JANUARY 25, 2022

I. Market Overview

Midtown Manhattan is empty. Again. The sense of desperation and fear that we felt in the spring of 2020 has been replaced by a general weariness. Strangers bond over the question "will this ever end?". Yet, the local businesses that survived the first round seem to be getting by. During the worst of the early pandemic shutdown, the hole in the wall pizza place around the corner from Spears Abacus managed to stay open despite a 90% decline in business. Thanks to a handful of major construction projects nearby, it now has a slow but steady stream of customers. Many of the construction workers buying pizza and calzones are building a new headquarters for JP Morgan.

2021 started with vaccine-induced optimism but ended with Omicron. Along the way, global economic activity began to boom, and inflation appeared to be stickier than anticipated. Interest rates rose, making the bond market a challenging place to generate positive returns. U.S. stock market averages boomed, but underlying conditions were oddly challenging. Despite positive returns in the mid-20% range for most averages, almost 40% of U.S. stocks posted **negative** returns for the year. Nearly a third were down more than 10%. Such stocks are sometimes referred to as torpedoes because they come out of nowhere and can sink a portfolio. It is often the case that stocks that underperform have some common characteristic, size or similar industry groupings. This was less so in 2021, making torpedoes especially difficult to avoid.

As usual, Washington provided its own crosscurrents. Congress passed one big spending bill, but Build Back Better has ground to a halt. In the absence of clarity around fiscal policy, monetary policy is back in the spotlight. In early December, the governors of the Federal Reserve Bank abandoned the word "transitory" and acknowledged that inflation was not abating. The Fed would taper its purchases of bonds more quickly than anticipated and would likely raise short-term interest rates sooner and faster than markets previously forecasted. The shift was quickly dubbed the Powell Pivot.

> *"Powell's pivot on inflation turns the trader pandemic playbook on its head."* –
> Headline from Trader Talk, CNBC on December 1, 2021

The pivot from accommodation to tightening presumably would usher in a new set of investing "rules". But at least the rules would be clear. What worked best during a period of easy money would likely lag as interest rates rise. New leadership would emerge. Investors refer to this as a regime change. When it is orderly, it can be relatively easily navigated. Orderly went out the window with Omicron.

Because Omicron surfaced during the holiday season, its impact, particularly on the travel industry, has been particularly visible. We have read or known firsthand about thousands of cancelled flights. Guestlists shrank or expanded as family members and friends tested positive or were suddenly available because others contracted Covid. Events were cancelled. Hotels lost

guests. Businesses closed for lack of healthy employees. Assuming that these challenges are felt throughout the economy, the debate about the future of inflation will resurface.

Using our local pizza place as an example, if it must lay off its few remaining employees or close altogether, it would be bad for the economy. However, if even a few more office workers return and join the pipefitters and electricians buying slices, it might require the pizzeria to hire back another helper at the same time that it is forced to raise prices because it is more difficult and expensive to get cheese, tomatoes, and flour. This could be good for the economy but bad for inflation.

Central bankers are charged with predicting which path is more likely and adjusting monetary policy accordingly. Market participants, especially shorter term traders, will examine Fed actions and statements under a microscope and will speculate on the persistence of the Powell Pivot. Many will place bets on whether there will be a regime change.

When we invest, we avoid the behavior and language of Las Vegas. But we think a lot about the kinds of risks that are present in financial markets. Potential inflection points (regime changes) present specific kinds of risks that can be quite difficult to accurately predict. That is one of the many good reasons that we invest in a portfolio of securities, not just a small handful. We cannot avoid risk, so do our best to diversify it. In this environment, we do not want to have too much exposure to either the old or new regime. We prefer to invest in businesses where the factors determining risk and reward are unique and specific rather than associated with general economic trends. However, this is not always possible.

We will continue to own companies that can prosper in a slow growth environment. These are highly profitable businesses that have little competition and receive steady demand for their products and services in all but the most dire economic circumstances. As a result, these stocks often trade at relatively high valuations, which investors are willing to accept in a low interest-rate environment. If the Omicron variant forces economies to retrench, these stocks should continue to outperform. If, in fact, we do enter a rising growth and interest-rate environment, we would not expect this group of stocks to be market leaders.

These investments are balanced by another portion of our portfolios invested in companies that benefit directly from an improving economy. Economic sensitivity is usually “rewarded” with lower stock valuations. Cheap stocks have noticeably underperformed in the low-growth environment since the financial crisis, creating potentially attractive opportunities. If Covid worries fade more quickly than anticipated, people go back to work, eat out more, buy another new car or upgrade appliances, the result can be better than expected earnings growth for the companies that provide those goods and services. The combination of lower valuations and surprisingly strong earnings generally results in higher stock prices, even when interest rates are rising.

Many companies in the latter group have been out of favor for a number of years. Mainstream investors are likely unaware that the best of them have meaningfully improved operations, competitive position and financial characteristics. Some are significant beneficiaries of new

technologies that improve their businesses further still. Undervalued and under-appreciated can be an especially enticing combination.

II. Portfolio Insight – Technology in Unexpected Places

In 2011 Mark Andreesen, one of the most respected venture capitalists in Silicon Valley, published an article in The Wall Street Journal titled, "Why Software is Eating the World". His premise was that ubiquitous internet access, powerful smartphones and cloud delivery of applications and computing power would enable software-based companies to successfully compete against entrenched players in traditional industries. Early and extreme examples would be Amazon and Netflix pushing Borders, Barnes & Noble, Blockbuster and others out of the bookselling and movie-rental businesses. "Over the next 10 years," Andreesen wrote, "the battles between incumbents and software-powered insurgents will be epic." He was remarkably prescient. Google and Facebook have muscled their way into advertising. Airbnb is a significant factor in hospitality. Apple and Spotify have made CDs obsolete. The list goes on. We believe that it is likely that, in the next decade, software will move even more deeply into industries that are generally thought of as existing only in the physical world.

