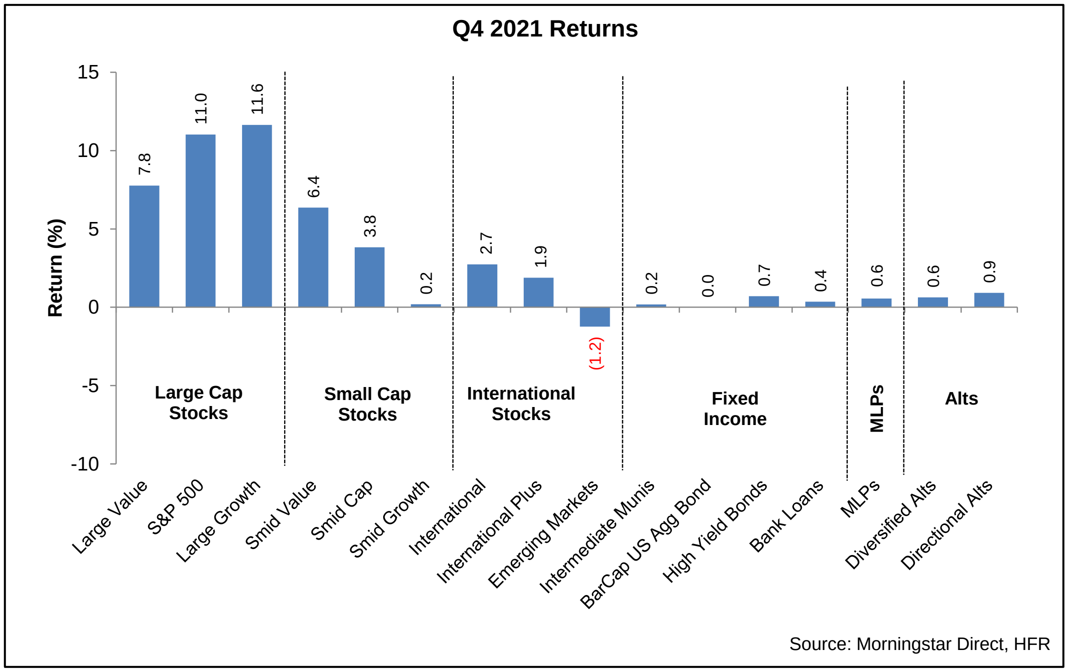
NEXT CAPITAL

Next Capital Management, LLC
Eleven Times Square, 15th Fl
New York, NY 10036
O: 212.433.1111
F: 212.382.2080
www.nextcapitalmgmt.com

Fourth Quarter 2021 Investment Review & Outlook



EXECUTIVE SUMMARY

Q4 2021 Recap:

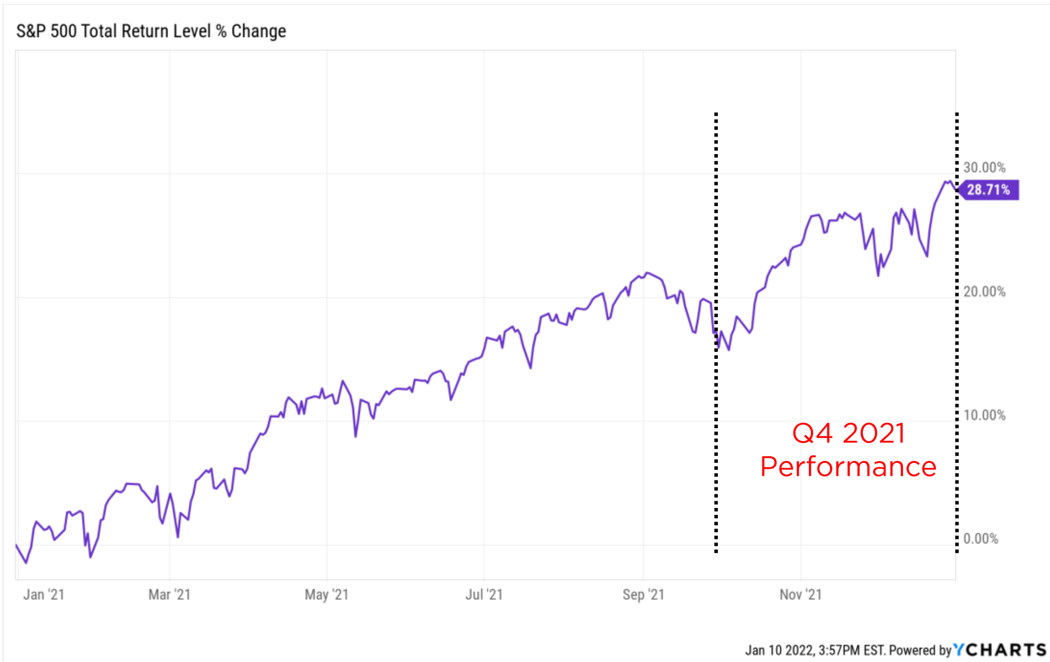
- US Large Cap stocks surged 11% in Q4, however, significant volatility emerged within many other market segments.
- Inflation remained elevated through year end, increasing fears that the Federal Reserve will have to react more aggressively to mitigate these pressures.
- Bond markets were flat in Q4, but finished with a negative return for the first time since 2013.

