April 2022

Stick to the Script

Looking back at the first quarter of 2022, it seems as though several years, not months, have passed. We entered the year with a strong economic backdrop, including growing wages for the rank and file. The only major issue investors were grappling with was **when** inflation would peak and how the Fed would deal with it. Investors are now trying to understand the ramifications of an attack on Ukraine by Russia, subsequent economic sanctions, and **if** inflation will peak this year.

Two famous – and similar - quotes aptly depict the current state of affairs. The first from Ernest Hemingway's, *The Sun Also Rises,* takes place when Bill asks Mike, "How did you go bankrupt?" Mike replies, "Two ways, Gradually, then suddenly." Rarely are groups of people compelled to act like one until a crisis is upon us. These crises are the "suddenly" moments. It has taken inflation accelerating as a result of further supply constraints emanating from the economic sanctions placed on Russia to make most Americans take notice. That is the "gradually" part of the inflation story. As we wrote last quarter, we have inflation, and it is not transitory. The seeds were being sown for the past several years through conflicted intentions (green energy), minor procrastinations (ever leaner inventory levels), and blind eyes we turned (free money). Now we must deal with a crop of weeds.

The second quotation is from Vladimir Ilyich Lenin, who said, "There are decades where nothing happens, and there are weeks where decades happen." The potential for the geopolitical and economic order of the world to change has not been this real since the wall fell in 1989. Russia's invasion of Ukraine has led to an almost incomprehensible range of consequences. The invasion's ramifications will impact the world as we know it for years to come. An example would be trading relationships and supply chains that once seemed safe, rationale, and reasonable. Europe feels differently today about getting most of its energy needs from Russia than it did a few months ago. Solving these types of issues involves mainly money and time. More complex cases would include thinking about whether the dollar will lose its dominant reserve currency status or whether China sides with Russia forming a stronger alliance that vies for more global power. These scenarios potentially have considerably more long-term and, in some instances, life-altering impacts - many of which would best be described as unknown unknowns. These are impossible to predict.

With the future seeming incredibly uncertain and the investment landscape appearing to change by the day, it would be easy for investors to throw up their hands, head to the sidelines, and wait for that obvious better entry point. **We could not disagree more!!**

In the midst of these uncertainties, it is important to stick to the script. Our simple belief is that over any reasonable timeframe, the economy and earnings grow enabling equity markets to move higher. Patient investors ultimately are rewarded, though patience is tried at times. Financial markets will continue to allow individual investors to accumulate wealth and achieve their financial goals. Perhaps Benjamin Graham said it best, **"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavior discipline that are likely to get you where you want to go."**

Once you've put your plan in place, it is important to stay the course as John Bogle, founder of The Vanguard Group, stated, "Your success in investing will depend in part on your character and guts and in part on your ability to realize, at the height of ebullience and the depth of despair alike, that this too shall pass." Both men using different investment philosophies were trying to make the same point; investment success is driven more by the amount of time you are in the market and sticking to a plan than trying to time the market.

As we said at the end of last year, "We continue to focus on investing in businesses that benefit from economic growth, possess pricing power, and generate significant cash flows that they can return to investors**.** Many of these stocks have not participated in the recent ebullient market performance, and as a result, we continue to find ways to deploy your capital prudently." This remains the core of our equity investment strategy. While many market participants are busy chasing the next great trade relying on technical analysis, fancy excel models describing total addressable markets, dot plots, and short-term forecasts, we have chosen to stick to what we know and understand. Once we find these businesses, the key to our client's long-term success in the equity market is not overpaying for them or holding them past the point of fair value.

If investors choose to ignore the price they pay for a security, they open themselves up to the potential for permanent capital loss. We have seen large drawdowns in "story" stocks that emerged from the pandemic, such as Peloton, Zoom, DraftKings, Zillow, Docusign, and Boston Beer. From their peaks, which all occurred about a year ago, they have fallen more than 70% - in Peloton's case, nearly 90%. Some of these and others are approaching prices that we find more interesting relative to their business prospects. Others remain substantially overvalued despite the dramatic declines they have already experienced. Each possessed a powerful story that investors ultimately pushed to prices that made no economic sense. While we didn't participate in those gains, we also have avoided the subsequent losses.

A similar situation is playing out currently in the fixed income markets. For the past several years, we have been waiting for what we felt was an inevitable increase in interest rates. Before COVID, we pointed out a 100-year Austrian bond issued in 2017 with a 2.10% coupon and had miraculously rallied to 197 so that it yielded only 0.70% for the remaining 98 years of its life. As recently as December 15, 2021, it still traded at 180. Fast forward 3-months, and as markets have finally begun to wake up to the inflationary building environment, this bond has fallen 30% to 125. It still only yields 1.8%. With inflation globally picking up and unlikely, in our view, to quickly abate, it is likely that this bond still has substantially further to fall. Obviously, with 95 more years to maturity, this is an extreme example, but long-duration bonds are the most sensitive to movements in interest rates. This is particularly true when they have low coupons. As a result of the long period of low-interest rates, there are many low coupon long-duration bonds populating the fixed income universe. As inflation expectations take hold, further declines in price for these types of securities seem inevitable. We have for several years been keeping the duration of our bond portfolios relatively short in advance of this opportunity. As the market has begun to recognize that inflation is not transitory and the Fed has begun to raise interest rates, we are suddenly being presented with opportunities to invest at substantially higher rates in the fixed income markets.

Despite what at first glance appears to be a treacherous backdrop at the moment, this heightened uncertainty provides the opportunity to invest capital. When done in the context of an overall plan tailored to fit specific needs, staying the course becomes an easier exercise. With better opportunities available across numerous asset classes, now is a great time to revisit your plan and modify it if necessary.