Second Quarter 2021 Investor Letter

Review of Second Quarter

The second quarter of 2021 was a good one for financial assets. Growth shares were up strongly, rebounding from their correction earlier in the year. Value shares continued to rise, climbing 4.9%. Commodity prices rose strongly (up 13%) due to surging demand and dislocations from restarting the global economy. Overall, US shares outperformed overseas shares during the quarter.

During the quarter, financial markets continued to see the same sort of rolling market corrections seen in the first quarter, especially in areas which have seen substantial speculative activity. Leading growth stock funds fell by around 30% from mid-February through early June. Bitcoin and other crypto currencies have seen their values fall by half or more. Short squeeze favorites such as Game Stop are trading well off their highs, although still much above their fundamental value. Many commodity prices have fallen 30-50% since peaking in June. Bond prices, almost certainly the greatest of all speculative bubbles, have remained resilient, due in no small part to continued buying by the Fed.

All that said, the overall level of equity prices remains high. High prices alone, of course, are not generally a catalyst for a price decline (otherwise prices never would have gotten so high) but they are a reason for investor concern, and some investors are concerned about a crash similar to the one in 2000 or 1987. While a possibility cannot be ruled out, we do not believe a crash is the most likely scenario, for a couple of reasons. First, interest rates are much lower than in those periods. As Warren Buffett has pointed out, stocks are worth more when interest rates are at low levels. Second, both of those crashes occurred after multiple interest rate increases by the Fed. A classic recipe for a crash is high valuations combined with rising interest rates. This is a scenario that is unlikely to occur in the near future.

It is remarkable to see how fast concerns about the global economy have shifted from fears of collapse last year to fears of overheating in 2021. (See the section on Mr. Market below.) Of course, the primary reason for this swing is the strong progress made in combatting the coronavirus (especially in the US) in the recent months. The average number of daily cases in the US has fallen from nearly 200,000 per day at the beginning of this year to around 10,000

currently, a decrease of 95%. (Update: cases have climbed back to around 50,000 in recent weeks.). While there are concerns about new variants of the disease, Americans seem ready to return to a level approaching normal economic activity. So the challenge for policy makers has quickly shifted from preserving the economy from collapse to trying to insure that the recovery is as rapid as possible but without too many excesses.

The rapid restart of the US economy has pushed up the prices of many commodities, which in turn has caused a pickup in the general price level. One of the biggest debates in economics currently is whether the pickup in the inflation rate is the start of a long term trend or merely temporary. Economists at the Fed seem inclined to fall into the temporary camp, while many economists in the private sector feel otherwise. We do not believe a period of runaway inflation is likely, although the inflation rate could return to something closer to the Fed's 2% target. As noted, there are already signs of an easing in some commodity prices, suggesting that the rapid increase was more of a short term phenomenon. Investors should also keep in mind that many of the deflationary forces which were in place before the pandemic are still in place. Periods of rapid inflation not caused by a war have been rare in the US.

Real estate prices have also been on a tear in recent months. Interestingly, the price gains which in the pre-pandemic period were mostly limited to the large coastal cities, have broadened out recently. Cities in the West such as Sacramento, Reno, Boise and others have seen big price increases as buyers, many of whom are now able to work remotely, have migrated from high priced local markets such as the Bay Area and Seattle to markets which are relatively more affordable. It is also possible that the pandemic and the subsequent reduction in interest rates served as a catalyst for first time home buyers to give up their expensive urban apartments and purchase a first home.

As of the beginning of the third quarter, probably the two of the biggest worries for investors are the outlook for inflation and a resurgence of the coronavirus or one of its variants. While many people we know are (legitimately) concerned about both of these possibilities, it is worth noting that it is unlikely they will both occur since they are based on incompatible economic scenarios. Should coronavirus cases start to increase again, this would be expected to slow the overall economy, which would presumably lead to downward pressure on the price level. On the other hand, if inflation picks up it will probably be due to a stronger economic outlook which would include fewer coronavirus cases.

Review of Past 18 Months—Mr. Market Goes for a Wild Ride

Investors who are followers of Warren Buffett and his mentor Benjamin Graham are familiar with Graham's famous stock market allegory of Mr. Market, the highly excitable person who, on any given day, is prone to having an extreme view of the future. As Buffett tells the story, the great thing about Mr. Market (who is the stock market in this allegory) is that, while on some

days he is too optimistic (and only offering to sell shares at high prices) and on other days too pessimistic (offering to give away shares at bargain prices), investors have the option to ignore him until he presents a price that is attractive to them. While Mr. Market is highly excitable, he never loses his enthusiasm and will always be back the next day with a new offering price for investors to consider. When thought of this way, financial markets can be thought of as institutions which occasionally offer investors the opportunity to buy or sell great companies at very attractive prices. All that is required is patience, an ability to say no most of the time, and an ability to ignore short term news while maintaining a focus on investment fundamentals.