NEXT Outlook:

- Large double-digit stock market gains will no longer be the norm as accommodative central bank policy unwinds. However, the fundamental backdrop is healthy and should be supportive of financial assets and corporate earnings.
- The forward path of inflation will be the biggest determinant of investor sentiment. If high inflation persists and causes the Federal Reserve to aggressively hike rates, it could trigger significant volatility for both stock and bond markets.
- We continue to focus on less interest rate sensitive fixed income investments and non-traditional assets to bolster portfolios in this “new normal.”

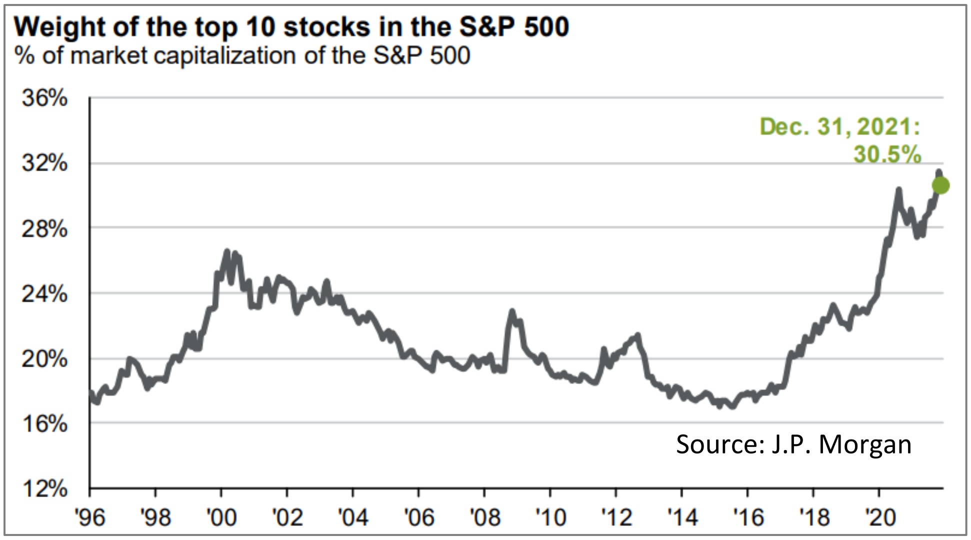
To Our Clients and Friends,

On the surface, 2021 was a banner year for financial markets. The S&P 500 rose 11.0% in the final three months of the year, propelling the index to a 29% annual gain. This was the third-best calendar year return of the past 20 years, surpassed only by 30% returns in 2013 and 2017. It was also remarkable for its unusual lack of volatility: the index never declined by more than 5% throughout the year, one of the tamest years on record.



