MARKET REPORT
THIRD QUARTER 2021

Key Points

- Fragile is the word of the quarter.
- Stocks were little changed.
- Shiny objects can get you in trouble.
- We continued our series on moats, discussing the network effect this period.

Total Return as of September 30, 2021						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	0.6%	15.9%	30.0%	15.9%	16.9%	16.6%
NASDAQ	-0.2%	12.7%	30.3%	22.7%	23.4%	21.0%
Russell 3000						
Index	-0.1%	15.0%	31.9%	16.0%	16.9%	16.6%
Value	-0.9%	16.6%	36.6%	9.9%	10.9%	13.5%
Growth	0.7%	13.5%	27.6%	21.3%	22.3%	19.4%
Russell Mid Cap						
Index	-0.9%	15.2%	38.1%	14.2%	14.4%	15.5%
Value	-1.0%	18.2%	42.4%	10.3%	10.6%	13.9%
Growth	-0.8%	9.6%	30.5%	19.1%	19.3%	17.5%
Russell 2000 (Small Cap)						
Index	-4.4%	12.4%	47.7%	10.5%	13.5%	14.6%
Value	-3.0%	22.9%	63.9%	8.6%	11.0%	13.2%
Growth	-5.7%	2.8%	33.3%	11.7%	15.3%	15.7%

The Quarterly Review

In reflecting upon the quarter, we pondered what single word could best describe the current investment, supply-chain, labor, political, health and environmental landscape. We settled on: *fragile.*

The investment landscape remained challenging during the period with U.S. stock valuations elevated well above long-term averages and bond yields suppressed. Indexes were little changed. Most asset classes are seemingly priced with a glass half-full mentality, disregarding risks lurking below the surface. Investing without regard for fundamentals and valuations is analogous to driving a car at night without turning on the headlights or wearing a seatbelt. Not a good idea, in our view.

Supply-chain challenges continued as some Asian manufacturers remained closed or compromised and U.S. ports struggled to get containers offloaded and products distributed across the country via trains and semi-trucks. Increased imports coupled with a shortage of dock workers, train operators and truck drivers are leading culprits. Skilled workers and professionals across an array of industries continue to be in short supply. These factors contributed to higher levels of inflation during the period.

New health policies related to vaccination requirements were divisive and the green movement advanced at an accelerating pace. The aversion to COVID-19 vaccinations will likely subside with the passage of time and the *forecasted* adoption rate of electric vehicles and renewable energy over the next decade may be optimistic and have unintended consequences.

U.S. Equities

Value and growth stock averages alike were essentially flat during the quarter, excepting small caps which were down a few percent. Even with value's strong year-to-date performance, value-oriented companies relative to their growth brethren, are nearly as compelling as at any point since early 2000.

In reviewing quarterly data for the S&P 500, Financials (2.7%), Utilities (1.8%) and Communication Services (1.6%) advanced the most while Industrials (-4.2%), Materials (-3.5%) and Energy (-1.7%) were the largest decliners. Seven of the 11 economic sectors advanced. Our equities fared well during the quarter, on average.

In the latter part of September, volatility briefly spiked on concerns that a large Chinese debt-ladened developer would miss interest payments, default and potentially lead to global contagion. The panic subsided, in part based on the belief that Chinese officials would put a tourniquet on the situation before it spiraled out of control. It is too early to know what impact an ultimate default could signal to global markets.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs. index, increased 0.1% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, decreased 0.1%. The 10-Year Treasury yield was only up four basis points for the quarter but increased 16 basis points in the last 10 days of the period to 1.53%. Investment grade credit spreads were little changed during the period.

Fixed-income markets remain very competitive, resulting in unusual scenarios. For example, we recently bid on an industrial company's investment grade bond maturing in a few years and were unsuccessful. The winning bidder accepted a yield at a <u>negative</u> spread to the corresponding Treasury. In other words, the winning bidder could have purchased a Treasury of equal maturity and received a higher yield with no credit risk. This is illogical but happened.

Absent derailment of economic progress in the interim, the Federal Reserve is expected to announce a reduction in its $120 billion combined monthly purchase of Treasury and Agency debt after its November meeting. If this happens, it would be an initial step toward normalizing monetary policy and could eventually lead to improved price discovery.

Commodities, as measured by the Bloomberg Commodity Index, increased 6.6% during the quarter and 42.3% over the last year as demand increased and excess liquidity found its way into financial instruments. Oil (WTI) increased 2.1% during the quarter, 54.6% year-to-date and 86.5% over the last year as supply remained constrained and demand increased. Elevated energy costs in Europe are limiting the production of chemicals, fertilizer and metals. China is restricting metal output to reduce energy consumption and pollution. The impact of swiftly rising energy prices is far reaching. Companies with pricing power will be able to pass cost increases along to end users, yet those without such power could see profit margins squeezed. Consumers should soon begin to feel more of the impact.

