MARKET REPORT
SECOND QUARTER 2022

Total Return as of June 30, 2022						
				Annualized		
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	-16.1%	-20.0%	-10.6%	10.6%	11.3%	12.9%
NASDAQ	-22.3%	-29.2%	-23.4%	12.2%	13.5%	15.5%
Russell 3000						
Index	-16.7%	-21.1%	-13.9%	9.8%	10.6%	12.6%
Value	-12.4%	-13.2%	-7.5%	6.8%	7.0%	10.4%
Growth	-20.8%	-28.2%	-19.8%	11.8%	13.6%	14.4%
Russell Mid Cap						
Index	-16.9%	-21.6%	-17.3%	6.6%	8.0%	11.3%
Value	-14.7%	-16.2%	-10.0%	6.7%	6.3%	10.6%
Growth	-21.1%	-31.0%	-29.6%	4.3%	8.9%	11.5%
Russell 2000 (Small Cap)						
Index	-17.2%	-23.4%	-25.2%	4.2%	5.2%	9.4%
Value	-15.3%	-17.3%	-16.3%	6.2%	4.9%	9.1%
Growth	-19.3%	-29.5%	-33.4%	1.4%	4.8%	9.3%

Key Points

- The Fed's impact is being processed by investment markets.
- The pantry of opportunity is better stocked.
- Consumer confidence is waning; forward P/Es have improved.
- Negative yielding debt is down to $2.1 trillion, globally.
- We discuss share repurchases in our capital allocation series.

A Synopsis of the Quarter

Markets seemingly began to process the impact of the Federal Reserve's (the "Fed") efforts to cool inflation through higher interest rates and quantitative tightening. Value-oriented equity and fixed-income strategies, like ours, **generally fared well** relative to broad markets.

Speculative and richly valued companies, as well as everything crypto (e.g., Bitcoin et al.) generally experienced significant price declines. Unfortunately, for those who participated in these areas of the market, the impairment of capital in many instances is **likely to be permanent** and another generation of unsuspecting investors has bought an education.

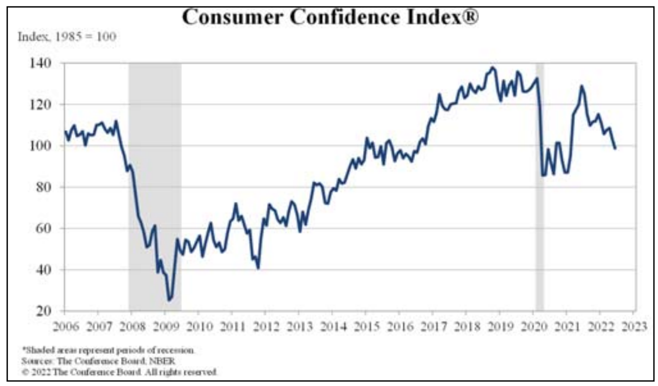
With each passing market cycle, we are increasingly perplexed as to why many market participants so eagerly dive headfirst into investments they do not understand or disregard the price paid relative to the value received. Greed, mediagenic promoters, peer pressure and social media all play a role. Fortunately for you and us, this same behavior can create **opportunities** in areas of the market where we practice our craft. We are patient, disciplined and work hard to be well-studied so when pricing becomes favorable we can act swiftly. As famed real estate investor Sam Zell once said, "We suffer from knowing the numbers." We, too, suffer from knowing the numbers which keeps us grounded and often out of the most "exciting" investments when market folly is through the stratosphere.

The broad market decline left the **pantry of opportunity better stocked** than it has been in many quarters. We capitalized on investments, where appropriate, with an eye toward reducing portfolio risk and increasing future return potential over the next 5-7 years.

U.S. Equities

All 11 economic sectors comprising the S&P 500 declined during the quarter. Consumer staples (-4.6%), utilities (-5.1%) and energy (-5.2%) declined the least. Consumer discretionary (-26.2%), communication services (-20.7%) and technology (-20.2%) declined the most.

