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Quarterly Letter to Investors

Second Quarter 2022

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During the second quarter, both stock and bond investors were forced to endure bear market conditions. We believe this is highly unusual, but we are living in unusual times. Stocks ended the quarter with declines of more than 20% year to date, the official bear market marker. While there is no official definition of a bear market in bonds, surely -11% total return on the 10-year Treasury note qualifies. Needless to say, it has been a challenging period. In this letter we will provide our assessment of why the markets are performing so poorly, our outlook for the future, and our best advice on how to work through these difficult times. Given the negative circumstances in the markets, we are very pleased with the relative performance of the portfolios and the defensive characteristics they have shown this year.

"I have but one lamp by which my feet are guided, and that is the lamp of experience."
~ Patrick Henry

Patrick Henry, the fiery orator of revolutionary days, is most often remembered for saying, "Give me liberty or give me death." In the same speech, he gave us the above advice on being guided by experience. Our firm now has more than 41 years of experience during which we have endured much, including five recessions and related bear markets. We have seen a lot and learned a lot. This experience is valuable, and like Patrick Henry, we are guided by it. Importantly, our experience has taught us how best to get through a bear market.

WHY BEAR MARKETS? It is very easy to identify the immediate cause of the turmoil in both stocks and bonds. It is inflation. Running at the headline rate of 8.5%, the highest in 40 years, this is a staggering number. It represents a condition that is stressing consumers and companies. A worldwide phenomenon, it insidiously erodes purchasing power and wealth, destroys confidence, and impedes forward planning for investment. High inflation is a bad thing, and the stock and bond markets are reacting negatively to it.

The reasons we have this inflation are well rehearsed. The Covid pandemic is at the heart of it, leading to what in retrospect were excessive fiscal and monetary responses, repeated supply side disruptions, and continuing lockdowns in China. Finally, the Russia-Ukraine war has further complicated supply side problems. Now the question is, can inflation be brought back under control? Alan Blinder, former Vice Chair of the Federal Reserve (Fed), recently said, "Inflation is not transitory, but it isn't permanent either." The Fed has the tools to reduce inflation and as Chairman Jerome Powell commented, "In the fight against inflation,

defeat is not an option." The primary tool is interest rates, and the Fed is moving aggressively to raise rates in order to reduce demand and restore balance between supply and demand.

Our view is that 8.5% inflation in the United States is unacceptable, and as a result there is tremendous pressure on the Fed to correct the problem. We expect eventual success in the fight against inflation, but we are also very much aware that getting there will not be easy. We see this as a serious problem for our economy, and the timing of the outcome is uncertain. Investors should be prepared for further difficulty, for the fallout from these measures can be damaging. It will require a deft move by the Fed to reduce demand just enough to impede inflation without bringing on a recession. And that is the crux of the matter in the markets. In the past, raising interest rates to fight inflation has more often than not been followed by a recession. Recessions do reduce demand, and this causes unemployment to rise, company earnings to contract, and stock prices to fall. All of these are factors that investors are considering as conditions deteriorate in the markets.

INVESTING IN BEAR MARKETS. We offer three pieces of advice that, from our experience, we have learned to be helpful in navigating through bear markets: 1) keep the long view, 2) stay invested, and 3) rely on quality. Our advice should come as no surprise, as long-standing clients know that we have consistently employed these approaches over our history.

Keeping the long view helps with perspective. The five recessions that have occurred over the past forty years lasted from as long as two years to as short as two months. We are not predicting a recession, although we recognize the risk of one, and investors are increasingly expecting one. It is important to keep in mind, should one occur, that they are relatively short in duration, and in each instance the U.S. economy has recovered and expanded to new, higher levels of real Gross Domestic Product (GDP). These recovery/expansion periods have been on average much longer than the contractions, extending as long as eleven years in the latest instance. Even though the economy experiences periodic interruptions due to imbalances, the basic condition of the economy is to grow. We have no doubt that, should we experience a recession over the next year or so, it will end, and growth will resume. Our economy is resourceful, and we have institutions that are capable of correcting imbalances and restoring stability. While the implementation of remedial measures can be unpleasant, they are necessary over the short term to ensure proper conditions for the longer term. Our advice is to keep the longer view.

We advise staying invested for the longer term. Bear markets put enormous pressure on investors. No one likes to lose money, and it is tempting to hit the panic button and sell everything. We believe the best way to limit actual losses is to stay invested through even the worst of markets. Bond investors at least have the option of recouping losses by holding to maturity, but stock investors have to depend on corporate earnings and dividends to recover, and that can take time. Even so, we are reminded of the saying that "the market pays you when it wants to, not when you want it to." Returns never occur in a straight line. They are variable and can be volatile, but if holdings are undergirded by rising earnings and dividends, the holder is set up to profit when the market does respond positively.

There is ample statistical support for the idea of staying invested for the longer term. Attempting to time the market is futile. No one can consistently and correctly identify when to sell and when to repurchase. Time and again we have seen investors panic and sell out, hoping to reenter at a better time. The fallacy of this is that the market begins to recover when things still look bad for the economy, and furthermore, some of the initial moves in the market's recovery phase are the largest. Rather than miss out on these strong moves, it is better to remain invested, positioned for recovery. In our Economic and Market Environment piece for the third quarter, we elaborate on this point.

Finally, while keeping the longer view and staying invested, rely on quality as the best means of investing in a bear market. With regularity, whether in good times or bad, we tend to end our letters with the advice to rely on quality. Our experience has taught us that quality is the best way to invest for both participation in the upside and protection on the downside. We believe quality is the most dominant characteristic in the portfolios, and as noted above, it is serving us well by protecting on the downside during this bear market. We do not know the ultimate outcome of this market phase, but for now, we are pleased that the inherent quality of the holdings is performing well by limiting the downside.

What is it about quality that works well in down markets? When the economy weakens or suffers from an excess such as the current inflation episode, markets tend to exploit weakness. Money naturally moves from weakness toward strength. And quality means strength – strength in the balance sheet, strength derived from its learned history of how to operate with consistency and predictability, strength in payout ratios that not only support continued dividend payments, but also allow for increases. When storm clouds gather, these characteristics represent attractive hiding places where investors can feel comfortable weathering the storm. We believe the portfolio has sufficient strength to provide protection in this difficult period and will enable us to participate nicely when conditions turn for the better, which they inevitably will.

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