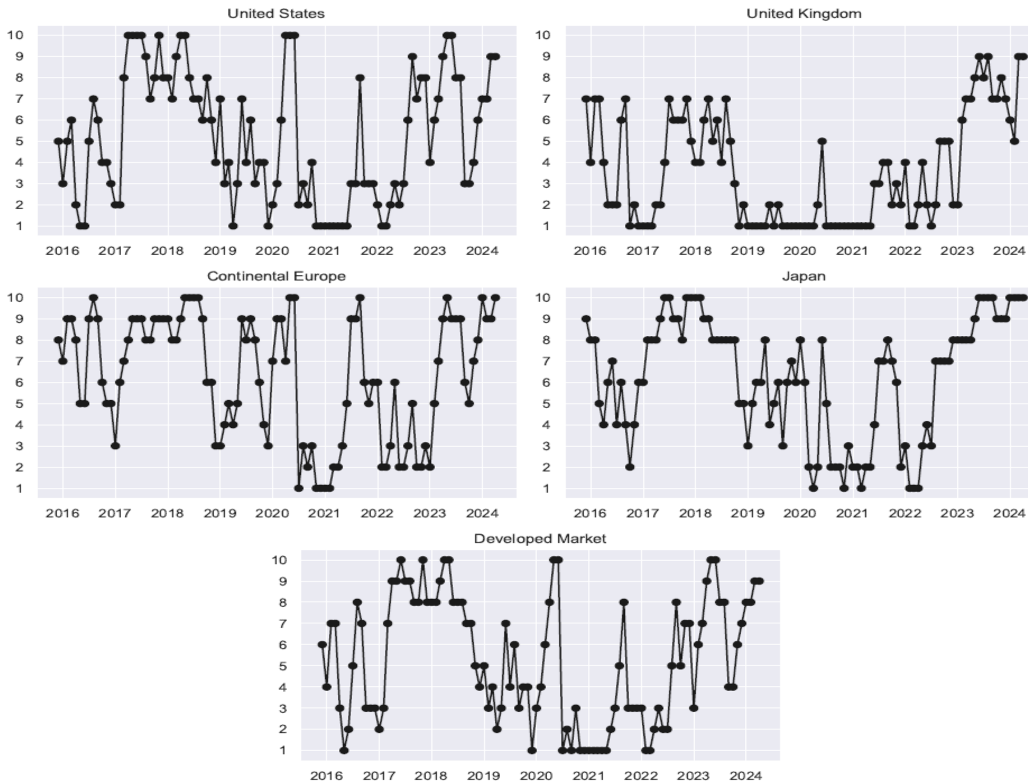
Chiron Domain Model-Market Sentiment

Asset allocation framework

Market sentiment	Portfolio positioning	Portfolio concentration	Target asset allocation	Investment emphasis
Full growth	Defensive	High	25%–60% Equities 15%–50% Fixed income 0%–50% Cash/other	• Growth equity securities • Sovereign credit, cash, gold/gold miners
Growth			50%–75% Equities 15%–40% Fixed income 0%–10% Cash/other	• Growth equity securities • Investment grade and sovereign credit, cash
Neutral			50%–75% Equities 15%–40% Fixed income 0%–10% Cash/other	• Value and growth equity securities • Investment grade credit
Value			50%–75% Equities 15%–40% Fixed income 0%–10% Cash/other	• Value equity securities • High yield credit
Deep value	Aggressive	Low	65%–80% Equities 10%–25% Fixed income 0%–5% Cash/other	• Value equity securities • High yield credit

