March 31, 2022

Quarterly Letter to Investors

First Quarter 2022

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During the first quarter both stocks and bonds broke recent form by producing mixed-to-negative returns. We saw that volatility increased as stocks experienced their most significant decline since 2020 only to rally significantly toward quarter-end. Bond returns were negatively impacted by inflation pressures and Federal Reserve (Fed) policy. Both short and longer-term issues declined in line with rising yields. We watched as uncertainty prevailed as a primary influence in both markets, leaving investors in a nervous state.

> "Facing it—always facing it—that's the way to get through...
> That's enough for any man. Keep a cool head."
> ~ Joseph Conrad, *Typhoon*

Can one imagine the radical uncertainty of commanding a steamer ship in the face of an oncoming typhoon? Conrad describes it masterfully in his novella, and the captain renders advice to his junior as to how to navigate the uncertainty: face it and sail into it. As investors, we rarely face such radical uncertainty, but currently there is plenty of uncertainty in the air, and we have no choice but to deal with it. If we face it and keep a cool head, we have a chance of coming out safely on the other side.

Of the many uncertainties we face today, we believe the greatest is that which surrounds the potential outcome of the conflict between inflation and the Fed and the implications for the financial markets. Stock valuations and the trend of interest rates are at stake. There are many angles to this situation, hence, the higher level of uncertainty. Let's explore several of the issues.

INFLATION. To know that inflation is running at a 40-year high is to know that we have a problem. How did we get here so quickly? Basically, we feel that it took a combination of two factors: 1) a global pandemic which proved to be a very disruptive economic event, and 2) well-meaning, but in retrospect, overzealous monetary and fiscal policy. As the global economy was shut down in early 2020, all economic activity on both the demand and supply sides ceased for a brief period, leading to the shortest recession in our history. Unemployment in the U.S. rose quickly to 15%. Naturally, this caused alarm among policymakers, and aggressive initiatives were undertaken immediately. Both monetary and fiscal policy became hyper-stimulative, the combination of which led to a quick rebound in demand, even before the lockdowns ended. However, the supply side was interrupted by clogged ports and continuing lockdowns across the globe. In short, demand overwhelmed supply, and with the emergence of each Covid variant and subsequent surge in cases, supply lines were disrupted again and again. Most recently, the sanctions imposed on Russia have been one more complicating issue for the supply side.

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The level of inflation is always a function of an imbalance in supply and demand. For decades we enjoyed declining inflation, primarily due to a shortage of demand. This put suppliers at a disadvantage, inhibiting their ability to raise prices. Now, the reverse is true: there is an excess of demand. The question is, has a 50-year secular trend of demand shortage been permanently reversed? The answer to this question, uncertain at this point, will likely decide the future course of inflation.

THE FED'S RESPONSE. The only institution in our government that is able to effectively fight inflation is the Fed. In fact, it is part of their mandate to ensure stable and low inflation. The target is 2%. Obviously, at 8%, inflation is running far above target, so they have reversed policy and now are on a path of raising the federal funds rate, the chief policy tool. One 25-basis point increase in federal funds has been implemented, and the signal is that another six increases will follow this year, reaching a rate of 2.8% by year-end 2023. In addition, the Fed will be reducing its balance sheet, but to what extent is unknown. Time will tell if these measures will be sufficient to tame inflation. Again, the answer is uncertain.

In essence, the Fed is trying to thread a needle. The effort is to pull off a "soft landing" in which demand is crimped just enough to cool things down to allow inflation to recede. The risk is that in turning the policy dials, the ultimate effect is too severe, leading to a recession. Unfortunately, in the past this has been the outcome more often than not. In conclusion, the Fed faces a very difficult task, and we certainly wish them success in this endeavor, for much hinges on the outcome.

A FRAMEWORK OF CERTAINTY. When dealing with the future there is never complete certainty, but there are circumstances under which uncertainty is reduced and economic forces can unfold in a more predictable manner. We believe that such a framework was in place immediately prior to the Covid pandemic. The economy was not working perfectly, but its performance was acceptable with real Gross Domestic Product (GDP) growth averaging around 2%, inflation low and stable at near 2%, full employment, and low interest rates. Considering where we are now, notably way out of line on inflation, a return to such economic conditions would be desirable. It is the goal of the Fed to help us get back there, a worthy goal, but as we have just written, a difficult task indeed. The transition back to that state of affairs has been delayed. This should not be surprising, for macroeconomic events are complicated, and too many forces are at play for things to move smoothly in one direction. But if the inflation problem can be handled reasonably well without the severe interruption of a recession, there is a decent chance that the transition back to what we call normalcy can be achieved. The economy is already at full employment, and if inflation cools, interest rates should be contained at reasonably low levels. Undoubtedly, such an environment would offer more compelling economic certainty.

INVESTING IN A WORLD OF UNCERTAINTY. We have highlighted some of the uncertain economic issues and only obliquely referred to the uncertainty of the Russia/Ukraine war. This invokes what we earlier referred to as radical uncertainty, which arises from the possibility of expansion of the war beyond Ukraine to the involvement of countries with nuclear weapons. Geopolitical uncertainty always exists in one form or another, and currently, it has been magnified.

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While Joseph Conrad was not offering advice on investing, we can apply some of his navigational wisdom to the investment question. First, we can face the uncertainty before us and be honest about the risks involved. Uncertainty and risk are related, and where uncertainty exists, risk also dwells. Just being realistic about the uncertainty and what risks it brings is the first step, to be followed by investing in the type of securities that have the best chance of succeeding in an uncertain environment.

Actually, our investment philosophy is anchored in the assumption that the future is always uncertain, and as such, the range of potential outcomes for any particular investment is wide. Uncertainty widens the range; more certainty narrows the range. To the extent possible, we want to bring more certainty to our investment choices by focusing on quality. Whether it is on the equity side, where we focus on unusually consistent businesses, partially evidenced by consistent and rising dividends over the long term, or on the fixed income side, where we concentrate efforts on the balance sheet and the basic strength of the underlying business, it is the quality of the company that counts for us.

As Conrad suggests, keeping a cool head is always the best posture. The more quality one has in the portfolio, the easier it is to keep a cool head. Quality also bolsters confidence and helps bring decisiveness to the decision-making process. We feel it is always easier to commit to a really strong company. We do not expect all of the uncertainties we have discussed to be resolved in the near term, but until we again enjoy an environment of greater certainty, we will face the uncertainties with confidence that quality will prevail and get us through.

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