




SPEARS / ABACUS

4Q2022 COMMENTARY

- 2022 was a challenging year; interest rates and inflation were to blame.
- A short, shallow recession is the consensus view. We remain cautious until proven otherwise.
- The silver lining? Higher yields are good for bond investors. Lower stock prices are good for bargain hunters.
- We maintain our strategy of investing in businesses where the underlying fundamentals remain extremely attractive. We believe patient investors will be rewarded.

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I. Market Commentary

2022 was a challenging year. There is no way to soft-pedal the results. In round numbers, U.S., global and emerging market stock indices each declined approximately 20%. Long term bonds fared worse, falling nearly 30%. Broadly speaking, there was no place to hide.

As we have written previously, the culprit has been rising interest rates and the specter of significantly higher inflation. Central banks around the world have used monetary policy (raising interest rates) to try to tame rising prices. So far, that strategy has had greater impact on financial markets than the real economy. Most growth measures have remained resilient while the labor market is historically strong. Business revenue growth has been steady, though rising expenses have applied modest pressure to earnings. On the other hand, stock valuations have shrunk meaningfully.

As is often the case during sharp market declines, speculative investments performed the worst. Crypto currency became front page news, as price drops uncovered both well- and less-well-publicized crypto frauds. More traditional speculators were burned as well. An astonishing 613 special purpose acquisition companies (referred to as “SPACs” or blank check companies) were sold to the public in 2021. Retail investment “products”, such as exchange traded funds (“ETFs”) were created to give even broader access to these questionable investments. In 2022, DSPC¹, an ETF that invests in an index of SPACs, dropped 70%. In 2023, DSPC will close its doors and return what little remains of its investors’ capital.

Very long-term “visionary” investors also felt the sting of rising interest rates. Companies with great future promise but little or no current earnings were hit particularly hard. The once highly regarded Ark Innovation ETF, ARKK, held nearly \$30 billion of investor assets in early 2021 and declined 67% in 2022, as large holdings like Zoom Inc., Tesla and Shopify came down to earth.

Mainstream growth companies with higher-than-average valuations were also victims of higher rates. At Spears Abacus, we avoided the worst of these very large companies, but not all.

Name	2022 Return
Meta Platforms Inc. (Facebook)	-64.2%
Netflix, Inc.	-51.1%
Amazon.com, Inc.	-49.6%
Alphabet Inc. Class C	-38.7%
Microsoft Corporation	-27.9%
Apple Inc.	-26.3%

1. AXS De-SPAC ETF Source: FactSet

We have never felt completely comfortable with Meta/Facebook, Netflix or Amazon. The latter three stocks (Alphabet, Microsoft and Apple) had outsized performance over the three previous years, 2019 to 2021. As a result, their valuations were stretched. In our estimation, their underlying business fundamentals remain extremely attractive, and at current levels, their valuations seem more than reasonable. We believe patient investors will be rewarded.

Looking ahead, we sense that, a consensus has been reached by investors, observers and corporate executives. Most are confident that the Federal Reserve will successfully orchestrate the breaking of inflation.² That leaves the question of how much collateral damage will be inflicted on the economy?

The economic press will expand its vocabulary or simply return to well-worn phrases like “goldilocks economy” and “soft-landing”. If this hallowed state is achieved, investors will cheer, and markets could rebound sharply. We believe this scenario is entirely possible; in it, our investments would prosper. But we are mindful that optimistic projections do not always meet expectations. Consequently, our portfolios include holdings that should defend well against a more adverse environment. Rather than predicting dire circumstances, we think of this as insurance for negative events that might occur.

“Just about every region with the exception of China and Japan believes there is going to be some kind of economic slowdown. Ninety-eight percent of CEOs in the U.S. think there is going to be a recession – but it’s going to be short and shallow.”

- Dana Peterson, Chief Economist of the Conference Board

We always try to consider what might surprise investors in a way that would cause asset prices to fall. Of course, sometimes this is impossible. Events like Covid-19 or the war in Ukraine are manifestly unpredictable. However, there are more garden-variety surprises that might catch markets unaware. One consideration would be a longer-than-expected period of high inflation.

Jobs statistics have become the flavor of the month. Wage-induced inflation seems to be among central bankers’ primary concerns. In previous recessions, corporations were quick to lay off workers in high-cost areas and eventually replace them with lower cost workers in China and other emerging markets. This strategy seems far less popular thanks to a shrinking labor force in developed economies and higher costs in emerging ones. In a Conference Board survey, U.S. CEOs preferred “pricing strategies” to layoffs.² If wages continue to rise, central bankers, particularly in the U.S., may prefer to keep interest rates higher for longer than expected.

There is a silver lining here. Though the rapid rise in interest rates caused negative returns for bonds last year, for fixed-income investors, the current environment is the most favorable in years. Where appropriate, bonds can finally have a meaningfully positive impact on portfolios. Perhaps the largest change can be seen in short-term cash reserves. A year ago, cash was kept in bank deposit accounts, which provided safety but virtually no yield. Today, we deploy a strategy that combines higher yielding (but still safe) money-market funds and U.S. Treasury bills to take advantage of the fact that the Fed has raised interest rates to near 4.5%.

We have observed that major banks are generally not offering the same advice to their customers, even those with large cash balances. Banks use customer balances to fund their own lending activity which incentivizes banks to pay a low rate on deposits. Thanks to aggressive Fed actions, a pickup of over 4.0% is possible for investors with checking accounts at certain banks. For further details please click [here](#) and contact us to learn more.

2. Short U.S. Recession is Expected by CEOs – Theo Francis, The Wall Street Journal 1/13/2023 (print edition)

Even with higher rates, not all fixed-income investing is equally low-risk. Given the possibility of a recession, we would steer clear of junk bonds (which are more expensive than average).

Bonds that now have reasonable yields are a good reminder that sharp market declines like the one we endured in 2022 set the stage for bargain hunting. Last year's turmoil is forcing investors to differentiate between speculative and proven, between those that promise and those that deliver. This year is off to a good start. While the average stock may drop further, investors will benefit from owning the most resilient businesses that provide goods or services to growing segments of the economy. At Spears Abacus we continue to focus on just such investments and maintain our long-term optimism.

II. Personal Finance

A reminder that with the change of the calendar comes a few federal tax rule changes that may be relevant to you. As always, we recommend that you speak with your tax advisor about your particular circumstances, including any state or local tax changes. Effective in 2023:

- The annual gift exclusion amount has increased to \$17,000 per person per year, increased from \$16,000.
- The lifetime credit amount for gifting or inheritance (including generation-skipping) has increased significantly due to inflation adjustments. For 2023, the lifetime credit is \$12.92 million per person, and therefore \$25.84 million for a married couple. It is currently scheduled to revert back to \$5 million (adjusted for inflation since 2018) in 2026, although we expect additional changes before then.

Also of potential interest, the required minimum distribution (RMD) age for non-Roth retirement plans has increased to 73 for 2023.

We would be pleased to discuss these changes, and any opportunities that they present, with you and/or your tax advisor.

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.

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