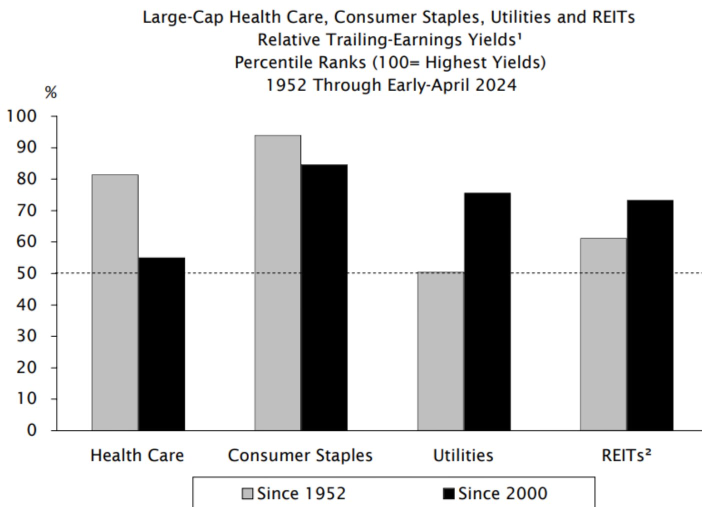
Chiron Developed Market Domain indicator is a compilation of the U.S., U.K., continental Europe and Japan Domain Indicators. Individual country/region domains are computed separately and are customized for those individual markets. Results are combined by using weights that are proportional to the market capitalization of the individual markets which comprise the Developed Market segment of the MSCI ACWI index.

The Chiron Domain Indicator is based on Chiron's proprietary quantitative Domain models. Our process gathers and analyzes data on over 8,000 companies and market variables utilizing third-party data sources. The Domain Model measures on a global and regional basis what style is being rewarded (value or growth) and is an anchor point for top-down asset allocation within our investment process allowing us to adapt to various market phases.



Above depicts our Developed Market Domain indicators. What stands out is what has been notable and experienced by many investors: Growth style domination in global markets in the last few quarters that culminated in a Momentum surge in the first quarter. Generally, our models are quite potent with readings that look this way and that has been true to start the year. Both EAFE and the S&P 500 have been dominated by large-cap, high-quality earnings growers and any supercharging of the macro/rates narrative (as in the U.S. and Japan) has been gasoline to that fire. Our European models have been far more sensitive to the severely inverted yield curve in Europe, but again Quality, Growth and Stability have all been potent attributes there. To end the quarter ,our security selection is largely playing along with our Domain work with a slight caveat: We are more GARP-oriented than we were to start the year and Stability looks increasingly virtuous in our work. We take note of this in places like Staples and Healthcare, where spreads are wider than history. In a world where there is no spread, there should be some value in that combination.

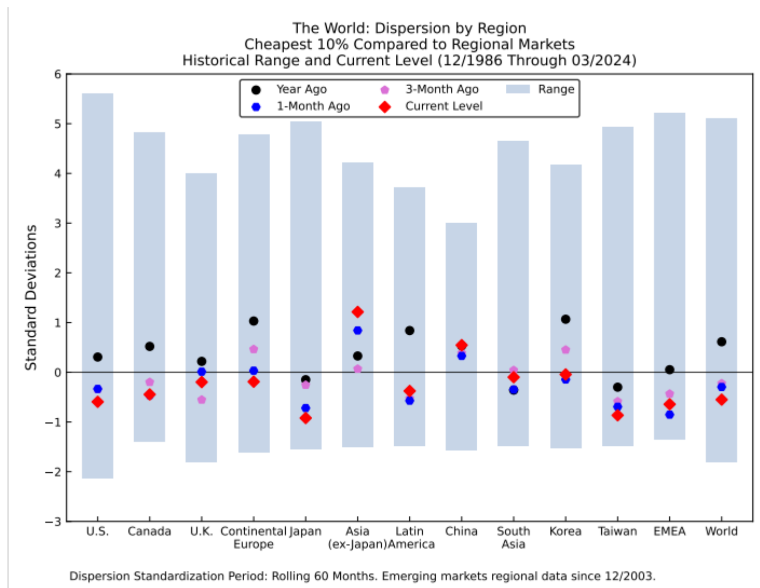
- **Stable stocks are selling at relative earnings yields in top-half of their long-term distributions:**



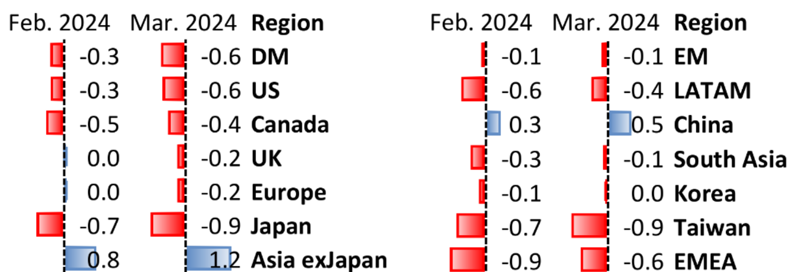
Source: Corporate Reports, Empirical Research Partners Analysis.
[1]Capitalization-weighted data.
[2]Since 1993.

