First Quarter 2022 Investor Letter

Market Review

Global stock markets fell in the first quarter, with the US market falling 5.3%, its biggest loss since the pandemic began in the first quarter of 2020. Shares of growth companies were the worst performers, with value stocks and dividend paying stocks holding up relatively well. Continuing a trend which we have highlighted over the past year, shares of the fastest growing, highest multiple companies fell the fastest. In fact, these companies went into an accelerated decline in January which can sometimes be a signal that a decline is reaching its end. At market lows in February, the NASDAQ has fallen over 20% from its high, while over 40% of the shares in the NASDAQ have declined 50%.

The biggest geopolitical event of the quarter was Russia's invasion of the Ukraine. The invasion was met with a surprisingly strong response from the Ukrainian military, which benefitted from strong support from Western democracies and unprecedented sanctions against Russia. The bellicose rhetoric of Russian President Putin, who indirectly threatened to use nuclear weapons in the event of direct intervention by the West, had an impact on financial markets at the beginning of the conflict.

The outlook for economic growth in 2022 was reduced during the first quarter as the war and higher inflation caused economists to reduce their forecasts for the year. Estimates for earnings growth have also been reduced. At the beginning of the year, Goldman Sachs forecasted 8% earnings growth for US companies. They recently cut this estimate to 5%. GDP forecasts for 2022 were also reduced during the quarter, as higher interest rates and energy prices have slowed economies worldwide.

Inflation continues to be an important concern for Americans. It is now clear that the experts who thought the inflation seen at the beginning of the economic recovery was transitory were far too optimistic. The original price increases caused by short term dislocations related to restarting the economy soon gave way to inflation caused by supply chain disruptions. Now higher energy prices are adding to inflation in all parts of the economy. The Fed is now in the difficult position of trying to reduce inflation by raising interest rates while not causing a recession.

Inflation and Fed Policy During Covid and Financial Crises

After the 2008 financial crisis, the Fed embarked on an unprecedented financial program designed to help save the banking system and to revive the global economy. Critics at the time warned that the program could cause higher inflation but, in fact, the inflation never materialized.

In 2020, the Fed was faced with the covid crisis and turned to a similar playbook. In March 2020, it launched an asset purchasing program on an even larger scale than the one in 2008-2009. Critics again

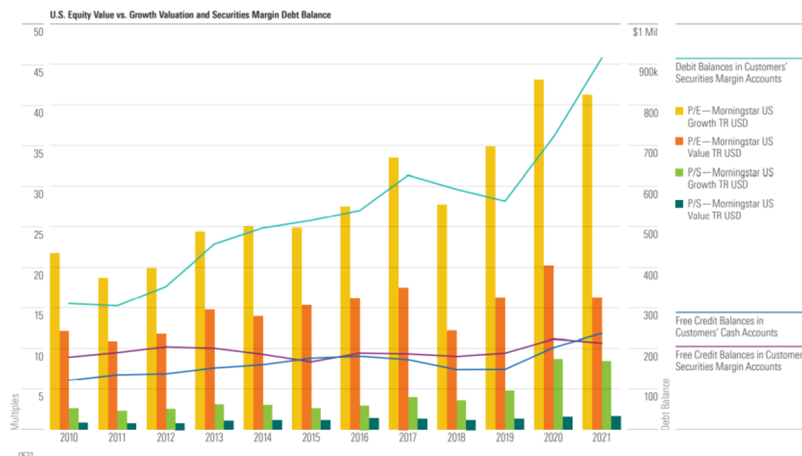
argued that the plan would be inflationary while economists at the Fed argued the opposite. This time, of course, the results were the exact opposite of the previous program. Economists who predicted inflation were correct, while those at the Fed and elsewhere were wrong.

What was different this time? While this topic will be debated by economists for years, here are a couple of possible explanations. First, the Fed's 2020 asset purchase program was larger and broader in scope than the one following the 2008 financial crisis. It could be that there is a limit to how much the Fed can grow its balance sheet without triggering inflation. Secondly, the context in which the two programs were implemented was substantially different. The 2008 crisis was a debt crisis which harmed the banking system and reduced the value of collateral. It was inherently deflationary, and this offset the inflationary impacts of Fed policy. The 2020 crisis was in many ways the mirror image of 2008. Rather than being caused by too much debt, it was caused by an artificial reduction in demand during a period of otherwise robust growth. This meant that there was no deflationary offset to the Fed's stimulus efforts. In addition, in 2020 and 2021 Congress passed two huge fiscal spending programs designed to lessen the impact of the crisis. The combined result of these monetary and fiscal programs was to trigger inflation as soon as the artificial restraint on demand ended. There will be a lot more said on this topic in the future, but for now these are some possible explanations for why inflation is so high.