Shiny Objects

Over the years we have written about how too much capital flowing into a theme, sector or industry can negatively impact future returns. This largely results because investors become enamored with a concept and disregard underlying economics – bidding the price up beyond any reasonable valuation. Future returns are essentially pulled into a current period. The company then must grow into the valuation ascribed to it which can result in a stagnant stock price for many years.

Occasionally, investors become so captivated that they get hoodwinked by a new breakthrough technology. This seems to have been the case with aspiring zero-emission semi-truck manufacturer Nikola Corporation. According to a Complaint filed by the Securities and Exchange Commission in the United States District Court, Southern District of New York against Trever R. Milton, the founder and former CEO of Nikola Corporation raised more than $1 billion over the “course of several private offerings, and then in connection with a business combination with a special purpose acquisition company” and “painted a picture of Nikola that diverged widely from its then-current reality.”

So, what did the CEO do? Allegedly, he falsely claimed that “Nikola’s first semi-truck prototype, the Nikola One, could be driven under its own power,” and used a “misleading video to create the false impression that the Nikola One was, in fact, driving under its own power.” In reality, it was unable to travel under its own power at the time the promotional video was made and was seemingly **put in motion by coasting down a hill**. There were numerous other false claims as well, according to the complaint. Although chasing shiny, unproven objects can be exhilarating and makes for great cocktail party conversation, it can be hazardous to one’s wealth.

Remaining objective, grounded and disciplined is always important when making investment decisions but is especially so during heady markets and periods of easy money policies.

Meme Stocks

What is a meme stock? Generally, a stock that captures the attention of speculators on online forums and ultimately goes viral. These speculators are generally younger, have **not** been through a market cycle and disregard fundamentals as a method for estimating a company's value. Can you imagine making an investment without first having a sense for what it is worth? Without a sense for what an investment is worth, it is impossible to estimate whether you are getting a deal or overpaying.

According to a July 12, 2021 Barron's article, the "meme stock surge has been propelled by a rise in trading by retail investors. In 2020, online brokers signed clients at a record pace, with more than 10 million people opening new accounts." In 2021, "brokers had already added more than 10 million accounts **less than halfway through the year**, some of the top firms disclosed." And a recent "Schwab survey found that 15% of all traders began investing after 2020." "New investors say they are motivated by a desire to prove themselves and punish the old guard as much as profits." At some point, this new generation of investors will likely learn that trees do not grow to the sky and that revenue growth and return on capital above its cost of capital is what drives corporate value over long periods of time (more on this below). We believe clients benefit from the experience our team has gained through numerous market cycles over the last 35+ years.

Economic Moats

An economic moat is a competitive advantage that permits a company to earn a return on its capital **above** its cost of capital for long periods of time. Excess return on capital and revenue growth builds long-term business value. Companies that exhibit such attributes are generally viewed as high-quality companies. All things equal, we prefer to own high-quality companies as we believe they will outperform over long-time horizons.

Moats come in different forms, including, but not limited to: cost advantages, intangible assets, switching costs, network effect and scale. Last quarter we discussed switching costs. This quarter we touch on **network effects**.

The network effect moat source is the rarest, but most powerful among competitive advantages. Network effects are present when the value of a good or service increases for new and existing users as more customers are added. Although these effects are hard to build, once established, a flywheel is created whereby the network can perpetually grow—building on itself. Take for instance a well-known online auction website, that has an established network. Buyers go to its established market to purchase goods. On the other end, sellers use it because they know they have a great chance of connecting with desirable buyers. This virtuous cycle continues, bringing new buyers and in turn new sellers to the network. All parties are in a win-win situation as the platform grows; more and more users join the network which improves the probability that a buyer and seller will be matched.

Generally, companies exhibiting a network effect moat have attractive profit margins, compelling return on capital metrics and can sustain these attributes for long periods of time. This is good.

Stakeholder Update

Team members are currently in the office four days each week with varying schedules. With the rise of the Delta variant, we did not go to five days per week on September 1 as planned. We will reassess later this year.

Looking Ahead

Our business-like approach to investment analysis and portfolio construction precludes us from adhering to typical academic diversification dogma. Rather than owning a wide array of investments for which we know very little, we favor owning 25-40 individual stocks and around 50 fixed-income instruments (within our mutual funds) across an array of economic sectors. This provides adequate diversification, in our view, but is not overly diversified and allows us to focus on each holding with more intensity. Greater knowledge at the individual security level can help reduce the risk of a permanent loss of capital and produce attractive long-term risk-adjusted returns.

As equity market **averages** become increasingly expensive, relative to earnings or cash flow, **we believe the flexibility afforded to us through a narrower focus is increasingly valuable**. We generally maintain a defensive bias as we navigate numerous crosscurrents.