JULY 19, 2022

Markets Post Worst First Half of Year In Decades – Wall Street Journal front page headline, July 1, 2022

The S&P 500 has dropped nearly 20 percent so far this year. In the second quarter alone, it declined more than 16 percent. Bonds were no safe haven. The broadest measure of high-quality bonds fell more than 10 percent, the worst first half in history (in this case, "history" dates back to about 1970).

We try to avoid rehashing statistics that are readily available in print and online. These numbers are so stark that we feel they deserve prominent mention. However, context is everything, and there are important points to keep in mind:

- Investing is not a one-way street. Assets prices have declined sharply before and will do so again.

- Our goal is to be able to withstand volatility and avoid permanent loss of capital. It is critical to be well-positioned as markets inevitably rebound.

- Our investment process is designed with precisely this fact in mind. We hold high quality, durable companies. Stock prices may fluctuate, but underlying businesses are stable.

- The best businesses get stronger during difficult periods. Weak competitors fall by the wayside.

- Front page headlines reflect the past and are generally very poor predicters of the future.

A 20% drop in stock market averages is painful, but not unusual. Declines of this magnitude have occurred a dozen times in the last 60 years or about once every five years. We were spoiled by the fact that the early Covid decline lasted a mere 30 days and that it had been 11 years since the previous similar drop.

What happened?

While there have been a number of well-publicized adverse events this year, we believe that the primary reason markets are down is money. Specifically, investor ***expectations*** about the future cost and availability of money. For the first time since the outbreak of Covid-19, and arguably since the Great Financial Crisis, investors are seriously considering the implications of a shrinking rather than expanding supply of money.

As we have written about previously, the mountain of cash that the Fed injected into the financial system had a much larger impact on the valuation of financial assets than it did on the underlying earnings of those assets. By the end of last year, most common valuation metrics were at or near all-time highs.

On December 31, 2021, the P/E Multiple[1] of the S&P 500 stood at 21.33 times expected earnings. As of June 30, the P/E Multiple has shrunk to 16 times despite the fact that expected earnings have actually increased. The entire market decline can be explained by this reduction in valuation, which, in turn, can be explained by higher interest rates and investor concerns about tighter monetary policy.

Where was the damage worst?

In order to withstand volatility, it is imperative to avoid the most overvalued assets. Over the last several years, there have been numerous instances of extreme valuation expansion. Covid related fiscal stimulus and near zero interest rates converted some portion of the population from savers to speculators, guiding some of that mountain of cash toward the riskiest assets. The boldest examples were assets with no earnings whatsoever like crypto currencies and some so-called meme stocks.

Asset	2021 Price Change	Earnings 2017 - 2021	YTD Price Change
Bitcoin	+58%	0	-57.9%
AMC Entertainment	+1,183%	$ 6.4 Billion Loss	- 50.2%

Of the 4000 or so publicly traded companies in the U.S., nearly 1000 dropped 40% or more this year. More than half of those are not expected to show a profit in 2022. Undoubtedly, some will survive and even prosper. Many will not. The result will be permanent loss of capital for shareholders.

Company	Industry	First Profits (Projections)	YTD Price Change
Carvana	Auto dealer	2025 or later	-90.3%
Aspen Aerogels	Building Products	2025 or later	-80.2%
The RealReal	Designer clothing consignment	2025 or later	-78.5%
Wayfair	On-line Furniture	2025 or later	-77.1%

By contrast, our portfolios hold companies that generate cash flow, not just accounting earnings (generally accepted accounting principles, or GAAP, leave a lot of wiggle room; cash is cash). We

[1] ***Valuation = Price divided by earnings*** To oversimplify, the measure of a stock's valuation is its price divided by its earnings per share. This is referred to as its Price/Earnings Ratio or P/E Multiple (sometimes just "P/E" or "multiple" for short). The same measure can be applied to broad market indices like the S&P 500.

think cash flow is important in all environments and even more so when lending conditions are tight and financing difficult.

What about inflation?

The yield on the 10-year U.S. Treasury Note peaked at around 3.50%, a whopping 2% (percentage points) higher than just a year ago. The increase can be traced back to inflation that has proved more severe and persistent than most ever imagined. Consumers immediately feel the pressure of inflation on highly visible essentials like gasoline, food and utility bills or discretionary items like air travel. But it is the expectations of inflation that concern policy makers at the Federal Reserve the most. Once inflation expectations become entrenched, it is difficult to get the consumer to stop spending as the belief is that things will only get more expensive. The cycle become vicious, and inflation becomes self-fulfilling.

After some waning confidence during the quarter, the market now believes that the Fed will be successful. Inflation expectations have come back down to 2.0%-2.5% over the long term, rather than the high single digit rates we are seeing today. As one problem is solved, another potentially arises. Tighter monetary policy often leads to a recession.