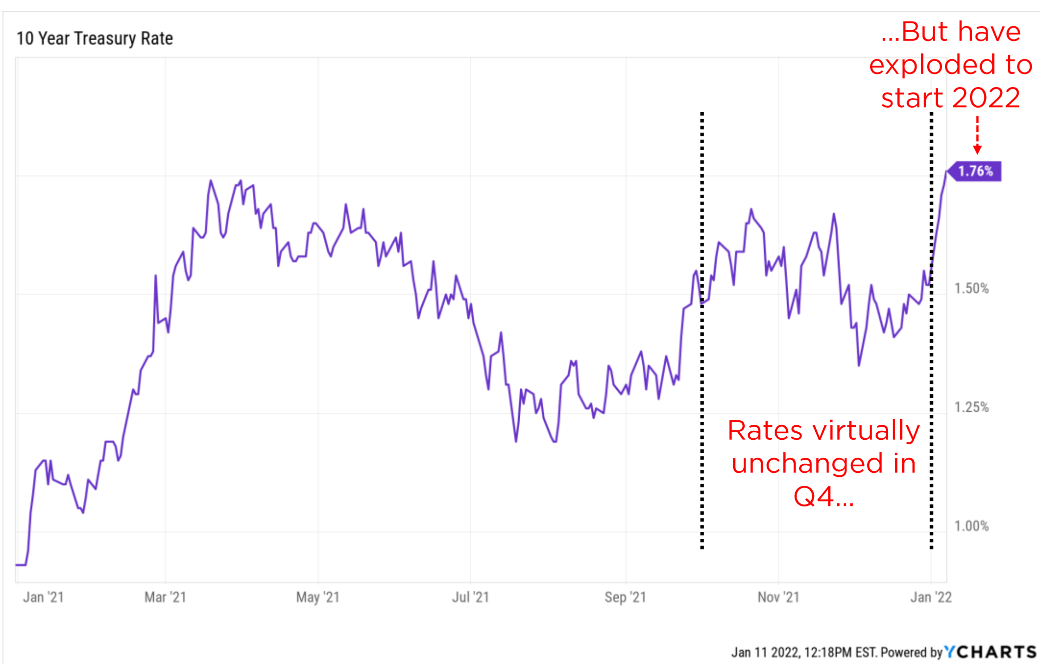
Encouragingly, it was strong earnings that drove performance for the blue-chip index. After a 2020 that saw price-to-earnings multiples expand (i.e., stocks got more expensive) and earnings fall because of the pandemic, the inverse took place in 2021. Earnings rebounded 35% to lift equities prices, while price-to-earnings ratios declined from more than 23x to 21x – still high, but no longer at record levels.

The S&P 500, however, was hardly representative of the broader stock market. The index's growing concentration – more than 30% of the S&P is now comprised of just 10 stocks – masked what was otherwise a turbulent market environment. After a strong start to the year, many small and mid-cap stocks (especially growth companies) suffered dramatic declines in the second half of 2021. In the technology-oriented NASDAQ index, for example, nearly 4/10 companies experienced declines of 50% or more. Foreign equities were also significantly weaker, especially in China where the stock market declined nearly 35% from its February peak.



These cracks have coincided with a troubling development in the US economy: persistently high inflation. Supply chain disruptions, surging demand for goods, and rising wages have all contributed to the highest inflation figures in decades (in December, the Consumer Price Index reached 7.0% year-over-year). Interest rates nearly doubled in 2021 as investors anticipated that the Federal Reserve (the "Fed") would be forced to stop their highly accommodative policies. To combat inflation, the Fed will need to reverse its program of ultralow interest rates and buying of government securities, which has encouraged risk taking and provided significant liquidity to the markets.

These developments contributed to a rare decline for the bond markets in 2021. As represented by the Bloomberg US Aggregate Bond index, high quality fixed income sold off approximately 1.5% last year. This was the market's first decline since 2013 and only the second negative calendar year in the past 20 years (Editor's Note: bonds have once again gotten off to a poor start in 2022, declining 3% through January).



Despite these trouble spots, 2021 was broadly a good year for investors. Strong performance by stock markets in the first half of the year, and contributions from asset classes like high yield, private markets, and real estate, helped lift most diversified portfolios to double-digit gains for the year. These results were reflective of an economy and financial markets that continue to heal from 2020's pandemic-related scars.

We also note that the potential for legislative headwinds we discussed earlier in the year – namely personal and corporate tax increases that may have affected financial markets – was ultimately a non-factor as moderate Senators withdrew their support for the bill. With an evenly split Senate and expectations for Republicans to make gains in the upcoming mid-term elections, it would appear this risk factor is diminished for the time being.