Chiron Dispersion Model— Market Valuation

The Chiron Dispersion/Valuation Model allows us to measure how we believe investors value equity issues. When the Dispersion/Valuation Indicator shows a wide reading (above 1 standard deviation), investors tend to value the most expensive stocks very differently than the market average. When the Dispersion/Valuation Indicator shows a narrow reading (0 to -1 standard deviation), investors assess equity issues relatively similarly. This Indicator is very similar to bond spreads. When the Indicator is narrow and rising, distress is building. When the Indicator is wide and falling, valuations are narrowing, and distress is falling.



Dispersion (Cheapest 10%) (Positive is "Cheap")



Feb. 2024	Mar. 2024	Region	Feb. 2024	Mar. 2024	Region
-0.3	-0.6	DM	-0.1	-0.1	EM
-0.3	-0.6	US	-0.6	-0.4	LATAM
-0.5	-0.4	Canada	0.3	0.5	China
0.0	-0.2	UK	-0.3	-0.1	South Asia
0.0	-0.2	Europe	-0.1	0.0	Korea
-0.7	-0.9	Japan	-0.7	-0.9	Taiwan
0.8	1.2	Asia exJapan	-0.9	-0.6	EMEA

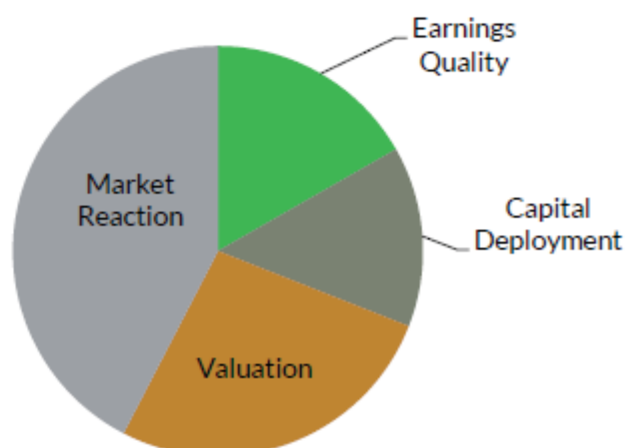
The punchline in equity spreads is much the same as Domain: There is little exploitable mean reversion to be found. We do see elveated spreads in Asia/China and with some possiblity the economy and, more importantly, markets are trying to bottom. While we don't expect any big "bazookas" in terms of stimulus, the recent surge in Chinese companies that are paying dividends, buying back stock and refocusing on things like return on investment (ROI) and return on equity (ROE) are positive steps. We think that following the Japanese/Korean model of corporate reform/shareholder enhancement may help to stem the flow of capital out of the country. Longer-term geopoltics are likely to reassert themselves after the U.S. election but for now, it is possible that Chinese markets have a reprieve from the awful performance of the last few years.

Outside Asia, we are more likely to experience spread widening on cyclical disappointment versus more spread compression on economic strength. We are skeptical of big cyclical rotation given the starting point and far more worried about left tails to the prevailing "Prett-ay, Prett-ay, Good" narrative.

Chiron Dispute Model — Short/Avoidance

The dispute model identifies characteristics that commonly lead to underperformance, such as high valuation, high cash burn, low profitability and poor momentum. We not only use this model to identify companies to avoid, but also to construct our proprietary hedge.

