Fourth Quarter 2022
Investor Letter

Market Review

The S&P 500 rose 7.6% during the fourth quarter of 2022 and fell 18.1% for the full year. Overall, it was the worst year for stocks since 2008, and the 3rd worst year since 1985. Bonds also fell during the year, with the Barclays Aggregate Bond Index down 12.7%. The decline in the bond market was the greatest since the Barclay's Index was created in 1976. For context, the second worst decline was only 2.9%.

2022 saw an unusual amount of performance dispersion among different parts of the stock market and other asset classes. For the most part, it was a year where assets which had become the most highly valued saw the biggest declines, while those which hadn't participated in the recent bull market held up relatively well. To illustrate, it is estimated that so called "growth" stocks underperformed "value" stocks by nearly 30% in 2022.

The decline in equities in 2022 took place in the first half of the year. The second half saw two ferocious rallies followed by significant declines. Overall, the stock market was about flat in the second half of the year.

As we've stated in previous letters, the catalyst for market declines this year was higher than expected inflation and the Fed's attempts to combat it by raising interest rates. At the end of 2021 the Federal Reserve (also called the Fed) realized that inflation was not a short-term phenomenon resulting from dislocations after the pandemic, but rather a more significant and potentially long-term problem. From that point they moved extremely rapidly to lower inflation by raising borrowing costs and hopefully slowing the economy. As we explained in our letter last quarter, a rapid increase in interest rates has the biggest impact on growth stocks and long-term bonds, since their valuations are based on earnings and interest payments far in the future. Since these assets were the most overvalued anyway, the price declines were the most dramatic.

There is some evidence the Fed is succeeding in lowering inflation. The most likely (although far from certain) scenario for 2023 is that there will be a slowing in Fed rate increases as inflation declines and the economy slows. It is reasonable to forecast that the economy could have a recession at some point this year, although the timing, severity and duration are impossible to predict.

For the first time in decades, the yields on short-term instruments are relatively attractive in our view. We have responded to this change by purchasing treasury securities for most clients. It is possible that the era of ultra-low interest rates is over. Should that be the case, fixed income instruments could once again become a key part of investors' portfolios.

Recession Watch

If concerns about inflation are reduced this year, attention will turn to the strength of the economy. If there is any consensus about the performance of the US economy, it is that a recession is possible in 2023. Most every major Wall Street house has built some likelihood of a recession into its forecasts.

History shows that every time there has been a spike in inflation in the past 60 years there has been a recession. Some have been mild, while others have been more severe. Every time the Fed has tried to slow the economy under circumstances like today's, the unemployment rate has ended up over 6%. (It is currently 3.5%). The odds favor a slowdown sometime this year.

What does all this mean for investors? Probably not as much as we think. For all the effort expended, it isn't at all clear that forecasting the economy is of much value to investors. As Warren Buffett has said, "If you guaranteed me there would be a recession next year, I would be buying and selling the same securities I am buying and selling today." If Warren Buffett can't make use of economic forecasts, what is the likelihood that other investors will have much success? (The answer lies in the fact that, as humans, we all wish to know what the future holds. We know on some level that the future is unknowable, but that doesn't keep us from trying to figure it out.)

Our strategy for 2023 will continue to be to work with our clients to set an asset allocation which makes sense for their unique circumstances, and then focus on allocating capital to investment advisors who we believe will be good stewards of their capital.

The End of the FANG Era

Every investment era has certain stocks or themes that define it. Sometimes those themes are good ones—in the 1970s there was a famous group of stocks called the Nifty Fifty which was composed of a group of companies which went on to be great: IBM, Kodak, Avon and others were in this group. In other times the companies which catch the imagination of investors lack compelling fundamentals but fit into a promising theme: think of that many companies from the dotcom era that saw their shares rise and then crash.