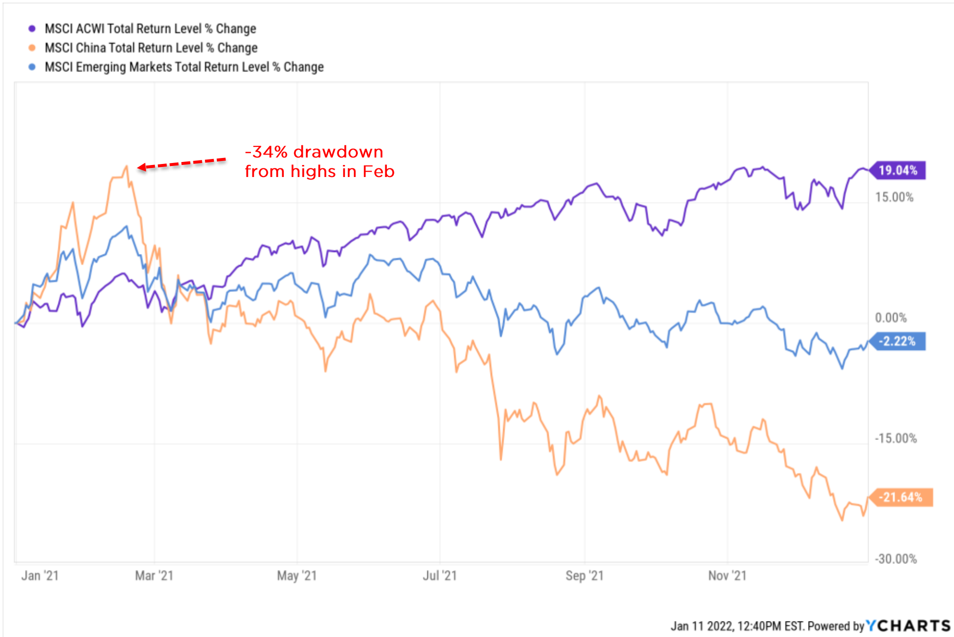
2021 Market Recap…

US large cap stocks, represented by the S&P 500, led all markets with a 29% return for the year. After a hot start to the year, value companies (think financials, energy, and other cyclical areas) once again underperformed their growth counterparts. It was the fifth straight year of lagging performance, and occurred despite broader weakness in the growth category. Robust performance by mega cap technology companies (e.g., Microsoft and Apple) ultimately lifted the growth index higher.

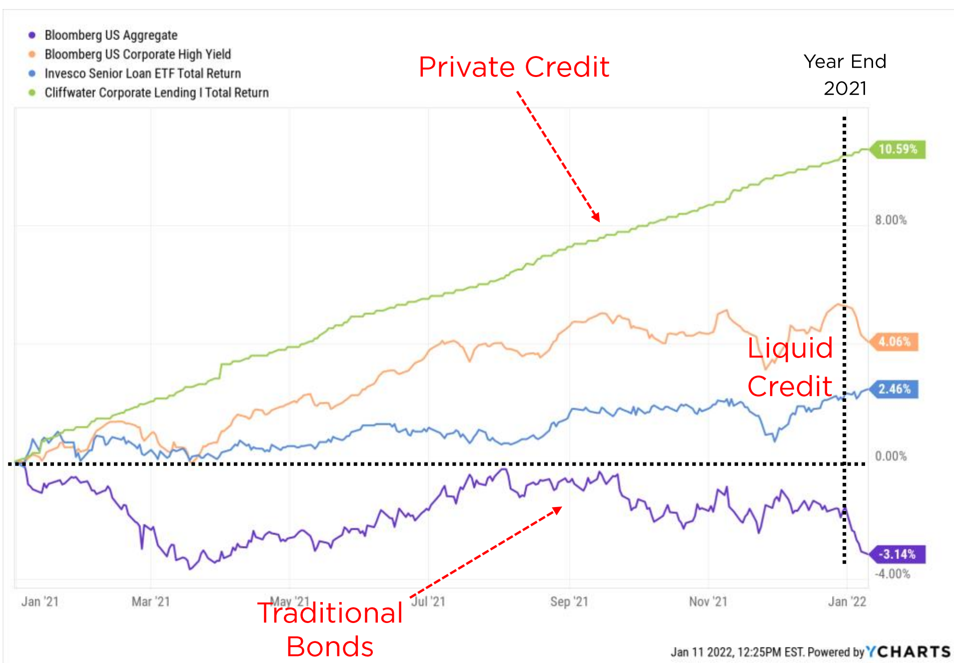
2021 began as a strong year for most stock markets, as small caps, emerging markets, and other riskier market segments rallied sharply. However, a series of developments – a crackdown by China on its financial markets, unexpectedly high inflation, and a glut of speculative companies brought to market by SPACs ("Special Purpose Acquisition Companies") – caused a shift in focus away from fast growing companies to more stable, cash flowing businesses. Higher valuation companies, and especially those that were unprofitable, were hit especially hard in the back half of the year. This left small and mid-cap stocks trailing the S&P by over 10% in 2021, and small and mid-cap growth stocks trailing by more than 20%.

