Fourth Quarter 2021 Investor Letter

Review

Stocks were strong in the fourth quarter, with most major indices rising about 10%. Market leadership in the quarter came from the same US large cap stocks which led the market higher for much of the year. International stocks, US bonds and commodities all lagged during the quarter. The US economy grew a very strong 6% for the year, and earnings for stocks in the S&P 500 were up 45% as the economy recovered from a weak 2020. Estimates for 2022 are for earnings to grow an additional 9%.

Interestingly, while large cap growth shares led the market higher, many smaller, more speculative growth shares substantially underperformed the market in the fourth quarter and for the year. We have highlighted this phenomenon since our first quarter letter last year, and it continues to be a trend as 2022 begins.

The market is off to a rocky start in 2022 but for now we are maintaining our overall positive outlook. Earnings should continue to recover, and inflation is likely to moderate (see below). There will almost certainly be a series of interest rate increases by the Fed, accompanied by a phase-out of the emergency policies implemented at the beginning of the pandemic. That said, these actions are widely anticipated and, in our view, are more likely to cause short term volatility than a prolonged market decline.

As with any year there are significant risks of which investors should be aware. First, the level of inflation is higher than it has been in many years, which poses a risk to all financial assets. Should inflation accelerate financial markets would most likely suffer a difficult period. Second, the resolution of the pandemic, which has lasted longer than most people expected, is still not known, posing a significant risk for the economy and investors. Third, there are significant geopolitical risks in places including Taiwan and Ukraine which could unsettle financial markets during the year. Fourth, valuation is also an issue for equity investors, as most markets continue to trade at above average levels. It is possible that 2022 could be a year where earnings grow but markets lag due to the earnings gains already being "priced in."

We also remind investors that the biggest risks to financial market are likely to come from things we haven't thought of, since they are the sorts of things which are likely to surprise investors and cause market volatility.

Inflation Update: Supply Chain Shock Causes Higher Price Levels

Since inflation started to appear in the economy last spring there has been a debate about what was causing it and how long it would last. Initially the Fed and many economists attributed higher price levels to the aches and pains of restarting the global economy. There was some reason to hold this view, as the spring saw many short-term spikes in commodity prices, many of which soon reversed. Since that time, however, inflation has continued to increase, and it is now clear that the increase in inflation will be more severe and prolonged than they anticipated.

What changed since the spring? Quite a bit, it turns out. Here are a few factors which were not anticipated by most analysts and our views about how they have impacted inflation.

First and most importantly, the pandemic did not end. There was a lot of optimism early in the year that vaccines would effectively end the covid pandemic. The number of new cases in the US fell dramatically from over 200,000 per day to under 10,000 per day by early summer. There was reason to expect that the US economy could be back to something close to normal by the end of the year.

The continuation of the pandemic has had an extremely unequal impact on the economy. For those who have kept their jobs and can work remotely, things may seem pretty good. For those who need to go to into work every day, it is a different story. Many of these workers now feel like they are taking a large amount of personal risk to earn a living by working in a restaurant, driving a truck or working in a factory. While most may not feel this way, if 10% of them decide their job is not worth the risk, it significantly impacts the labor force. For those who took Economics 101, this amounts to an upward shift in the supply curve for labor which means wages rise for many types of jobs. In our view this accounts for much of the disruption in the supply chain. This situation is compounded by the fact that wages for low level jobs have lagged far behind the rate of inflation in recent decades, meaning that they may need to rise substantially to reset to the levels where they have been historically.

Second, fiscal and monetary stimuli remain in place from the beginning of the pandemic, and there is no doubt that government activity is stimulating the economy. The tax cuts and covid-related stimulus programs in recent years are classic Keynesian ways of stimulating a weak economy. Add in the extreme monetary measures still in place from the Fed's covid response last year and there is basically every form of economic stimulus in place in a booming economy which grew a very strong 6% last year. In some ways it would be surprising if there were no inflation under these conditions.

