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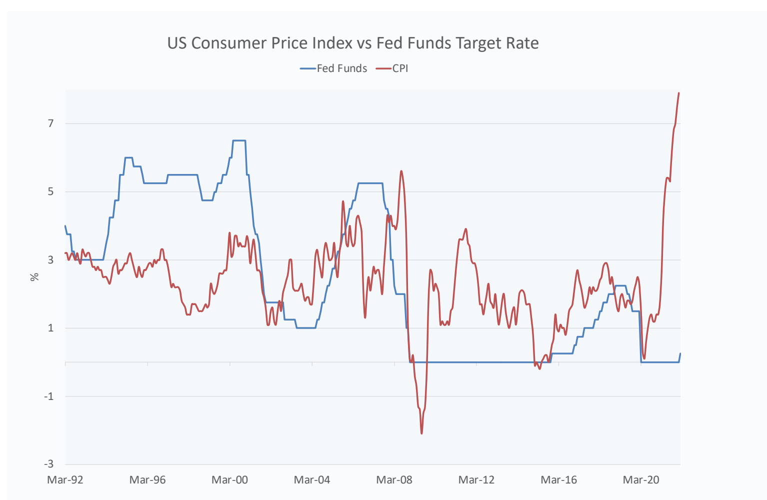
WHERE WE STAND – Q1 2022

A blended portfolio* of equities and bonds was down 5.7% in Q1 2022. See the black solid line in the chart below. Emerging market equities, US small capitalization stocks, developed markets-ex USA equities, bonds, and US large caps (in order of magnitude), all declined. See the colored broken lines in the chart.

*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

The narrative that financial participants have migrated to is that the US economy is overheating, resulting in inflationary pressures, that are no longer transitory. Also, that the Federal Reserve is not only going to continue to follow the 25basis point hike in March with similar increases at ensuing meetings this year, but that the next two meetings would need to have 50 basis point increases. As mentioned before, the Fed has a dual mandate: maximize employment and control inflation. The chart at the top right shows how quickly full employment has been regained after the Covid-19 related losses. This, a direct result of massive monetary stimulus from the Fed and equally unprecedented deficit financed fiscal stimulus (government spending and handouts). So, the first Fed mandate has been achieved.

On the other hand, inflation has exploded higher: covid related supply and demand disruptions and more recently, the Ukraine war, adding fuel to the monetary and fiscal inflationary flames. See the chart below for the relationship between the target Fed Funds rate and the US CPI to get a sense of the how 'far behind the curve' Fed policy makers must feel they are, and how they must try to fall asleep at night realizing that they may have committed a policy error in both providing too much stimulus in the first place, and how they have been to slow in taking that stimulus back. Policy errors often lead to recessions.



Fixed income markets typically lead the Fed action, and therefore in Q1 short term rates from around two years and out rose substantially. For example, 2-year treasury rates rose 1.68% from 0.72% to 2.40%. That's a lot. Ten-year rates rose too, by 0.85% to 2.35%. When short term rates rise to be higher than long term rates (as is the case now), known as an 'inversion of the yield curve', the belief is that the pending rate increases will slow the economy down enough to bring inflation back under control. The hope is that the slowdown will be a 'soft landing' and recession will be avoided. The true outcome of this is up in the air and depends on a myriad of variables that no one can really forecast with certainty. On the margin however, the probabilities of growth versus recession shift, and investors behavior becomes more conservative. This has been evident for a while now, as higher quality companies with profits, dividends, cash flow and reasonable valuations outperformed what had considered to be the growth companies of the future. The chart below shows Berkshire Hathaway (a quintessential portfolio of high-quality value equities) vs

a well-known fund (ARKK) that invests in high octane growth stocks like: Tesla, Shopify, Zoom Communications, Twitter, Spotify, DocuSign, Roku and others. The chart shows the roundtrip that ARKK had from the beginning of the pandemic in 2020, at one point being up 300% to, erasing all those gains during this quarter. This, versus the steady gain over the period (and an acceleration of outperformance in this quarter) that Berkshire has had, to the point that as of now it is outperforming by 20% over the period.

Inflation is a problem for most financial assets, however: rising interest rates are plugged into discounting valuation models and the result is lower present values, especially for assets whose cash flows accrue further in the future. In addition, when the yield curve inverts and thereby, the probability of recession rise, the certainty of those future cash flows for many assets becomes questionable. So not only is the discounting rate higher, but the size of the future cash flow plugged into the model needs to be reduced too, resulting in, again, lower present value. It's a matter of degree though: the likelihood of reduced cash flows due to recession for, say Pfizer or Lockheed Martin is very different to say Shopify or Tesla.

The feedback mechanism of rising interest rates is being seen in the real economy too. Mortgage rates have jumped higher from below 3% for a 30-year fixed mortgage to almost 5% now. This will have a knock-on effect for housing and the economy in general as seen for example, by housing company Toll Brothers' stock returning to pre-pandemic levels.

So, we find ourselves, as always in unchartered territory, at the end of a volatile quarter for financial markets and with near certainty that the rest of the year will be volatile too.

Where We Stand

We entered the quarter with all our equity holdings being of reasonably valued, high-quality companies. All profitable, relatively wide-moat companies with dividend history and excellent cash flow. We also hold a portion of fixed income as an effort to have our portfolios diversified. Our holdings all did relatively well, and in some instances, well in absolute terms, notwithstanding the broad sell-off in all financial assets.

Our drawdowns, if any, continue to be de minimis.

Because we had relatively high cash levels, we were in the ideal position to add to our equity (and bond) holdings as opportunities presented themselves to us during the quarter.

Currently, our framework is, that when we see companies that have projected IRRs over 10% over the next 3-4 years (under reasonable assumptions vis-à-vis earnings, dividends and future expectations for PE's and valuations), and those companies fit into sectors that suit our outlook and our portfolio balance, we invest. And so, we believe we are building portfolios that will prevail over the medium to long term.

We welcome volatility in the coming months, because although the impact will be negative on our portfolios in the short term, our dividends and interest will still be forthcoming. In addition, our cash levels are still quite high, and we hope that the volatility will give us more opportunities to continue to build the portfolios that prevail into the future.