Foreign companies similarly lagged, with developed market stocks rising "just" 12% on the year. Currency was a major factor, with the weaker euro and Japanese yen cutting nearly 8% from investor returns. After years of underperformance versus US markets, Europe and Japan appears comparatively more attractive from a valuation perspective. However, the latter markets have yet to follow through with robust earnings growth to justify larger allocations to most investors' portfolio.

Emerging Markets were the most significant outlier among the global stock market in 2021, declining 2% on the year. After rising 12% through the year's first six weeks, a sudden shift in Chinese policy that emphasized social objectives over corporate profitability caused a sharp decline in Chinese equities. China's selloff had an outsized impact on the Emerging Markets, given its 40% share of the index at the start of the year.



As noted in our preamble, the increase in interest rates from 0.93% to 1.52% during the course of the year proved to be challenging for high quality fixed income. Fortunately, there were pockets of value within the asset class. Non-investment grade corporate credit, including high yield and floating rate bank loans, performed significantly better with returns of 5% and 3.5%, respectively. Certain areas of the securitized market, such as residential mortgages and asset backed securities, also posted attractive mid-single digit gains. Finally, private credit investments generally delivered double digit returns in 2021 due to higher yields, low defaults, and loan prices being marked back up following pandemic-related declines.



Other non-traditional investments were also solid performers during the year, as private assets saw strong improvements in cash flows as the economy recovered. Through three quarters of the year (for which index data is so far available), Private Equity investments increased more than 30%. Private Real Estate was also a big winner, benefiting from inflationary trends across the country. With tight supply – especially in residential and industrial real estate – and demand soaring amid a resurgent economy, private real estate assets returned more than 20% in 2021.

Outlook & Current Market Update…

Market sentiment has shifted sharply in the early weeks of 2022. The evidence of deteriorating risk appetites in late 2021 – which affected pockets of the stock market – has spilled over into broader markets in the new year. After little volatility last year, the market has already "corrected" in January by falling more than 10% from its most recent high. The damage has been particularly acute in the growth segments of the market, where the NASDAQ index has fallen as much as 15%.

Investors' concerns have also manifested within the bond market, where interest rates have resumed their climb and fixed income investments have sold off more than 3%. While it may seem anomalous that both the bond and stock market are declining at the same time, persistently high inflation and the shift in tone by the Federal Reserve has created a uniquely challenging environment. After a period of "easy money," fears that the Fed will impede economic growth with restrictive policy has caused investors to re-evaluate their risk exposures.

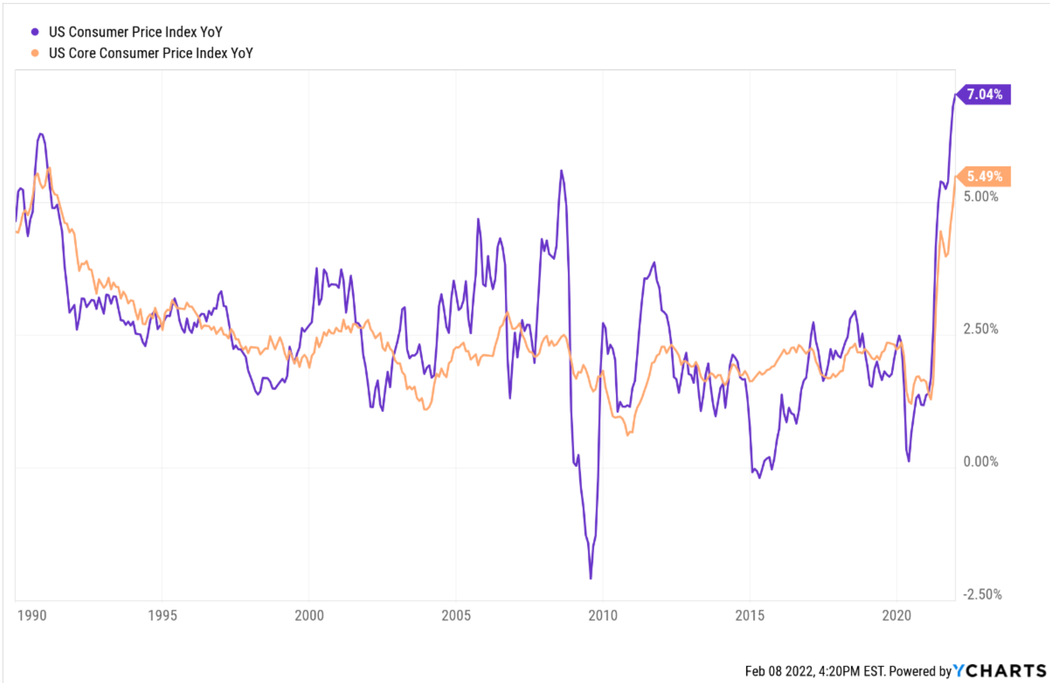
As we noted in a market update from January 24th, much of the recent market volatility – and the Fed's shift in policy – should be kept in perspective. We have enjoyed a near uninterrupted market rally since March 2020. Double digit market declines are typically experienced once per calendar year on average. That we are experiencing a minor reset after an extended run in stocks is not unusual.