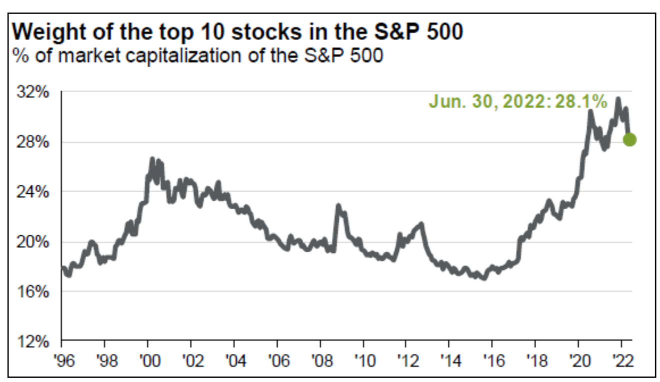
Consumer confidence has **softened** in recent months, in part due to higher transportation and food costs. Anticipated economic weakness contributed to the consumer discretionary segment experiencing the brunt of the quarter's decline. Short-term uncertainty can lead to **outsized** long-term compounding opportunities.



The S&P 500's quarterly decline brought its price to forward P/E ratio more in line with long-term averages. This statistic was running well above average for part of 2020 and all of 2021. Generally, the lower the price-to ratio at a point in time, the greater the return potential over the subsequent 5-7 years. Although more downside is always possible, the expanding shopping list is helpful.

(Source: U.S. | 3Q 2022 Guide to the Markets)

Although still elevated, market concentration has declined as indicated in the accompanying chart showing the percentage of total S&P 500 market capitalization represented by the largest 10 stocks. Less concentration is **preferrable** and is reflective of a healthier market with broader participation. Concentrated markets often end with an element of uncertainty.



Source: U.S. | 3Q 2022 Guide to the Markets

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr index, declined 3.8% during the quarter and 9.1% year-to-date. U.S. Treasuries and Agencies, as measured by a similar index, declined 1.6% and 5.5%, respectively.

Treasury yields rose during the quarter with the 2-Year ("2s") increasing 0.70% to 2.97% and the 10-Year ("10s") increasing 0.72% to 3.04% at quarter-end. With only a seven basis point (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve is flat. Where appropriate, we modestly extended the average duration of our fixed-income holdings during the first half of the year as higher yielding opportunities surfaced. Finally, fixed-income investments are once again producing a more meaningful level of yield.

After peaking around **$18.4 trillion** in December 2020, the aggregate amount of negative yielding debt globally has declined to around **$2.1 trillion** – an 89% decline. As the Fed and its counterparts around the world engage in quantitative tightening (i.e., reducing the size of their balance sheets), yield should more accurately reflect the risks taken – leading to creditors being more fairly compensated for the use of their capital. Yield opportunities have **changed materially** since the beginning of the year. Corporations who issued long-term debt at record-low yields in 2021 did well.

Market stress is taking its toll on the high yield bond market. Year-to-date, around $60 billion of high yield bonds were issued. This compares to around $250 billion during the same period last year. A decline of roughly 76%. As is often the case in the world of credit, when the window closes it slams shut.

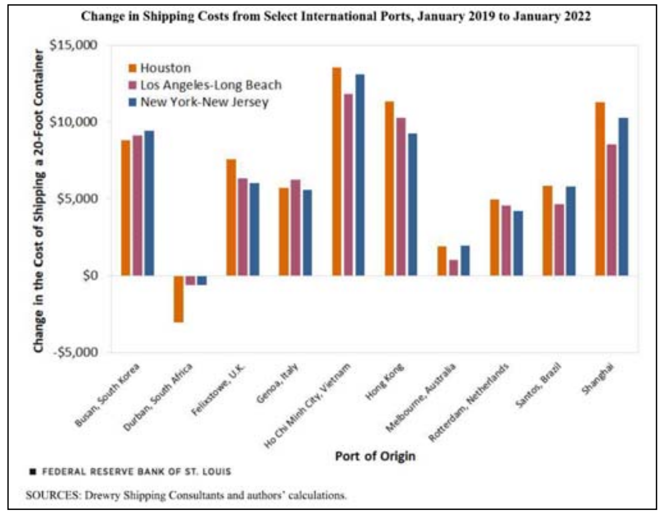
Commodities, as measured by the Bloomberg Commodity Index, declined 5.7% for the quarter but are up 18.4% year-to-date and 24.3% over the last year. Oil (WTI) gained 5.5% during the quarter, 37.4% year-to-date and 43.9% over the last year as demand rebounded and global supply was constrained. Elevated commodity prices, like higher interest rates, should help nudge supply and demand back into equilibrium.