Perhaps the most obvious example of this is in the automobile industry. Software has been making inroads into the auto industry for years, arguably since VW introduced electronic fuel injection in the 1968 Type III.

While there has been a dramatic increase in software content over the last half century – engine management systems, anti-lock brakes, navigation systems, etc. – most cars on the road today are not all that different than the VW Type III. An internal combustion engine under the hood, with a human behind the wheel calling the shots.

We believe that the next ten years will be very different as power-train electrification and increasing "active safety" content bring a once-in-a-generation change in personal mobility. In the end, it will not be a car with a computer in it, but a car that is a computer.

The potential implications of this are already visible in the market. The market cap of Tesla, a perceived or presumed winner, is 30% larger than the ten largest auto makers by volume. In our opinion, this is not because the market believes that Tesla will one day produce all the cars in the world, but because in a world of software-enabled vehicles, new high-margin profit pools

will exist. There is skepticism in the market, but we don't think that Tesla will be alone in capturing this opportunity.

Much the way that smartphone makers have been able to monetize those platforms through app stores and search deals,[1] we believe that automakers will increasingly find ways to monetize the data produced and consumed by the vehicle and the captive audience inside.[2] For instance, at least one U.S. automaker is already using vehicle driving data to launch an insurance business that can compete by offering lower rates to proven safe drivers.

And, as Tesla has shown, there will be opportunities for companies outside of the auto industry. Google's Waymo division is one of the leaders in autonomous driving, chip makers like Analog Devices are seeing huge increases in content per vehicle, Apple is rumored to have its own automotive ambitions and even Microsoft has gotten in on the action with a cloud partnership with GM's Cruise to help manage the masses of data required for fully autonomous driving.

III. Personal Finance – Brief Update on Taxes

To the surprise of most observers, the Build Back Better budget reconciliation bill did not pass in 2021. Maybe more surprisingly, it may not pass in any form whatsoever. This means that many of the tax changes envisioned by the Democratic platform may not happen. This includes forms of higher income, transfer and capital gains taxes, but also the anticipated increased cap on state and local tax deductions.

As we said in our last letter, we would not generally recommend making major decisions based solely on proposed tax regulations. Influencing the timing of contemplated transactions that have reasons beyond just taxes is good planning. Transfer (estate and gift) taxes are already scheduled to increase (or more accurately, the exemptions decrease) in five years without any actions from congress (in the meantime it has increased to $12.06 million in 2022). As such, it is always wise to accelerate gifts that you intend to make. Even absent the changing gift-tax landscape, gifts are generally more powerful to make earlier rather than waiting, as the appreciation will accrue and compound to the recipient, rather than the giver (making a large estate larger).

Ways of making this gift that were presumed to be undercut by BBB remain in place. Grantor Retained Annuity Trusts (GRATs), Intentionally Defective Grantor Trusts (IDGTs), and other irrevocable grantor trusts may continue to be viable ways to structure a gift. Also, as a reminder, the annual exclusion amount (a gift that is excluded from reporting or tax) has increased to $16,000 per person in 2022.

As always, we recommend speaking with your trust and estate counsel regarding any estate planning needs or questions, and we would be happy to participate in or assist with that discussion.

---

1 Google reportedly pays Apple about $11 billion per year to be the default search engine on the iPhone. Google and Apple's App store receive 15% to 30% of all purchases.
2 Terms were not disclosed but Ford signed a six-year deal for Ford vehicles to be powered by Android and have Google Apps and Services built in.

Important Note About SA Investor Commentaries

This letter should not be relied upon as investment advice. Any mention of particular stocks or companies does not constitute and should not be considered an investment recommendation by SA. Any forward-looking statement is inherently uncertain. If you would like to learn more about SA and its investment program, please contact us at www.spearsabacus.com.

Please contact SA if your financial situation or investment objectives have changed in any way or if you wish to impose new restrictions or modify existing restrictions on your accounts. You should be receiving, at least quarterly, a statement from your custodian showing transactions in your accounts. SA urges you to compare your custodial statements to any statements that you receive from SA.

SPEARS ABACUS

Spears Abacus is an employee owned investment management, financial planning and advisory firm. We offer individuals and their families independent advice and proprietary portfolio management based on detailed knowledge of their unique goals.

Tej Ahluwalia
Trader & Investment Research Analyst

James E. Breece, CFA
Principal & Portfolio Manager

Alina M. Carlson, CFP®
Client Service & Planning Manager

Michele D. Cleary
Principal & Director of Operations

Stacey M. James
Senior Trader

Lisa Kennedy
Executive Assistant

Marge M. MacLennan
Principal & Chief Financial Officer

Diana Massey
Portfolio Administrator

Robert P. Morgenthau
Principal & Portfolio Manager

Paul F. Pfeiffer
Principal & Portfolio Manager

John V. Raggio, CFA
Principal & Portfolio Manager

Robert M. Raich, CPA
Principal & President

Josephine Segota
Portfolio Administrator

William G. Spears, CFA
Principal & Chairman

Manny Weintraub, CFA
Principal & Portfolio Manager

Daniel Wetchler, CFA
Senior Analyst

Jeannie Woo
Operations Manager