We believe that this is the risk that investors will focus on in the coming months. We are already seeing the first signs. In the last week of the quarter, the 10-year Treasury rate dipped below 3%. Credit spreads[2] are increasing, indicating that lenders are less inclined to extend cheap credit to lower quality borrowers. If this proves to be the case, the high quality and resiliency of our stock and bond holdings should prove even more valuable relative to riskier and more expensive securities.

Portfolio Discussion

There are going to be a number of small, single product companies that are probably not going to survive what's happening and the valuation multiple changing is actually, I think, good for larger companies like Adobe.

– Shantanu Narayen, Adobe CEO, during June 16, 2022 earnings call

During the second quarter, we were active in adding new positions to the portfolio. And, whether it be specialized software, video gaming, food delivery or payments processing, the new investments share a common attribute – each company is an incumbent facing threats from start-up challengers.

To state the obvious, the days of free money have come to an end. To put numbers to it, last year Snapchat issued convertible bonds with an interest rate of 0.0% (not a typo). Today, the same

[2] Credit spreads measure the difference in borrowing costs between the U.S. Treasury and lower quality borrowers.

bonds trade at 71 cents on the dollar, and investors require a 7% annualized return to take the risk.

The pendulum swing in the availability and cost of capital from abundant to scarce, cheap to expensive has taken place to different degrees across public and private markets. For relatively large public companies like Snapchat, higher borrowing costs are painful but not fatal. For small, development stage companies, the funds may not exist, and, as Shantanu Narayen said, a number will not survive.

Many businesses with great technology and lots of future promise, but no profits today, will be forced to consider selling to an industry player with deeper pockets or to cut spending on sales and marketing and reduce investment in product development to conserve cash. In either case, this is good news for the incumbents with established business models and strong cash flow that these challengers sought to displace.

We also see the benefit for larger companies extending to what has been one of this cycle's scarcest resources – human capital. As noted by *The Wall Street Journal*, "after years of fighting to keep engineers and other sought-after employees from leaving for rivals or buzzy startups, the healthiest of the big tech companies are increasingly attractive for tech workers suddenly more keen on stability."[3]

Right now, investor focus is on the losers in this sea-change. We are looking for the beneficiaries, and our focus on highly profitable businesses means that we own many incumbents. Most of these stocks are down with the market this year, but we believe that their competitive positions have been strengthened and that the multi-year outlook is, if anything, brighter.

Financial Planning

Whenever markets drop as much as they have this year, it is worth considering how the tax system may help soften the blow. The most obvious technique would be realizing losses that can be used against current or future realized gains. Of course, when a drop such as this one occurs after years of strong markets, you may not actually have unrealized losses in your portfolio (if you have held Apple for many years a ~20% drop is still a large lifetime gain). However, recent investments are more likely to have unrealized losses. It is worth taking those losses, which may produce a 20%+ tax benefit (depending on your income tax bracket and state), or a near 40% benefit if it is a short-term loss and can be used against short-term gains. If you like the stock or bond and want to hold it for the long term, you can buy back the position 31 days later (the IRS prohibits taking the loss if you repurchase earlier than that) or you can double up the position today and sell the higher cost tax lot 31 days from now if it is still at a loss. For stock and bond portfolios that we manage, we will look to employ these techniques to reduce your tax burden.

A sharp market decline may also provide a good opportunity to reconfigure retirement assets or make gifts to children and grandchildren. While we don't know the future, we do know that prices are lower today and therefore have a better chance of being higher in the future. This

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[3] Mims, Christopher, "The Tech Crash Could be a Talent Bonanza for Big Tech", *The Wall Street Journal*, May 8, 2022

increases your odds in situations where you transfer assets with the hope and expectation that they will increase in value.

For example, converting a traditional IRA into a Roth IRA may make sense, or at least more sense, when values are lower. This conversion will be taxed as income today (at the lower value) and the presumably higher value distribution at retirement will be tax free. If you consider a conversion, keep in mind it is better to pay this tax from non-IRA funds.

Similarly, if you have a grantor trust (such as a GRAT[4] or IDGRT[5]) that allows you to swap assets, you may consider swapping in assets that have dropped significantly and may have more potential to rebound to higher values. This would increase the ultimate value of the assets you transfer to your beneficiaries. Of course, lower prices may be the impetus to create a new GRAT or other trusts or to make outright gifts – often it is not the assets today that will be subject to estate tax, but the appreciation that happens within your estate.

While the short-term market gyrations may not be enough reason to take a specific planning action, it may increase the benefit of one you have already taken or are considering. While we urge you to discuss any of these with your tax advisor to understand fully your specific situation, we would be happy to discuss the above or any other questions with you.

[4] Grantor Retained Annuity Trust
[5] Intentionally Defective Grantor Retained Trust

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