MARKET REPORT
FOURTH QUARTER 2021

Key Points

- The last two years have been a blur.
- Buffett's and Graham's comments are timeless.
- Market concentration is at the highest level since the '90s; value stocks are relatively cheap.
- Inflation is difficult to accurately forecast; we continue our series on moats; investing with a margin of safety is paramount, in our view.

Total Return as of December 31, 2021						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	11.0%	28.7%	28.7%	26.0%	18.5%	16.5%
NASDAQ	8.5%	22.2%	22.2%	34.3%	25.0%	21.0%
Russell 3000						
Index	9.3%	25.7%	25.7%	25.8%	18.0%	16.3%
Value	7.5%	25.4%	25.4%	17.7%	11.0%	12.9%
Growth	10.9%	25.9%	25.9%	33.2%	24.6%	19.4%
Russell Mid Cap						
Index	6.4%	22.6%	22.6%	23.3%	15.1%	14.9%
Value	8.5%	28.3%	28.3%	19.6%	11.2%	13.4%
Growth	2.9%	12.7%	12.7%	27.5%	19.8%	16.6%
Russell 2000 (Small Cap)						
Index	2.1%	14.8%	14.8%	20.0%	12.0%	13.2%
Value	4.4%	28.3%	28.3%	18.0%	9.1%	12.0%
Growth	0.0%	2.8%	2.8%	21.2%	14.5%	14.1%

The Year in Review

It is hard to believe a second COVID-filled year has passed, complete with follow-on offerings of Delta and Omicron. In spite of those hurdles, much political nonsense, tight supply chains, incredible competition for intellectual capital and the highest levels of inflation in roughly 39 years, America persevered. Business was conducted, and excepting small cap growth issues, market averages logged stellar gains.

However, for many Americans the last two years have been a blur as work and school schedules were upended, and caring for loved ones, youthful and seasoned, took precedence. The downtime appears to have ushered in a period of self-reflection and reprioritization of life's activities for many, as evidenced by the number of people quitting their jobs.

Somewhere along the way, the isolation resulting from physical distancing, seems to have created a greater bias within America's workforce toward "me" rather than "we," the "company" or "country." This cultural shift, if real and persistent, could have a far more

devastating long-term effect on workplace culture, productivity, institutional knowledge, the economy and the country than COVID. In most cases, bright, energetic, determined and driven individuals are better in the aggregate than individually.

U.S. Equities

We periodically review Warren Buffett's writings from years past and in recently doing so found a few of his comments from a November 1, 1974, Forbes article timely:

> *I call investing the greatest business in the world, because you never have to swing. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it.*
>
> *You're dealing with a lot of silly people in the marketplace; it's like a great big casino and everyone else is boozing. First the crowd is boozy on optimism and buying every new issue in sight. The next moment it is boozy on pessimism, buying gold bars and predicting another Great Depression.*

While always important, we believe discipline and adherence to our time-tested investment process is especially important in the current environment.

We also ran across a few noteworthy comments from a 1974 seminar given by Ben Graham, Buffett's mentor, titled Renaissance of Value, which we excerpted:

> *So far I have been talking about the virtues of the value approach as if I never heard of such newer discoveries as "the random walk," "the efficient portfolios," the Beta coefficient, and others such. I have heard about them, and I want to talk first for a moment about Beta. This is a more or less useful measure of past price fluctuations of common stocks. What bothers me is that authorities now equate the Beta idea with the concept of "risk." Price variability yes; risk no. Real investment risk is measured not by the percent the stock may decline in price in relation to the general market in a given period, but by the danger of a loss of quality and earnings power [sic] economic changes or deterioration in management.*
>
> *If you believe – as I've always believed – that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonably good intelligence; second, sound principles of operation; third, and most important, firmness of character.*

In our view, these statements are as true and relevant today as when first spoken in 1974. As you know, we think about risk in the context of: What is the risk of a permanent loss of capital? This definition is very different than that of many financial academicians who often think about risk in terms of: standard deviation, Beta and other Greek letters. Variability does not bother us, losing money does.

All 11 economic sectors (S&P 500) printed double digit returns for the year and solid returns for the quarter excepting communication services which was flat. From a quantitative standpoint, broad markets remain expensive and the top ten companies by market cap accounted for around **30%** of the S&P 500 at year-end (see accompanying chart). **The market is more concentrated than at any point since the late-'90s**. This can bode well for more narrowly focused value-oriented investment strategies like ours (i.e., 25-40 companies versus hundreds).

Source for all charts: 1Q 2022 Guide to the Markets

	Forward PE		Div. yield**	
Style	Current	Long-term avg.*	Current	Long-term avg.*
Value	15.77x	14.09x	2.00%	2.60%
Growth	30.61x	20.63x	0.71%	1.33%

Value type stocks posted strong results for 2021 as illustrated in the index data on page one. However, they remain as cheap today, relative to growthier companies, as at any point since the late-'90s / early '00s as shown in the accompanying table to the left.

The recent industry moniker for growth companies is "long duration assets" since their expected cash flows are further out in the future than the typical value company.