What does this mean for investors? First, high levels of inflation will cause uncertainty. Since most market participants have no or little experience with high levels of inflation, it is reasonable to expect substantial volatility as markets and investors come to terms with a higher level of price increases. Many news stories and many investors will default to the worst-case scenario, even though this is far from the only possible outcome. Just as most recessions do not result in a replay of the Great Depression, most periods of inflation do not result in a period like the 1970s in the US or the even more dramatic examples of inflation from Latin America or pre-World War II Germany.

Second, at some point there is likely to be a reset of interest rates towards higher levels. While interest rates have been abnormally low for many years, it is highly unlikely that short- and long-term rates can remain at current levels if inflation stays anywhere near expected levels. We would therefore suggest being very cautious with fixed income investments and to avoid reaching for yield by extending maturities or risk levels.

Third, watch for a change in expectations of inflation as this would be a big negative for the economy. When investors, employers, and workers start to expect high inflation, it begins to impact many parts of the economy in a negative way. Workers demand higher wages because they expect higher prices. Prices increase because of higher wages. Investors factor higher inflation into their valuation of bonds and equities. All of these factors can end up feeding on each other in a cycle that becomes hard to break. This chain of events occurred in the 1970s and it took years for inflationary expectations to fall.

The worst-case scenario for inflation is still far from the most likely one. In fact, episodes of high inflation in the US which did not arise from a war (e.g., the Civil War, World War II, Vietnam) have been relatively rare. Still, it is good to be aware of the potential dangers of high inflation.

Is Value Still Relevant?

In the 1980s and 1990s it was widely accepted that the long term returns from value investing were superior to those from growth investing. While the data showed that growth investors periodically experienced brief, exciting periods of outperformance, it also showed that these periods tended to end badly, and that when the dust cleared value always seemed to end up on top. (The boom-and-bust cycle in technology shares in the late 1990s and early 2000s was perceived as a classic example of how growth investors eventually blew themselves up at end of each cycle.).

The same studies which favored value stocks also showed that small cap stocks outperformed large cap, which led to the well accepted conclusion that small cap value shares were the best bet for the long term.

What are investors to make of the past decade, when large cap growth shares have persistently outperformed everything else? Is this just another period of growth-investor excess which will eventually end in tears? Or has something changed that makes this time truly different? Here are a few thoughts for investors looking to answer this question.

One thing which can be said for certain is that the principles of value investing are as true today as ever. Buying a company for less than the value of its earnings at some point in the future remains the most important principle in investing, and it always will. This literally is what is meant by being an investor. But the fact that this principle is timeless does not mean that in practice its application won't evolve as the economy and investing world changes. As we have written previously, the US economy is primarily service and government-based now, which is much different than 100 years ago when agriculture and manufacturing were the two biggest industries. This development has had the impact of making our economy less cyclical than it once was, with fewer and shallower recessions than in the past. It has as also made earnings more predictable. It is possible that this increased predictability has made it easier for market participants to look out further in forecasting earnings than they have in the past. This approach has historically been associated with growth investing. At the same time, the insight of the great value investors was traditionally the ability to look past the current recession or crisis and see what the value of corporate assets might be when the economy recovered. The ability to add value from this insight may have been diminished in a world with fewer deep recessions.

Warren Buffett has stated that growth can be thought of as a component of a company's value. To illustrate his point, imagine two companies which each earn $100 per share. Company A is profitable and but has no growth and sells for a multiple of 12, or $1,200 per share. Company B has steady, profitable growth of 15% per year and sells for a 20 times earnings or $2,000 per share. Since the two companies each have the same earnings per share, the difference in valuation of $800 per share for company can be thought of as the additional amount investors are willing to pay for the growth component of Company B's earnings. (For this example we have not taken into account capital structure or differing returns on capital but the point would be essentially the same.)

Our answer to the question posed above is that the principles of value investing are as important as ever, but the way in which they are applied may be different than in the past. In that sense, the world of investing, like all parts of our economy, is always evolving.

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