MARKET REPORT
FIRST QUARTER 2022

Key Points

- Stocks were off during the quarter; value-oriented issues fared the best.
- Prognosticators have been talking about a recession; we discuss our approach.
- Yields moved up significantly; this created opportunities.
- We start a new series on Capital Allocation.
- Many things in life come and go, but the power of compounding is constant.

Total Return as of March 31, 2022						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	-4.6%	-4.6%	15.6%	18.9%	16.0%	14.6%
NASDAQ	-8.9%	-8.9%	8.1%	23.6%	20.4%	17.8%
Russell 3000						
Index	-5.3%	-5.3%	11.9%	18.2%	15.4%	14.3%
Value	-0.9%	-0.9%	11.1%	13.0%	10.2%	11.6%
Growth	-9.3%	-9.3%	12.9%	22.7%	20.2%	16.6%
Russell Mid Cap						
Index	-5.7%	-5.7%	6.9%	14.9%	12.6%	12.9%
Value	-1.8%	-1.8%	11.5%	13.7%	10.0%	12.0%
Growth	-12.6%	-12.6%	-0.9%	14.8%	15.1%	13.5%
Russell 2000 (Small Cap)						
Index	-7.5%	-7.5%	-5.8%	11.8%	9.7%	11.0%
Value	-2.4%	-2.4%	3.3%	12.7%	8.6%	10.5%
Growth	-12.6%	-12.6%	-14.3%	9.9%	10.3%	11.2%

A Synopsis of the Quarter

The confluence of geopolitical instability, 40-year-high inflation, continued supply chain issues, more restrictive monetary policy and deteriorating consumer sentiment contributed to increased levels of volatility and the U.S. equity market's retrenchment during the quarter.

Shares of companies trading at the highest multiple of earnings, free cash flow or sales were disproportionately impacted (think growth and speculative stocks). Strategies rooted in business-like fundamental analysis with a value orientation, like ours, generally fared the best. Volatility is the friend of long-term investors and we used it to our advantage during the period.

Fixed-income yields lifted and credit spreads (number of basis points a corporate credit yields over a Treasury of equal maturity) widened across maturity and credit spectrums as current and future expectations for monetary conditions tightened.

The horrible situation in Ukraine exacerbated tight commodities markets, lifting the price of various grains, metals, oil and natural gas.

U.S. Equities

Of the 11 economic sectors comprising the S&P 500, only energy (+39.0%) and utilities (+4.8%) posted positive returns for the quarter. Communication Services (-11.9%) led to the downside, followed by consumer discretionary (-9.0%) and technology (-8.4%).

Around quarter-end, various prognosticators began talking about the prospects of a recession. This conversation, in large part, was being fueled by the flattening yield curve (which temporarily inverted in early April). An inverted yield curve (when short-term yields are higher than longer term yields; think 2-Year Treasury relative to 10-Year Treasury), typically precedes a recession by 9-18 months or thereabouts. From a practical standpoint, this type of information is more of something to be aware of than it is actionable.

The market often corrects to the downside long before a recession is declared by the National Bureau of Economic Research ("NBER") and recovers well in advance of the official announcement that a recession has ended. Economists' track records are generally dismal, yet many market participants place significant value in their thoughts. Relying on an input that has a low probability of consistent success is not something we currently or have ever embraced. We do not reposition portfolios based on anticipated economic conditions. Are we generally aware of the economic landscape? Of course. Do we make economic forecasts and bet on those forecasts? No chance.

If we do not make economic forecasts and reposition portfolios accordingly, what do we do? We strive to own reasonably valued high-quality companies that have one or more moats, conservatively structured balance sheets and competent and trustworthy management teams who communicate candidly with their shareholders.

Our fundamental analysis results in an estimated equity value for the companies we own or may want to own in your portfolio. The market price relative to our estimate of equity value drives portfolio management decisions (i.e., price-to-value), allowing us to comfortably filter out a lot of "noise" in the marketplace. In fact, with each passing year we dismiss an increasing amount of information as irrelevant. Why? Because the amount of "information flow" available today is mind numbing and the sheer volume inherently makes each piece less valuable.