Covid-induced manufacturing shutdowns in China and west coast port bottlenecks continued hindering supply chains, driving material costs up and causing delays. As reported in Barron's on June 20, 2022:

> *Last month, Morgan Stanley surveyed more than 400 executives of large corporations from the U.S. to Germany to Japan. They said the most important factor in supply-chain decisions is geopolitical stability, followed by skilled labor, physical infrastructure, and a developed supply-chain ecosystem. On nearly every count, the U.S. outranked Europe, China, and Mexico. Some 18% of the companies planned to significantly expand U.S. manufacturing in the next 12 months, while 36% anticipated doing so within three years.*

Although it would be illogical for corporations to entirely abandon the overseas infrastructures they have built, **America's rule of law, access to energy and established infrastructure** are likely to be held in higher regard over the next decade as the wheels of globalization have developed flat spots. The U.S. will likely be a net beneficiary of the sea change, in time.

For a perspective on the **change** in shipping costs from various points of origin to Houston, Los Angeles – Long Beach and New York – New Jersey for the period of January 2019 to January 2022, see the accompanying chart. The increased costs are notable, and are, in part, a result of containers not being efficiently returned to the points of origin. Disparate approaches to Covid health policies globally and labor are often cited culprits. There is no easy solution, from our vantage point.



The Land of Crypto

The bloom came crashing off crypto during the quarter. Primary, as well as secondary and tertiary cryptocurrencies fell from grace. A crypto lender froze withdrawals as customers ran for the hills and a crypto-focused hedge fund failed to meet margin calls and was ordered to liquidate. The crypto lender was reportedly making loans backed by cryptocurrency. As values fell, the house of cards collapsed. When an **unregulated** crypto lender fails, there is **no FDIC** to swoop in and orchestrate a sale to a stronger institution. The aftermath will be messy. Increased regulation is certain to follow, but it will not be much consolation to those who lost vast sums of money.

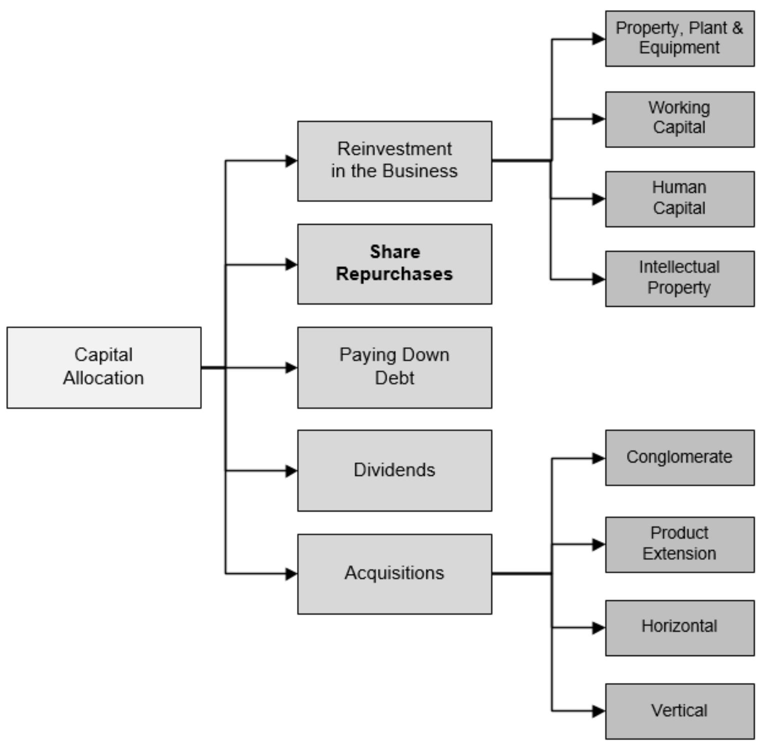
Capital Allocation

Capital allocation is the process of determining the most efficient investment strategy for a company's financial resources with the goal of maximizing shareholder value. This is the single most important function of a company's management team.