While this allegory is a great one, it is not perfect. While Mr. Market is excitable and prone to manic episodes, there are actually times when the outlook for and intrinsic value of listed companies are subject to unusual uncertainty. This happened over the past 18 months as financial markets swung wildly in response to the coronavirus pandemic. All intelligent investors, even the great ones, struggled to come to terms with the implications of the pandemic for the economy and their portfolios, not to mention the health of their families and loved ones.

The struggle could be seen in the deeply thoughtful writings and statements of investors like Buffett and another of our favorites, Howard Marks of Oakmark. Both of them expressed extreme concern for the economy and financial markets during the heights of the crisis, but they also remained true to their value based principals and their long term outlook. In the process they revealed some great wisdom along the way. Struggling to make purchases during extreme uncertainty in April of last year, Marks stated that while it may not be "the" time to buy, it was "a" time to buy. This statement was an acknowledgement that even great investors are unable to call the absolute low or high in financial markets (highs and lows are ultimately a short term, emotion driven phenomenon and therefore unpredictable), but that valuation metrics are still paramount in investment decision making. Stocks and high yield bonds (Oakmark's specialty) were fundamentally cheap in April 2020, and while the potential existed for the overall market to go lower, buying them at that level was still a sound investment decision.

Similarly, Buffett was extremely cautious about the economic outlook at his annual meeting in May 2020. He stated, correctly, that the outlook for the global economy was extremely uncertain. At the same time, he reiterated his long term positive outlook and supreme confidence in the American economy. Some who saw the meeting were then surprised when, over the next six months, Berkshire Hathaway purchased record amounts of its own stock. This was particularly notable because Buffett had historically been very reluctant to repurchase Berkshire shares, saying he would only buy them when they became true bargains. His enormous purchases last summer during a time of great global uncertainty were just such a time. Once again, the greatest investors are able to put aside the headlines and extreme views of Mr. Market and make investment decisions based on fundamentals.

Importantly, it was not easy for either Buffet or Marks to make these decisions. Their writings make clear their concerns and appreciation of the risks involved. There is a belief that all great

investors sit around calmly during a crisis and then magically purchase shares right at the market low, but the actions of Buffett and Marks during this period show that this is not true. Rather, great investors are better at dealing with the emotions that impact all investors and maintaining their focus on the things which matter most.

In terms of our own decision making during the crisis, it was not perfect but it was not terrible either. One of the great things about modern communications is that there is a permanent record of your communications which, for those who are willing to do so, can be reviewed. In general, we were too sanguine in January and February of 2020 regarding the potential for the coronavirus to impact the global economy. We had seen how it was more or less contained to a single area in China and assumed that other countries would have a similar experience. That view turned out to be incorrect. Once the selloff started, we maintained our fully invested position, knowing that trying to time the decline and subsequent recovery would be futile. (In fact, the market recovery began with a rally of more than 10% in just a few days. Investors who had raised significant cash would have been hard pressed to react quickly enough to participate in that move.) In late March 2020, we noted in an email to a friend that the previous time the market had fallen as much in one month (22%) was when Germany had invaded France at the beginning of World War II. We pointed out that in that particular case the market subsequently rallied, even though the war was just getting underway.

In the first week in April 2020, we sent a special letter to investors reviewing our thoughts on the crisis. (The letter is on our website.) We encouraged them not to panic and to remain invested. We concluded with the following statement:

"If anything is clear, however, it is that this crisis won't last forever. It is probable that an effective treatment or vaccine will be developed in the near future. (More than 30 companies worldwide are working on vaccines and many promising therapies are being tested.) Other efforts at mitigating the spread of the disease are expected to have some success. Financial markets cannot accurately predict the timing of these events, but they do have a good record of anticipating them based on new information."

One of our goals is to provide some perspective on financial markets so that clients can make good decisions when it matters most. By having a sense of market history, good investment principals and an appreciation of the long-term potential of our economy, investors should be able to achieve good investment returns over a medium to long term time frame.

Bill Andersen

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