Fixed Income & Commodities

The fixed-income landscape changed materially during the quarter as yields began lifting early on and ended the quarter higher. We had above average levels of cash and commercial paper in our fixed-income strategies at year-end (due to a limited number of investment opportunities meeting our criteria). Higher yields provided an opportunity to reposition our fixed-income strategies, swapping cash and commercial paper for securities maturing along the two- to three-year segment of the yield curve (where the greatest change in yields occurred). In our strategy that calls for convertible securities, the combination of higher yields and equity market volatility provided opportunities to increase our convertible exposure, finally. The yield changes illustrated below are notable for a quarter.

Yield & Credit Spread Data
For the period: 3/31/2022 versus 12/31/2021

	U.S. Treasury		Corporate Rating							
			A				BBB			
Maturity	Yield	Change	Yield	Change	Credit Spread	Change	Yield	Change	Credit Spread	Change
3-Mo	0.67	0.55	1.44	1.04	0.76	0.49	1.56	1.01	0.88	0.46
6-Mo	1.06	0.86	1.58	1.14	0.52	0.28	1.79	1.16	0.73	0.30
1-YR	1.61	1.22	1.89	1.32	0.28	0.10	2.26	1.45	0.66	0.22
2-YR	2.27	1.51	2.51	1.62	0.24	0.10	2.90	1.73	0.63	0.22
3-YR	2.55	1.56	2.83	1.59	0.27	0.04	3.24	1.72	0.69	0.16
4-YR	2.53	1.36	2.97	1.50	0.45	0.14	3.41	1.62	0.88	0.26
5-YR	2.39	1.12	3.07	1.41	0.68	0.29	3.52	1.52	1.13	0.40
7-YR	2.43	1.01	3.23	1.25	0.80	0.24	3.70	1.36	1.26	0.35
8-YR	2.39	0.95	3.29	1.19	0.89	0.24	3.76	1.30	1.37	0.35
9-YR	2.36	0.90	3.35	1.14	0.99	0.24	3.83	1.26	1.47	0.35
10-YR	2.32	0.81	3.43	1.10	1.11	0.29	3.92	1.21	1.61	0.40
15-YR	2.36	0.74	3.74	0.98	1.39	0.24	4.25	1.05	1.90	0.31
20-YR	2.61	0.67	3.84	0.89	1.23	0.22	4.34	0.98	1.73	0.30
25-YR	2.59	0.64	3.79	0.83	1.20	0.19	4.23	0.91	1.64	0.27
30-Yrs	2.46	0.54	3.72	0.79	1.27	0.25	4.14	0.89	1.68	0.35

Note: Composite data illustrated.

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs index, declined 5.5% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, decreased 4.0%.

Inflation has migrated from headlines to the kitchen table in recent months. Commodities, as measured by the Bloomberg Commodity Index, increased 25.5% during the quarter. Oil (WTI) posted gains of 30.3% and natural gas (Henry Hub) rose 52.9% as sanctions against Russia, the world's second largest producer of natural gas, intensified an already tight market. Russia also produces around 12% of global crude oil, 12% of fertilizer, 10% of wheat and 6% of refined nickel. Ukraine's production of corn, sunflower seeds and wheat are, of course, disrupted as well. In the near-term, inflation is front and center for a host of reasons, including but not limited to: easy monetary policies, COVID-induced supply chain disruptions, energy policy, war, ocean-freight shipping costs and de-globalization. When looking beyond the horizon, inflation's trajectory is less clear.

