OCTOBER 19, 2023

Spears Abacus 3Q23 Commentary

Economists (and financial journalists) are laser focused on predicting the next recession. When will it arrive? How severe will it be? Will it arrive at all? Implicit in this conversation is the belief that a recession will be accompanied by a reduction in interest rates. That is conventional wisdom, and there is no compelling reason to assume that the laws of economic cycles have been repealed. However, we believe that it is unlikely that rates will return to the historically low level seen for most of the period between the financial crisis and early 2022, when rates began to rise in earnest.

Just as super-low rates and accommodating monetary policy had a profound impact on markets and economies, so too will a higher rate environment. There were winners and losers when money was cheap and abundant. We think it is likely that there will be a different set of winners and losers when capital is harder to access and more costly.

Let's imagine that the world is divided into two groups: capital providers ("providers") and capital users ("users"). Providers have excess capital to invest, usually with the goal of generating enough income and growth to fund present and future expenses. Users seek funding for significant near-term expenses, new business ventures or increased investment in existing businesses. Users want the lowest cost funds possible. Providers seek the highest return consistent with acceptable risk.

I. The Low-Rate Era – Big Winners and Less Big Winners

We can call the period between the Great Financial Crisis and the end of 2021 the low-rate era. The combination of low interest rates, easy monetary policy and fiscal stimulus resulted in benefits for both providers and users. Especially those willing to take on risk. Only conservative bond investors missed out on the party.

		Annual % Return 12/16/08 - 3/17/22
More Risk ↑	**NASDAQ Composite Index**	17.60
	Growth Stocks	16.05
	S&P 500	12.62
	Value Stocks	9.40
	Junk Bonds	8.78
	Long-Term Gov't Bonds	3.75
	Intermediate - Term Gov't Bonds	1.96
Less Risk ↓	**Short-Term Gov't Securities**	0.88

Source: Bloomberg. 12/16/08 is the first date the Fed cut rates below 1%. 3/17/22 was the beginning of the current Fed tightening cycle.

This pattern of returns incentivized providers to take greater risks, which resulted in even greater benefits for users. Debt financing was so inexpensive that issuing bonds to finance mergers or to buy back stock almost always resulted in an increase in earnings per share. M&A activity increased more than 250%. Stock buybacks increased by a factor of ten. Money poured into venture capital, private equity and private debt funds. Initial public offerings ("IPOs") were muted in the wake of the financial crisis but exploded in the late 2010s, climaxing in 2020. Most of the IPOs that year were for so-called "blank check" companies that raised money from investors on the promise that it would be invested in *something* within two years.

	2009	Peak Value (2009-2022)	2023 Estimate
Stock Buybacks	$125B	$1,273B	$910B
Global M&A	$2.2T	$5.7T	$2.2T
Venture Capital	$33B	$337B	N/A
Initial Public Offerings	79	1035	150
Private-Debt	$164B	$1.5T	N/A

Source: Goldman Sachs, Wall Street Journal, FactSet

II. Normal Rate Environment – Better is Better; Worse is Worse

In the low-rate era, the biggest winners were low-quality, speculative users who likely had little or no opportunity to raise capital in 2009 but suddenly had the same abundant access to low-cost financing as high-quality users. Providers, desperate to put capital to work, became markedly less discriminating (and occasionally lazy). This has begun to change, as rates have returned to more normal levels giving providers better options.

While the very fast transition to higher interest rates was painful for bondholders, U.S. Treasury securities yielding 4.5% to 5.5%, depending on maturity, seem downright generous. The biggest change can be seen in the options that investors have for their excess cash. In the low-interest era, money-market funds earned so little interest that they could not even cover administrative costs. Investors and depositors were content holding cash balances that earned no interest at all. Today, with the short-term risk-free rate (90-day U.S. Treasury bills) around 5.5%, depositors have aggressively moved assets to higher yielding cash alternatives.

As we know, this caused big problems for a small handful of banks, especially First Republic Bank, Silicon Valley Bank and Signature Bank. Poor management decisions caused those banks to either fail outright or to be sold to stronger institutions. In contrast, the best-managed banks, notably JPMorgan, were able to take market share from troubled competitors.

Banks, like most financial institutions, are both providers and users. As providers, the normal rate environment is a benefit; higher rates on loans means more revenue. But as users, rising rates mean higher costs. In general, the current rate environment has eroded the profit margins of most banks. Regional banks have been particularly impacted, which is reflected in the 25% year-to-date decline of the S&P Regional Banks Industry Index. We believe, eventually, the vast majority of banks will be able to rebalance their loan portfolios and return to moderate growth. We do not believe that banks pose substantial risks to the greater financial system, but we do think that most are likely to be substandard investments for the foreseeable future.

Most business loans are either made by banks or through the issuance of bonds. However, since the Great Financial Crisis, there has been very rapid growth in the so-called private debt market: loans made in private agreements between businesses and institutional investors like private-equity firms (e.g. Carlyle Group, Blackstone and KKR) and hedge funds. The private-debt market also experienced ten-fold growth during the low-rate era.

