**Western Pacific Wealth Management**
**First Quarter 2021 Investor Letter**

## Orderly Rotation

The first quarter of 2021 marked a reversal of the tremendous outperformance by growth stocks seen since the market low in March 2020. While many were expecting a violent reversal similar to the first two quarters of 2000, in actuality the process was quite orderly. Many growth strategies were down in the mid-single digits for the quarter, and many value strategies were up 10-12%. Not that there was not some drama during the period, as holders of GameStop and a few other stocks popular with short sellers would point out. In addition, it should be noted that the relatively muted returns for the quarter mask a bigger decline in many leading stocks from their highs in mid-February through quarter end.

As we have noted before, there are some substantial differences between this period and the end of the tech bubble. By far the most important is the quality of the companies which are the leaders this time. Unlike the previous period, the leading companies today meet virtually all the requirements that a quality-oriented investor could want; they earn high returns on capital, they have leading market shares in growing markets, low levels of debt, highly motivated managements, high levels of recurring revenues, engaged boards of directors and innovative products. While these advantages may not last forever, they are substantially different than the leading companies in the previous period. As Stanley Druckenmiller pointed out in a recent interview, the companies in the previous tech cycle were mostly involved in building out infrastructure for the internet. The problem they faced was that once the build out was finished their growth was bound to slow. So, the tech collapse in the early 2000s was really caused by a confluence of high valuations and collapsing fundamentals. The situation is profoundly different today when fundamentals are strong even while valuations are high.

Another big difference between now and 2000 is the level of interest rates. Interest rates represent the return on a less risky investment than stocks, and so are always an important consideration in valuing equities. In 2000, the Federal Reserve discount rate reached a high of 6%, which meant that most interest-bearing instruments yielded more than that rate. Compare that to now when the same rate is 0.25%. As Warren Buffett and others have pointed out, this level of interest rates, accompanied by reasonable expectations that rates will remain low, supports higher than usual stock market valuations.

The other side of low interest rates, of course, is that income investors are facing very real challenges. Long gone are the days when a bank savings account or high-quality bond could provide a yield in the high single digits. What should income investors do in such a situation? Our most important suggestion would be to avoid taking undue risk in order to increase the return on a yield portfolio. Investors who add riskier positions are likely to eventually incur a loss of principal far in excess of the incremental gain they hoped to achieve. For investors who are comfortable with slightly more volatility, we would suggest considering high quality utility stocks and other defensive equities with good dividends. It may be instructive to consider companies that did not cut their dividends last year during an unprecedented shock to the economic system. Companies which made it through this period most likely have dividends that are fairly secure. Importantly, we suggest not looking to outperform the indices (which are highly skewed towards growth stocks) with this portion of your portfolio. Instead, look to generate a steady, growing stream of income. Companies which increase their dividends 3-4% per year may not sound exciting, but when held for the long term can provide excellent results. Another benefit (at least for now) is that dividends are taxed at a substantially lower rate than the tax rate on interest payments or on a bond or savings account.

**Richard Driehaus 1942-2021**

Richard Driehaus passed away in March. For the first 18 years of my career, I was an analyst and then portfolio manager for Driehaus Capital Management. When I joined the firm, it was mostly known as a brokerage firm and for its work with the American Century Funds (formerly 20th Century Funds) in Kansas City. The firm grew from 10 people to around 150 during the years I was there. Richard Driehaus was known for his outstanding record as a growth stock manager and was a true pioneer in the field. At the end of 1999, Barron’s recognized him as one of the 25 most influential mutual fund investors of the 20th century. This was all the more

remarkable because he never managed a large mutual fund and was not a high-profile investor by most measures.

The investing principals I learned from Richard were timeless ones and went far beyond the limited scope of the growth vs. value debate. The most important lessons were: (1) always think for yourself, (2) do your own research, (3) be open to new ideas and business models, and (4) always be willing to take a large position when your conviction warrants it. The following story illustrates how each of these were applied:

In an interview for the book *New Market Wizards* by Jack Schrager, Richard told the story of a young analyst (who happened to be me) who brought him a recent IPO called Home Shopping Network. HSN, a predecessor in some ways to Amazon and other online retailers, had developed a business model of a cable television channel whose only programming was to sell merchandise all day. While the merchandise and much of the programming was a bit schlocky, the demand for their product was huge. Furthermore, the business had amazing scale because each time a new cable system was added (at minimal cost) the number of viewers increased. Richard instantly recognized the beauty of this business model and within a short time HSN became his largest position ever (at that time). The stock subsequently made a huge move.

Fast forward to a few quarters later and the same analyst returned from an on-site investor day with news that, while the company was still growing by adding new cable systems, sales growth on the older ones was actually slowing down. Richard heard this information over the weekend and on Monday began to unload his position. Within a short time, he was no longer a shareholder. Richard's ability to recognize a new concept, make a large investment, and then turn around and sell on a single piece of crucial new information were remarkable, and were some of the qualities that made him a truly great investor. On a personal level, he was a gracious, generous and profoundly kind person. He gave me many career opportunities for which I will always be grateful.

**Firm Updates**

As we mentioned last quarter, after a great 10-year relationship with Ranger Capital in Dallas, our firm made the decision to part ways at the end of 2020. The transition, which was cordial from both sides, has been very smooth. Our new name, Western Pacific Wealth Management, is meant to highlight our Western roots and show our focus on helping individual investors and high net worth

families achieve their investment goals. My new partner, Roger Johnson, who lives in the beautiful town of Bend, Oregon, has been a client and good friend for more than 10 years. He's had a very successful career as an investment counselor and portfolio manager.

As always, thank you for your support. Please feel free to call us at 847-987-8015 with any questions.

Best Regards,

William R. Andersen
Western Pacific Wealth Management
263 Market Square, Suite B
Lake Forest, IL 60045
847-987-8015
bandersen@westernpacificwealthmanagement.com