The most recent bull market provided examples of both good and bad investments. Meme stocks, speculative companies with no earnings, and cryptocurrencies were all similar to the dotcom stocks and most will have a similar fate. On the other hand, some of the leading stocks from the most recent period are among the greatest companies that US or world has seen in terms of most financial metrics. At the peak, the largest of these were given the acronym FANG, which stood for Facebook, Apple, Netflix and Google. Each of these companies was an analyst's dream: they had huge market shares, high returns on invested capital, addressed growing markets and were able to scale virtually infinitely. These stocks sold at high multiples of earnings, but they were justified due to their incredibly rosy outlooks.

Then things changed. While a lot has been written about the decline in valuations of large tech companies this year, less has been said about the negative changes to the business models of many of the leading companies. Facebook, Netflix and even Google are all facing challenges to their near monopolies which make their futures look less optimistic than their pasts.

One lesson from this recent period is that virtually no monopoly nor business model evades competition forever. Our economic system encourages competition, forcing entrenched companies to evolve or decline. Of course, nobody expects the FANG companies to go away, but investors may do well to look to the next generation of growth companies for the best returns.

Despite Forecasts, US to Remain World's Leading Economy

A year ago in this letter, we asked the question whether value investing was still relevant (fortunately we said yes). Our point was partly to illustrate how, after a long period of outperformance by growth stocks, investors were starting to question whether the traditional metrics used by value investors like Warren Buffett even mattered anymore.

Today we often hear similar statements about the US and its democracy. Many citizens (of all persuasions) feel like our democracy has lost its vitality, that our economy does not work like it used to and that the period of US dominance in the global financial and political system will soon end. People in this camp use words like "late-stage capitalism" to describe problems or excesses they see in our economy, as though there were a viable system to replace it.

This line of thought has been around for a long time. Eleven years ago, I wrote the following about Nouriel Roubini, one of the chief pessimists today:

A mini-industry has evolved to capitalize on negative economic thinking. Last week at the annual Milken Global Conference, a debate was held between Mike Milken and Nouriel Roubini. Roubini, a professor and former IMF economist who now has a successful consulting firm, has become one of the chief proponents of the negative long-term view. To his credit, he was one of the first to point out the evolving problems in the housing market, several years before they became apparent to most others. While that was a great call, he has remained very negative even in the face of evidence supporting a recovery. Roubini, who has a vampire-like quality, has in our opinion a sort of caricature view of the U.S. which is common to many Europeans. This view holds that the U.S. is past its prime and lacks the political and economic will to face and overcome great challenges. While it's certainly easy to see how someone could have this impression by reading the papers or watching cable television, the United States' long-term track record of successfully addressing large problems shouldn't be discounted.

We disagreed with the negative view back then, and we disagree now. While it is true that the US has many challenges (as it did in 2012), our country still is uniquely positioned to address its challenges and remain a leader of the world. One needs only to look at the horrible human rights records, wars of aggression and recent sham elections in the leading candidates to replace the US as world leader, to see how essential we are. It isn't an exaggeration to say that a world dominated by any other country would be a worse place in every way.

In the early 1990s, just after the fall of communism in Eastern Europe and the Soviet Union, I had the opportunity to establish one of the first US investment research offices in Prague, Czech Republic. It was a time of great optimism for many people. Eastern Europeans were happy to finally be rid of the oppressive Soviet Union. Americans and Western Europeans were happy to be over the Cold War. There was a view that, with Communism finally out of the way, human freedom and liberty would finally be able to flourish. Some were forecasting that all of Eastern Europe would like the West in as little as five years. Others were more cautious, saying it would take a generation or more.

What we've seen since the end of the Cold War has been a mix of success and disappointment. Some counties like the Czech Republic and Poland have done relatively well. Others have done much less well. None have risen to the point that they would be a viable alternative to the US as world leader. For different reasons (and for a different letter), the same is true of the nations of Western Europe. The point is that no country in Eastern or Western Europe, Asia, Latin America or anywhere else is equipped to offer the combination of economic, military and moral leadership that the US can provide. This doesn't mean the US will succeed, of course, but it shows how important our responsibility is.

Thank you as always for being a client. Please feel free to reach out to Roger or me with any questions you may have.

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