> *"Private lenders that took disproportionate risks in recent years have been disproportionately rewarded. That's going to change." – Carlyle Group*

Private lending is still a fraction of the size of bank lending, but it focuses on a riskier cohort of borrowers. In some cases, loans made in private arrangements enabled less-established start-ups to challenge leading competitors. Not always with positive results.

The saga of SmileDirectClub is a veritable greatest hits of many of the excesses of the low-rate era. The company aimed to disrupt the orthodontics industry by offering invisible braces directly to consumers and bypassing orthodontists.

Founded in 2013, it received venture-capital funding in 2014 and private-equity growth capital in 2018 (at a $3.2 billion valuation), and it sold shares to the public in an IPO in 2019. The offering price of $20 per share valued the profitless company at $8.9 billion. That's when the trouble began.

Over the first month of trading, the stock declined 40%. In an otherwise glowing research report, a research analyst employed by one of SmileDirectClub's underwriters (a firm that made millions in fees and commissions on the IPO) wrote:

> *"We suspect much of this inauspicious beginning has been driven by a rotation into more defensive and value-oriented stocks, and away from more speculative new issues that are not currently profitable."*

But the company still had big growth plans and continued to find willing capital providers. Between May 2020 and April 2022, SmileDirectClub borrowed more than $1.3 billion in the private-debt market. It was never able to turn a profit and on September 29 filed for bankruptcy. The stock currently trades for four cents per share (and is probably worth less). Bonds are valued at pennies on the dollar.

While this is bad news for SmileDirectClub's capital providers, it is good news for the company's primary competitor, Invisalign (Align Technology). While SmileDirectClub never turned a profit, it did attract several hundred thousand customers, taking market share and growth from Invisalign.

We believe that the real benefit of a normal-rate environment is that it will be much more difficult for weak or irrational competitors to be sustained by low-cost or even no-cost money. The low-interest era put poorly managed companies on equal footing with well-managed ones and robust business models with fragile ones. When users are forced to compete for capital, the best businesses will pull away from the field. We believe that investors will be rewarded more for differentiating between good and bad, rather than just allocating funds to stocks or bonds in general.

This summer, Spears Abacus again employed a diligent, energetic and hard-working group of interns. For the third year, Prep for Prep has helped us identify strong candidates from under-privileged backgrounds. As in summers past, they capped off their time at the firm with a stock pitch. Unlike past years, this group issued a sell recommendation (so far, they've been right, for the right reasons). The title of their pitch was "Estee Lauder: Beauty is Only Skin Deep."

Their thesis was that Estee Lauder's incredible growth in China caused the company to neglect what enabled this success in the first place – their brands. Estee Lauder has grown revenue by a 30% annual rate over the five fiscal years ending 2022, but our interns' analysis suggested that all that growth was attributable to China. The rest of the business didn't grow, and the U.S. likely declined. The cause, in their opinion, was management's focus on emerging-market expansion at the expense of brand health.

Estee Lauder isn't the only company where the reality of the health of the business is less promising than what it appears on the surface. Readily available cheap capital has supported spending, enabled questionable corporate capital allocation decisions and encouraged excess risk taking in investment markets. An increase in interest rates will rein in much of this behavior. For some companies this will present a manageable headwind, but for others it will be ugly, as poor decisions made in a forgiving operating environment are exposed.

III. Financial Planning

As this past quarter was one of back-to-school, we were reminded of some important points to remember as your children or other relatives arrive at that strange time in which they reach legal majority but are still very much children.

While everyone's situation is different, here are a few things that most experts agree you should consider when your child turns 18 or 21:

- **Understand any Financial Account Changes.** Many young people have assets held in UTMA or UGMA accounts. Generally, this account legally becomes their personal account at age 21 (18 in some states). Some brokers or banks will freeze the accounts until you change the ownership; others may wait for you to notify them. Most importantly, speak to the child before the account is theirs so that they understand your wishes, and give them advice on what to do with the funds and how to understand what it means.

- **Sign a Health Care Proxy and Power of Attorney.** This is something all of us should have at any age. But often parents and their children wrongly assume that the parents will still make decisions if something unfortunate happens. Have your children sign a health care proxy allowing you, or someone they choose, to step in if they become incapacitated. We recommend that they also sign a Durable Power of Attorney, which gives you broad power to help them, not only if they are incapacitated, but also if they are busy studying, traveling abroad, or just still teenager at heart.

- **Sign a HIPAA Release.** You should consider this even if your children are in your house, under your financial support, or on your health plan. Once they are 18, you can no longer access or discuss their healthcare status. Some children will want to limit this, but others will assume their parents are important partners in their health. They can sign a release which allows you access.

- **Sign a FERPA Waiver.** Similarly, you do not necessarily have access to their academic records, even if you are paying for it. If your child is willing, have them sign this release (usually through an online link for most schools), which will help you to help them administratively and to ensure all charges are paid.

These are just a few suggestions; of course, every situation is different. As always, we urge communication well before the legal change occurs. We are happy to help you think through these or any related issues.