Underperformance characteristics



Estimated Forward 3-Month Relative Returns of	Current	1M Change	Average	Curr - Avg	Percentile (1%=Highest)
Chiron Core Q5 – DM US	-3.65%	0.51%↑	-1.35%	-2.30%	86%
Russell 2000 – S&P 500	-3.93%	1.29%↑	-0.43%	-3.50%	86%
DM US 2020 Valuation Q1 – DM US	-2.33%	-0.82%↓	0.38%	-2.71%	86%
DM US FCF Margin Q1 (High) – DM US	-1.14%	-1.37%↓	0.71%	-1.85%	89%
DM US Valuation Q1 – DM US	-3.79%	-4.21%↓	1.05%	-4.84%	95%

This quarter end was an interesting window into avoidance and Dispute. While we were mostly unhedged in Q1, there are some troubling findings brewing at the bottom of the market. First, bad Core model scores are likely to be punished alongside cheap valuation and small caps. This fits neatly with our Domain and Dispersion spread work. If there is no mean reversion, then it is back to trend following. We prescribe a more GARP-based approach at the moment relative to pure Value. The other interesting aspect of avoidance at quarter-end was the penalty being assigned to high free cash flow margin considering its historical predictive power in equity markets. One explanation is the composition: Currently, the top margin quintile is tilted toward semiconductor/semi-cap equipment space, where margins are generationally high, and skepticism around the sustainability of the margins is creeping in. Also, most of the early-quarter winners were AI beneficiaries, which also happen to be high margin software and Communication Services names. We are still emphasizing the Free Cash Flow margin as we almost always do, but we are surrounding it with more attributes like Capital Deployment (buybacks and dividends), Quality, and Stability. The Holy Grail is finding high-margin, high-quality, stable names with skepticism built into the price.

Chiron Investment Management, LLC, acquired by FS Investments in 2020, is an active manager that uses a variety of analytical tools and market "signposts" that inform its investment decision making. The materials contained herein are provided for illustrative purposes only and are not intended to constitute "investment advice" or an investment recommendation within the meaning of the federal, state, or local securities laws. These charts contain historical market data only and do not reflect actions that were or might have been taken by the Chiron Investment Management team if faced with similar data inputs. You are solely responsible for evaluating and acting upon the information contained in these materials if you choose to act on them without the involvement of Chiron Investment Management as your adviser. Chiron Investment Management will not be liable for any direct or incidental damages or losses resulting from applying any of the information obtained from these materials or from any other source mentioned. Chiron Investment Management does not render any legal, tax or accounting advice and the educational and market information contained in this material should not be construed as such. Please consult with a qualified professional for advice in these disciplines.

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To determine if the Fund is an appropriate investment for you, carefully consider the Fund's investment objectives, risk, charges and expenses. This and other information can be found in the Fund (full and summary) prospectus, which can be obtained by calling 877-628-8575 or by visiting www.fsinvestments.com. Please read the prospectus carefully before investing.

RISK FACTORS
Investing involves risk, including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. Mortgage-backed securities may experience significantly greater price and yield volatility than traditional debt securities. Including the potential for a complete loss of expected future cash flow based on the prepayment behavior of underlying borrowers. In addition to the normal risks associated with investing, international investments may involve risk or capital loss from unfavorable fluctuation in currency values, differences in generally accepted accounting principles or from social, economic or political instability in other nations. Emerging markets involve heightened risks related to these factors as well as increased volatility and lower trading volume. Convertible and preferred securities have many of the same characteristics as stocks, including many of the same risks. In addition, convertible securities may be more sensitive to changes in interest rates than stocks. The Fund may invest in derivatives, which are often more volatile than other investments and may magnify the Fund's gains or losses. The Fund's use of futures contracts, forward contracts, options, and swaps is subject to correlation, leverage, liquidity and market risk.

Investments in smaller companies typically exhibit higher volatility. Investments by the Fund in precious metals-based companies, and in asset-based securities indexed to the value of such metals, may expose the Fund to adverse macroeconomic conditions elevating the risk of loss. Value and growth investment styles may increase the risks of investing in the Fund. If the Adviser's assessment of market conditions or a company's value is wrong, the Fund could suffer losses or produce poor performance relative to other funds. In addition, "value stocks" can continue to be undervalued by the market for long periods. If a growth company does not meet expectations, the price of its stock may decline significantly, even if it has increased earnings. Many growth companies do not pay dividends. Companies that do not pay dividends often have greater stock price declines during market downturns. There is no assurance that the Fund will meet its objective.

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