The current market panic over higher interest rates also appears somewhat myopic. Extraordinary government action over the past two years has provided a massive influx of cash and stimulus into our financial system. Both corporate and personal balance sheets have been repaired, labor markets are healthy, and a growing economy still stands to receive a final shot in the arm (pun intended) once society fully re-opens from the pandemic. Even if the Fed increases short term interest rates to 1.00% or 2.00%, those would still be among the lowest levels on record. "Real" interest rates – those measured after inflation – would remain deeply negative and are highly stimulative to the economy.

We do believe it's prudent, however, to recalibrate our expectations for financial markets moving forward. Excessive stimulus has helped fuel double-digit market gains in recent years that are unlikely to be repeated. With market valuations near record highs, we expect further increases in stocks to be more commensurate with earnings growth (expected to be in the mid-to-high single digits). As government support recedes, we will also likely enter an environment where company fundamentals will matter more than macro themes; volatility and single stock dispersion is likely to increase as a result.

Note on Inflation…

The persistence and strength in CPI figures last year surprised even the most hawkish economists. While central banks like modest levels of inflation (2% is typically the desired target), consistent 5%+ inflation creates more urgency to counteract its effects, lest it seriously diminish consumers' purchasing power and damage the economy. Thus, while we are generally constructive on the macroeconomic backdrop today, we acknowledge the "bear case" for financial markets is if inflation does not normalize over the next 12-24 months. If persistently high inflation forces the Fed to hike short-term rates not by 1-2%, but 5% or more, we would expect significantly more volatility for financial assets. Stock market valuations would no longer be justified at those levels, and we would also expect a materially negative impact to fixed income markets if that scenario unfolded.



Fortunately, there are many reasons to think that inflation levels will recede. The supply chain constraints that occurred as a result of the pandemic will, ultimately, be resolved with the benefit of time – they will either be repaired or replaced as companies adapt to current circumstances. Likewise, the surge in goods-related demand that stressed those supply chains is also likely to diminish as consumer behavior normalizes away from pandemic-related purchasing patterns. Wage inflation is perhaps a less transient element, but technological innovation (deflationary) and our aging, maturing economy (disinflationary) are strong secular forces that will continue to counteract long term price increases. Leading data points such as the Institute for Supply Management's Prices Paid index (the raw input costs for manufacturers) is already showing signs that inflationary pressures are subsiding.

Nevertheless, while we ascribe a lower probability of a high inflationary outcome, we have been positioning portfolios to help mitigate these potential risks. Specifically: a focus on private real estate assets, historically a direct beneficiary of inflation; emphasis on floating rate and short duration fixed income assets, which are less sensitive to increases in interest rates that would likely accompany higher inflation; and reducing overweights to equities and other riskier assets that could be more vulnerable in a severe market decline. We will note that while one can take explicit bets on inflation via investments like TIPs, inverse fixed income trades, or commodity investments, we do not like these approaches because they will generally work *only* if the high inflation scenario plays out. We prefer assets that can work in a variety of environments.

Final Thoughts…

Although the prospects for repeating the "easy money" returns of the last two years is diminishing, we continue to have confidence in the portfolios we have constructed for our clients. Our emphasis on non-traditional assets like hedge funds, private investments, and real assets all have the potential to produce stable, attractive returns regardless of the equity or fixed income market environment. We believe that approach will help differentiate performance in the years ahead.

As always, if anything has changed in your financial life, or you feel that your tolerance for risk has changed, please call or email us at your earliest convenience.

Sincerely,

Your Investment Team

2/4/2022

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