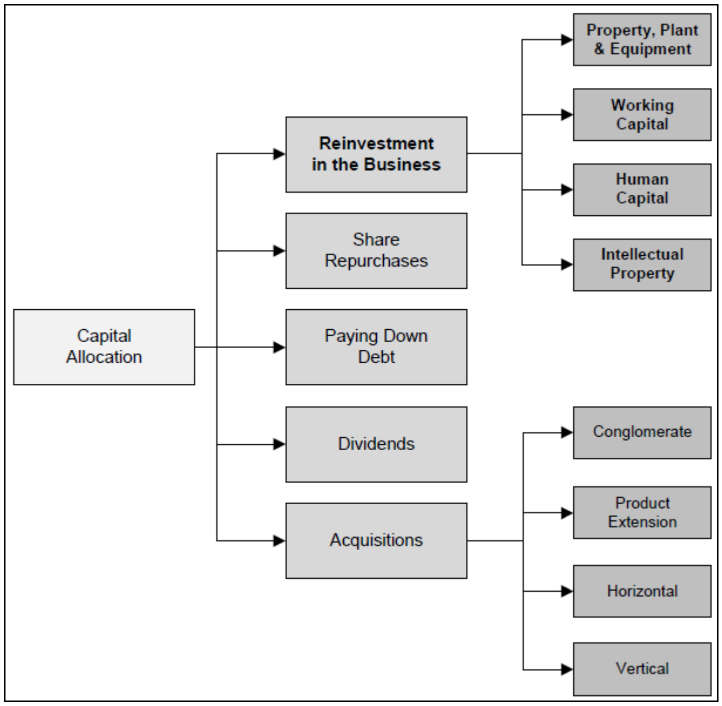
Capital Allocation

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.

Management teams have numerous "levers" to pull when allocating capital and pursuing their goal of maximizing shareholder value. We discuss **reinvestment in the business** below and will cover each of the following levers in a future quarter: share repurchases, paying down debt, dividends and finally acquisitions.



Reinvestment in the business (or organic growth) can be fueled by funneling resources back into the business. We will touch on four basic drivers: investment in property, plant and equipment, working capital, human capital and intellectual property.

- Property, plant and equipment (PP&E) are assets that help create a product or service. The land, machinery, vehicles, buildings, computers and software infrastructure that support creation all fall under this category. A certain level of investment is needed to simply maintain the business (maintenance capex). However, investing in additional PP&E can help a company meet higher demand and increase overall production of its goods or services (growth capex). Management should also assess expenditures that create efficiencies and lower costs, creating value to shareholders.

- Working capital is the difference between a company's current assets and current liabilities: cash, accounts receivable, raw materials, finished goods, accounts payable and current debts all fall under this bucket. Working capital is a measure of short-term liquidity and financial health. Management typically allocates funds to this section of the balance sheet to ensure the business operates efficiently. For most businesses, working capital needs to grow as the business grows.

- Human capital is simply the people that run the business. Everyone from a cashier to the CEO. Management must allocate funds to hire and train their workforce. Educating and developing skilled workers should increase productivity and profitability.

- Intellectual property is any proprietary information that may provide the company with a competitive advantage. Brands, patents and copyrights are all common examples of intellectual property. Capital can be allocated to strengthening a company's brand, or even used to defend it from competitors that infringe on its territory.

Each of these drivers are important contributors to organic growth, generally the highest quality form of growth. All things being equal, reinvestment into the business is our preferred capital allocation choice. Next quarter we will discuss share repurchases, the next best option for deploying capital under the right circumstances.

Looking Ahead

Pandemics, wars, crisis, administrations, and fiscal and monetary policy all come and go over time. The one thing that is constant throughout life is the power of compounding. Compounding is most often associated with investments, but equally applies to knowledge. Through life and business experiences, as well as a commitment to continual learning, an individual's knowledge base compounds over time increasing in value with each passing year. At the company level, the same is true for institutional knowledge (the collective information of an organization and its people). One of our five core values is: "Relentless Learning – Continuous Improvement. Get Better Always."

Our investment process has been continuously executed for nearly forty years now and a commensurate amount of knowledge has accumulated. With the benefit of having lived and managed through numerous economic, market and monetary policy cycles, we pledge to use our collective experience to navigate the shifting investment landscape. We will keep a keen focus on not unnecessarily interrupting the compounding process.