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Quarterly Letter to Investors

First Quarter 2023

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"...the Committee decided to raise the target range for the federal funds rate to ¼ to ½ percent and anticipates that ongoing increases in the target range will be appropriate."

~ Federal Reserve (Fed) statement, March 16, 2022

It is hard to believe that this event occurred only one year ago. It was such a meager move, raising the federal funds by only ¼ percent to less than ½ percent, but it set off what became the most severe monetary tightening in the shortest time period in U.S. history. This small move began a cycle that produced a tumultuous year for the economy, one in which investors in bonds and stocks experienced bear markets, a banking crisis, and the possibility of a recession. And indications are that the tumult is not over. Basically, the cycle of the Fed and its fight against inflation continues to dominate the conversation around investment and the economy. In this letter we will attempt to add perspective for thinking about the cycle and what expectations may be appropriate. We suggest considering the entire cycle in three distinct phases: Tightening, Holding, and Easing.

PHASE 1: TIGHTENING. This is the phase we are now in. The Fed has aggressively raised rates in order to fight inflation, and while inflation is nowhere near the 2 percent target, this phase may be nearing an end. In fact, the Fed itself is suggesting such. Whether there is one more or several increases, at some point they will reach what they consider to be a terminal rate. This will be a level at which they believe that the effect of their tightening will eventually work its way through the economy, and inflation will be moving down toward the target. Should this turn out to be a relatively short phase, it will no doubt be due to the very aggressive manner in which the Fed has raised rates in the last year. If we are nearing the end of Phase 1, this is good news for investors.

PHASE 2: HOLDING. Once the terminal rate is achieved, Phase 2 will begin. This phase will be one where the Fed is watching and waiting. They will want to see evidence that higher rates are affecting the economy. The signs they will be looking for will be inflation falling steadily, unemployment rising, and overall demand in the economy weakening. While the Fed is projecting that this phase will last into 2024, we note that in the past, holding phases have been relatively short. This typically occurs because the Fed has been overly aggressive with their rate hikes, and the economy tips over into a recession. Several factors, most notably a sharply inverted yield curve, are suggesting that this may be the case in this cycle.

PHASE 3: EASING. Since falling interest rates are good for stocks and bonds, this is the phase all investors want to get to. If in fact it takes a recession to get to this phase, it will not be pleasant, for recessions bring with them economic pain, and as the recent bank liquidity crisis reminds us, there are often unintended consequences. When this phase might begin and how far the Fed might cut rates is of course uncertain. However, in the past the Fed has not waited to cut rates until their inflation target had been achieved, and in past cycles, the rate cuts have averaged five full points. Such dramatic reductions may not be the case this time, since the terminal rate is likely to be lower than in past peaks.

INVESTMENT IMPLICATIONS. Our brief description of the three phases of a monetary cycle leaves many questions unanswered. There is great uncertainty surrounding the timing and success of each phase, not to mention the possibility of a recession, and after that, the type of economic environment we will experience when the cycle is complete. The most we can say with assurance is that we are in Phase 1, and we are looking forward to Phase 3.

At this time the range of potential outcomes for the economy is very wide. At one extreme, some believe we have moved into a completely different economic environment than the one we became accustomed to after the financial crisis. Perhaps 2 percent inflation is not attainable and we are destined to live and invest in a world of higher inflation and interest rates. Some suggest we will have to endure a long, secular bear market in both stocks and bonds. On the other end of the spectrum is the outcome that the Fed is working toward and hoping to accomplish: Gross Domestic Product (GDP) growth on a sustained basis of around 2 percent, inflation of 2 percent, and low interest rates. We believe the odds favor something resembling the latter scenario, and in the mode of longer-term optimism, we assume the economy will right itself and once again provide a constructive environment within which companies and individuals can prosper.

How is the best way to invest given this wide range of potential outcomes? If uncertainty is the hallmark of the current economic and investment environment, it seems to us the best way to deal with that uncertainty is to try to replace it with as much certainty as possible in our investment selections. Our overall approach is characterized by quality, which is a way of incorporating as much certainty as possible.

For stocks, we find certainty in the characteristics of the underlying business. Here we note the difference between the short-term volatility of a stock and the longer-term stability of an underlying business. The action of a stock on a shorter-term basis is highly unpredictable. In contrast, think of a business as an organic, ongoing entity that, if managed properly, is capable of determining its own destiny. We focus on how stable a company's business has been over a longer time period. What we have found is that there is more stability and certainty in companies that pay dividends. Furthermore, the more consistent the pattern of dividend payments, the higher is our confidence in the sustainability of the business. What we really like are companies that have increased their dividends every year for a long time. This extended view enables the investor to look beyond short-term volatility and uncertainty with more confidence that the longer-term outcome will be favorable. Of course, our research on individual stocks encompasses much more than the

dividend factor, but it is the starting point, and we believe it brings with it an attractive set of investment characteristics.

For bonds, replacing uncertainty with certainty is even more important. As a more conservative asset class, bonds do not provide sufficient return potential to afford the possibility of credit risk. The balance sheet is the supreme consideration in bonds. With the aforementioned federal funds rate increases over the past year, high quality fixed income today offers yields we have not seen in over a decade. The portfolio strategy we are building around this opportunity is to gradually extend average maturities in order to be prepared for Phase 3 and interest rate reductions. The basic idea is to own these higher yielding bonds for a longer period of time.

We emphasize quality in both stocks and bonds, and in stocks, we insist on dividend integrity. This combination naturally brings with it a defensive element, which we believe is a stabilizer in the return pattern that is likely to roll out over time. Since we believe it is best to remain fully invested for the longer term, that is, not trying to time the market, our goal is to invest in a way that is appropriate for all seasons. We want to participate when the markets are rising, but we also want to protect on the downside when markets are falling. This has been our approach for some 42 years now, and we believe it has successfully guided our clients in the direction of their goals. We perceive nothing in the overall environment of today that would suggest that this approach will not be as successful in the future as it has been in the past.

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