With expected cash flows being further out in the future, growth companies are often more sensitive to changes in interest rates. All things being equal, a decrease in, say, 10-Year Treasury yields can lead to investors awarding these type stocks a higher valuation. Of course, an increase in yields, which may be afoot, can have the opposite effect. This situation arises, in part, when investors link the discount rate used in discounted cash flow models to the 10-Year Treasury (or another risk-free security of different maturity) and add an equity risk

premium (often 3%-5%) to arrive at their "discount rate." When the reference Treasury yield increases or decreases, so does the discount rate which impacts the intrinsic value of the company being valued.

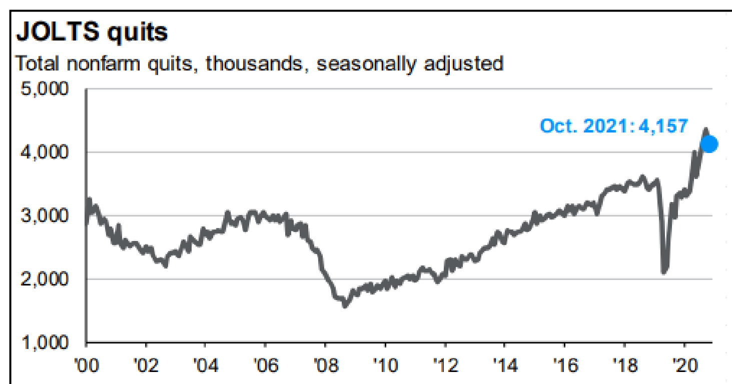
In our work, we use absolute discount rates that are not linked to a Treasury. Although our methodology may have kept us out of a few companies in recent years or caused us to sell sooner, it should serve you and us well should interest rates normalize to higher levels.

Using the S&P 500 as a proxy, operating profit margins are just off the highest levels since 1992. When taking wage pressures, other inflation factors and the current landscape into consideration, margins, on average, may have peaked for this cycle.

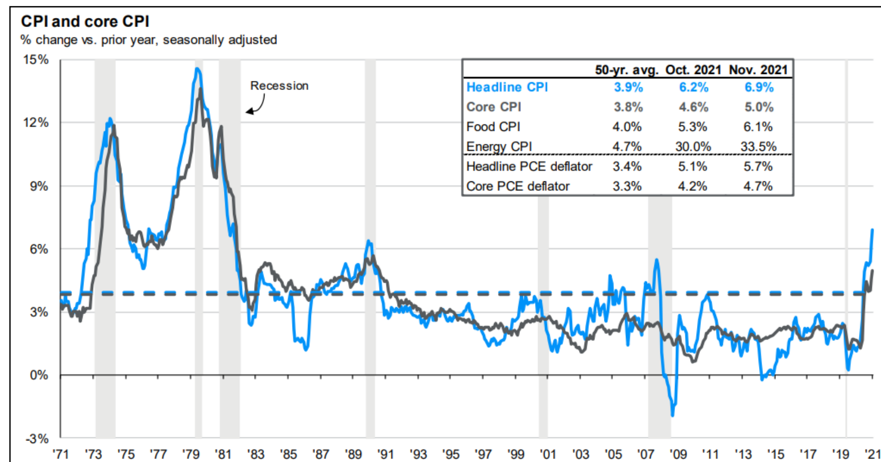
So, how does one navigate the current environment? We believe owning reasonably priced higher quality companies capable of successfully pushing through price increases (i.e., have a moat) is the best approach. Of course, not every holding in our portfolios will meet this criteria but many will. Occasionally, a lower quality company becomes available at a significant enough discount to intrinsic value to justify ownership until the discount narrows.

Employment & Inflation

As previously mentioned, employees are quitting their jobs at the highest rate in the last 21 years. Arguably, the recent period of self-reflection, strong savings, desire of many overwhelmed front-line workers to try something new and the robust job market have created this unique scenario.



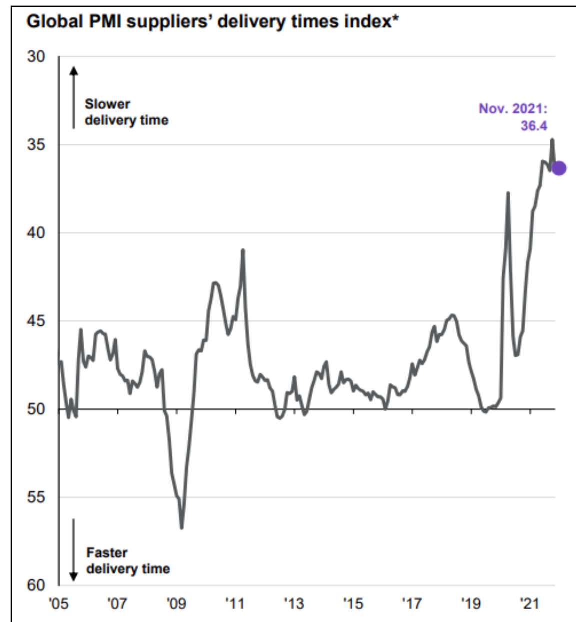
In the recent words of James Bullard, President of the Federal Reserve Bank of St. Louis, "there was a significant unanticipated inflation shock in the U.S. during 2021." See accompanying chart for historical context.