Too often, management allocates funds in a manner that destroys shareholder value. If resources are allocated to projects that produce returns lower than a company's weighted average cost of capital or WACC (i.e., an acceptable minimum rate of return on capital projects), the value of the company will eventually erode. On the other hand, when capital is effectively allocated year after year to projects that produce returns above the company's WACC, the magic of compounding takes place and shareholders are rewarded in the long run through additional corporate value creation. To illustrate, take a company that has $100 million of equity capital on its balance sheet and earns 15% on its capital for five years: By the end of year five, the company will have over $200 million ($100 x 1.15 x 1.15 x 1.15 x 1.15 x 1.15) of equity. Management's diligence and capital allocation decisions over that period caused the equity **to double**.

We prefer companies that first and foremost have durable competitive advantages (moats), but also leadership teams that understand the importance of successful capital allocation programs and the compounding effect they can have on value.

Along those lines, management teams have numerous "levers" to pull when allocating capital and pursuing their goal of maximizing shareholder value. We will cover each of these levers throughout this series: reinvestment in the business, share repurchases, paying down debt, dividends and finally acquisitions. Last quarter we discussed reinvestment in the business. This quarter we examine **share repurchases**.



A share repurchase happens when a company uses corporate funds to buy its stock in the marketplace. This **decreases** the number of shares outstanding, **increasing** the remaining shareholders' ownership of the company. Under the right circumstances, this is the second-best capital allocation lever, in our view, after appropriate reinvestment in the business.

Share repurchases have been a hot topic of late, often vilified by politicians and the media. Below, we lay out the most important factors to consider when weighing the pros and cons of repurchases: intrinsic value, tax implications, management incentives and other opportunities.

- **Intrinsic Value** – The underlying value of a company often diverges from its market price for a variety of reasons. Similar to our research process, management teams must assess whether their stock is trading at a discount to its intrinsic value. If it is, and underlying fundamentals of the business are strong, share repurchases are a great use of capital. However, if the shares are fundamentally overvalued, repurchasing them can negatively impact shareholder returns.

- **Tax Implications** – Cash dividends are typically a taxable return of capital. Share repurchases are only taxable to the selling shareholder (assuming the selling shareholder is in a gain position). In a share repurchase, investors who prefer to receive cash can sell shares back to the company. Long-term investors increase their ownership without any tax liability through reduced share count.

- **Management Incentives** – Executives are often incentivized to hit short-term targets centered around the income statement and metrics such as earnings per share ("EPS"). Share repurchases use cash to lower share count, which all things being equal, automatically increase EPS. If management is primarily incentivized to increase EPS they may choose to repurchase shares, ignoring the company's intrinsic value and more favorable capital allocation options. We do not like automatic share repurchase programs used to offset the use of options and stock in compensation plans. Such plans ignore the intrinsic value consideration. When evaluating a company, we prefer compensation structures with long-term equity as the main driver.

- **Other Opportunities** – Management should allocate capital to activities with the best long-term return to shareholders. Every company's circumstance is different. Management must evaluate each of the capital allocation levers, at a point in time, to determine which provides the best return potential. Share repurchases are a great tool but will not always be the right lever to pull.

Each of these factors are important considerations when evaluating share repurchases. When a security is trading at a discount to its instrinsic value, thus creating a margin of safety, and appropriate investments in the business have been made – share repurchases are generally an excellent use of capital. **Next quarter** we will discuss paying down debt and dividends.

Looking Ahead

Investment markets are going through a **period of transition** as excess pandemic-related liquidity is worked out of the system and consumers and corporations alike adapt to elevated levels of inflation and snarled supply chains.

We believe our value-oriented approach is well-suited for navigating this uncertain environment where companies with sound balance sheets and the ability to produce free cash flow are now "more interesting."

Throughout history, wealth has been hard to build and easy to lose. In many cases, it would be accumulated over long-time horizons and occasionally lost due to irresponsible spending, ill-advised investments, poor planning, etc. In recent years, the **opposite** has taken place. Incredible wealth has been amassed speedily on the backs of flimsy business plans that resulted in newly formed companies being awarded market capitalizations in the billions of dollars. **This is not normal**, yet until lately many who quickly accumulated wealth could not process the possibility of their good fortune reversing. Of course, our focus is on preserving and growing your wealth at a level of compounding commensurate with the risk taken.