APRIL 20, 2022

## I. Market Overview

There is no need, here, to recap recent headlines. It is impossible to ignore the human toll of the invasion of Ukraine. Though we cannot completely set aside our emotions, we are also focusing on the implications for financial markets and asset returns.

While the war has rightly commandeered significant media attention, it is important to remember that other economic trends were already in place. Stubbornly high inflation was proving to be more recalcitrant than predicted. Central banks, including the U.S. Federal Reserve, had begun to signal a tightening of monetary policy. Interest rates had begun to rise.

The war has added to the many uncertainties. There is an enormous range of possible outcomes for a host of economic indicators and asset classes. While our "crystal ball" is especially opaque, we believe there are several things that are highly likely, especially if the conflict drags on.

As we have written many times over the years, investors fear unpredictability. So far, the result has been an increase in short-term volatility across most markets. We believe this will continue.

Prices for energy and food are likely to remain elevated, if not to rise further. According to the Federal Reserve Bank of Dallas[1], Russian exports account for 8% of global petroleum production. Most of those exports are still flowing, though clearly threatened by current and possible future sanctions. The price of crude oil is up more than 30% so far this year. Natural gas prices have increased more than 60% in the U.S. and even more in Europe.

Natural gas is the primary feedstock for fertilizer, leading many observers to predict both higher prices and shortages. By itself, this would lead to higher prices for grains (corn, wheat and soybeans). Perhaps more profound is that Russia and Ukraine together account for nearly 30% of global wheat exports. Given that wheat is generally planted in the spring, we can assume that this year's fall harvest will be meaningfully smaller than usual. Demand for basic foodstuffs is very stable; higher prices seem inevitable.

When observing inflation, the U.S. Federal Reserve prefers the so-called "core inflation" calculation, which excludes the impact of Food and Energy. The rationale is that the latter categories are historically volatile and reflect short-term occurrences, often weather-related, while core inflation is a truer measure of the overall economy. We believe that the current environment may challenge that orthodoxy for two reasons.

There is an old saying that the best cure for high prices is high prices. The implication is that markets respond to high prices by increasing supply of a given commodity, easing pressure and

[1] https://www.dallasfed.org/research/economics/2022/0322

ultimately reducing prices. It seems highly unlikely that such an adjustment would be feasible under these circumstances.

We also believe that political pressure will be unusually intense. Rising food and energy costs are highly visible and have a disproportionately large impact on low and middle-income families. With mid-term elections on the horizon, both parties will be especially attuned to the needs and fears of a large swath of the electorate.

Monetary policy is likely to remain under the microscope. The Fed will continue to feel pressure to "cure" inflation, whether or not it actually has the tools to do so (Fed bankers themselves tend to think they do not). The bond market has already begun to react. Treasury focused fixed-income indices turned in the worst quarterly performance ever, with most indices having inception dates going back to the early 1970s. The biggest interest rate moves were felt in near-short maturities: the two-year U.S. Treasury rose from 0.80% at year-end to 2.40% by the end of March.

Despite these significant headwinds, the reaction of most equity markets has been relatively muted. After a rapid decline during the days leading up to and immediately following the invasion, most major stock indices have rebounded.

There are reasons to be optimistic. We continue to hold stocks because we think there is a very good opportunity to make money over our investment time horizon. Pent up demand for autos, housing and commercial construction is tremendous. The strong demand for labor limits the possibility of wide-spread unemployment. And while the market itself is down only 6% from its all-time high, below the surface, many of the excesses of the last bull market have already corrected. Nearly 600 U.S. stocks have fallen more than 60% from their highest prices in the preceding twelve months. Many were speculative small and micro-cap companies. But there were plenty of household names, as well, like work-from-home beneficiaries Zoom and DocuSign, play-at-home beneficiaries Peloton and Roku, and shop-from-home staples PayPal, Etsy and Wayfair.

This is not to suggest that we will be focusing solely on yesterday's fallen angels. As always, we prefer high quality, durable businesses. Our optimism needs to be tempered by our view that inflation and higher interest rates are likely to persist somewhat longer. Our investment process relies on translating this kind of general observation into analysis of specific securities. As we evaluate current portfolio holdings and search for new ones, we must consider how these two factors impact the profitability of individual companies.

## II. Portfolio Insight

Much has and will be written about how to invest in an inflationary environment. "Buy commodity producers" or "value outperforms growth" or "financials do well when interest rates rise". All of this may be good advice but spending much of our day looking at companies, we are struck by one simple reality: companies with fat profit margins are much better positioned to deal with inflation than those with slim margins.

Consider two companies. The chart below shows the impact on each business of a 6% increase - the current consensus expectation for inflation for 2022 - in its cost of goods sold (COGS).

Impact of 6% Cost of Goods Sold Inflation

| Company A (% of revenue) | Before | After |
|---|---|---|
| Revenue | 100% | 100% |
| COGS | 50% | 53% |
| Gross Profit | 50% | 47% |
| SG&A[2] | 25% | 25% |
| Operating Profit | 26% | 23% |
| Decline in Profit | | -12% |

| Company B (% of revenue) | Before | After |
|---|---|---|
| Revenue | 100% | 100% |
| COGS | 80% | 85% |
| Gross Profit | 20% | 15% |
| SG&A | 9% | 9% |
| Operating Profit | 11% | 6% |
| Decline in Profit | | -45% |

The math is clear. Company A is not immune, but the decline in profitability is nothing compared to the impact to a low gross-margin business like Company B. What's more, in order to return to previous levels of profitability, Company A would need to increase prices by less than 3%, while Company B would need to increase prices by almost 5%.

High-margin companies may not initially lead the market as investors seek "inflation plays", but we believe that strong businesses with good margins are well positioned to weather a period of elevated cost pressures.

## III. Personal Finance

Many years of ultra-low inflation and above-average stock market returns may have obscured the reason that one invests for the long term. At Spears Abacus, our objectives are to preserve and increase the real purchasing power of our clients' financial assets. Simply put, if your cost of living increases 2%, your assets need to increase at least 2%, after taxes and current spending, to stay even.

A higher rate of inflation requires a correspondingly higher return on investment. The math is simple. That is, until you encounter taxes. For a taxable investor, higher inflation can create a compounding issue. High inflation erodes purchasing power, but it can also increase tax obligations as the government will tax your higher returns, even if they are just keeping pace with inflation.

The longer we encounter above-normal inflation, the greater the negative impact of taxes can be. This increases the importance of tax efficient strategies and the tax awareness of all investors. Avoiding short-term capital gains, investing in tax-exempt bonds (once yields become attractive enough), and deferring gains through low-turnover strategies – hallmarks of our investment approach – will become even more valuable contributors to achieving our primary goal: preserving and enhancing purchasing power over the long term.

[2] Selling, General and Administrative Expenses

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