Stock Market Valuation Update

In the years since the financial crisis of 2008-2009 equity markets have been in a persistent uptrend. From a low of 6,600 during the crisis the Dow has risen its current level of over 34,000. Some market observers to say that markets are in a "bubble", a term used to describe a period when valuations are at unsustainable levels and prices are driven more by speculation than fundamentals.

Are we currently in such a period? The answer, in our view, depends on where you look. Consider the following chart from Morningstar Markets Observer.



Essentially it shows the PE multiple of two different sectors of the market over the past decade. As you can see, the PE of Morningstar's "Growth" category has been on an upward trend during this period. The average PE of growth stocks was around 20, at the beginning of the period, and is currently about 40. To put it another way, investors are currently willing to pay about twice as much

for growth stocks as they were 10 years ago. That is a big change. On the other hand, look at the valuation of value stocks. During the same period, the multiple on these shares has increased from 12 to 15. An increase yes, but nothing like a bubble.

Our advice is to be very careful when someone makes blanket statements about whether the market is under or overvalued. In most cases the person making the statement is deliberately oversimplifying the situation to make a point or get attention. The truth is generally more complex, as it is in the current situation.

Three Parts of the Investment Process

At any given point investors must consider a myriad of factors related to financial markets, geopolitics, the economy and their own financial situation. Each of these is enough to require a substantial amount of time, and the fact that many of these things seem beyond our control can make it even more stressful. A recent poll showed that three of five Americans wake up thinking about their financial situation.

As with anything complicated situation it can help to break it into multiple steps and look at each of them individually. We will focus specifically on the investment process and three important parts within that process which are essential to maximize the chances of long-term success.

1. *Asset allocation*. This part of the process deals with how much of a portfolio to invest in different asset classes such as stocks, bonds, real estate, cash etc. Decisions on asset allocation should be made taking into account the overall investment environment, but, equally importantly, the specific financial situation of the investor. How many times have we all been told that the best long-term returns come from owning stocks? This is basically true, but if having all your money in the stock market causes you to lose sleep or to make bad decisions such as selling out every time the market falls, then this allocation may not be the best for you. That said, asset allocation is possibly the most important decision most investors and their advisors will need to make.
2. *Portfolio Management*. Portfolio management refers to the process of managing a portfolio of stocks or bonds. It involves making a judgment about how various securities fit together in a portfolio, how much to concentrate and diversify, how much of each security to own, and when to buy and sell. The goal of the portfolio manager is different from the asset allocator. The portfolio manager should be looking to outperform his or her peers and as well as a benchmark, over a full market cycle. If they can't do this, they can be replaced by another manager or by a low cost index fund.
3. *Security selection.* Security selection is the process of identifying, researching and making a judgment about the investment potential of specific stocks. This step is what people often think about when they think of investing. Finding the next Google or Apple before other investors is one of the ultimate goals of people in this field.

One reason it helps to understand this process is because in conversation or in the financial media people often confuse the different steps. An analyst on television may be talking about her favorite

stock idea but give no consideration to how much of it would be appropriate for a particular investor to purchase. Someone else may be discussing a big international news development and its impact on financial markets. While it may be fascinating and important, investors should ask themselves whether what the person is taking about should have any impact on their personal asset allocation which they have decided on after careful deliberation. Not to mention is whether the issue under discussion is really going to impact how the fundamental outlook for any specific companies over the next few years (probably not).

The End of Globalization?

The war in Ukraine and worsening relations in China have led some prominent investors to speculate that we could be reaching "the end of globalization." This would mark a seismic shift in a force which has driven economic growth since the end of the Cold War. If globalization is dead, investors should almost certainly expect much slower economic growth in decades ahead.

We don't believe this is the case. Globalization is based on important economic principles which date back to Adam Smith, who wrote *The Wealth of Nation*s in 1776. Smith, generally considered the first modern economist, laid out a strong case for global trade based on the relative advantages which individual countries enjoyed in particular industries. Without going into too much detail, Smith showed that overall wealth was increased when countries produced the goods they were best at. These principles hold up today as they did back then.

Does this mean that globalization won't evolve? Of course not. It may be that in the future trading partners will put pressure on each other to abide by stronger environmental standards, or pay higher wages, or not invade their neighbors. It could also mean that globalization will take a place alongside other economic goals rather than being one of the most important drivers of economic growth as it has been since the end of the cold War. All these things can happen without losing the vital benefits of international trade. Simply put, the benefits from global trade are too important to the billions of people seeking a better life to be ended over any of the political or economic disputes the world currently faces.

Thank you for being a client. Please feel free to call if you would like to discuss your investments or any topics in this letter.

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