	50-yr. avg.	Oct. 2021	Nov. 2021
Headline CPI	3.9%	6.2%	6.9%
Core CPI	3.8%	4.6%	5.0%
Food CPI	4.0%	5.3%	6.1%
Energy CPI	4.7%	30.0%	33.5%
Headline PCE deflator	3.4%	5.1%	5.7%
Core PCE deflator	3.3%	4.2%	4.7%

"In December 2020, the inflation forecast in the Summary of Economic Projections (SEP) indicated that the median Federal Open Market Committee (FOMC) participant thought 2021 inflation would be **1.8%** for both core and headline PCE inflation, below the FOMC's 2% target." When it comes to future levels of inflation, no one, including, economists, talking heads, politicians or us really know. Considering the unknown, we strive to structure portfolios for long-term success regardless of what short-term hurdles can be served up.

Supply chains are strained. Shipping costs are very elevated and inventories are lower than usual. Product delivery times remain challenged (see accompanying chart), contributing to the recent higher level of inflation. Some large retailers have resorted to chartering their own container ships. Delivery times can improve once COVID's impact subsides.



Semiconductors, one of the more storied supply chain issues, are used in a wide range of goods. Based on an Economic Synopses (2021 # 28) prepared by the Federal Reserve Bank of St. Louis, "approximately 25 percent of 226 manufacturing sectors use semiconductors as a direct input, and these industries account for 39 percent of total manufacturing output." Although semiconductors usually only account for a small fraction of total input cost, they can cripple production when not available. Leading producers are building plants in Arizona and Texas in a push to bring production back to the U.S., but this capacity will not come online for a few years.

It seems that a more organized approach to global health policies could have yielded a better economic outcome. Global central bankers routinely coordinate monetary policy.

Perhaps COVID will lay the groundwork for such a contemplation by global health officials in the future.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs. index, declined 0.6% during the quarter and 0.9% for the year. U.S. Treasuries and Agencies, as measured by a similar index, decreased 0.5% during the quarter and 1.6% for the year. The 10-Year Treasury yield was down three basis points for the quarter, but began rising in the second half of December for a year-end yield of 1.50%. Investment grade yields generally rose a little during the quarter and credit spreads widened modestly.

Commodities, as measured by the Bloomberg Commodity Index, decreased 1.6% during the quarter but increased 27.1% for the year. Oil (WTI) increased 2.6% during the quarter and 58.7% for the year as supply remained constrained and demand increased.

The combination of demand resurgence following 2020's downturn, weather events, energy shortages and supply chain, as well as production backlogs have led to a supply/demand imbalance for many commodities. Underinvestment in the oil & gas patch in recent years and the current institutional reluctance to deploy capital into fossil fuels could lead to higher prices for longer.

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 a long-time horizon.

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 **efficient scale**.

The efficient scale moat exists in industries that serve a limited market size. This moat repels new entrants, as entering the market would push the industry's returns below its cost of capital. Companies that exhibit the efficient scale moat generally operate in industries with one or more of the following characteristics:

- Mature demand – a market that is declining or slowly growing.
- Excess capacity – existing firms can meet incremental demand with little or no added marginal cost.
- Commodity products – no differentiation available.

- Inelastic demand – lowering prices would not spur incremental demand.
- High sunk costs – requires capital intensive investment.
- Barriers to entry – new entrants are unwilling to endure short term losses when incumbents are unlikely to exit a market.
- Credible deterrence – new firms find it hard to forecast risk-adjusted returns if incumbents possess strategic alternatives that are seen as attractive.
- Historical precedent – a market that has seen little entry or exit for an extended period.

These attributes suggest efficient scale is most often present in markets with limited size and industries that require intensive capital investment. Examples exist across many sectors; however, they are commonly found in industries such as regulated utilities, communication services, midstream oil and gas, REITs and railroads.

The efficient scale moat allows companies to earn a net positive return on capital by operating in markets that deter new entrants, in turn providing an opportunity to create long-term value for shareholders.

Looking Ahead

When evaluating investments, the certainty that a higher priced asset, relative to its underlying value, will produce a lower future return than a lower priced asset is undebatable. If you accept this reality, you will be able to intellectualize the likelihood that broad markets will produce subpar compounded returns over the decade following peak valuations. We believe **investing with a margin of safety is paramount.**

The confluence of a concentrated U.S. equity market, lofty valuations, potentially tighter monetary conditions, supply chain disruptions, a mobile workforce that is re-evaluating life's priorities and elevated levels of inflation could produce headwinds for broad markets in general. Indexed based investment strategies may have a **tougher decade ahead**.

Our more narrowly focused, business-like approach to investing could prove more advantageous than usual.

Remember, Wall Street is geared toward optimism. What you are likely to read and hear in the media is bullish, until one day it is not. Since it is impossible to predict when that "one day" will come, we believe the best approach is to own reasonably valued higher quality companies, on average, which can grow wealth and preserve purchasing power. We continue viewing equities and fixed-income through a lens tinted with conservatism. Our search for value continues with great enthusiasm and endless ambition.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS