VALUE MATTERS / 1Q 2022

Eyes on the Prize

Weitz | INVESTMENT MANAGEMENT

WALLY WEITZ, CFA
Co-Chief Investment Officer
& Portfolio Manager

BRAD HINTON, CFA
Co-Chief Investment Officer
& Portfolio Manager

The first quarter of 2022 was eventful.

Russia invaded Ukraine and the West imposed sanctions on Russia. Death and destruction in Ukraine and disruption of global financial and commodities markets followed. A near-term path to stopping the war is not in sight, and the longer-term implications for Vladimir Putin's role in Russia and Russia's place in the world are unclear.

Covid is still with us, although it has become generally less of a crisis for most. Infections, deaths, and travel restrictions have moderated, but supply chain disruptions have persisted. With luck, the worst is behind us, though our capacity to deal with a new, or renewed, public health crisis is uncertain.

Inflation has raised its ugly head and is unsettling the economy and our policymakers. The causes of inflation are complicated, but the old-school belief that "inflation is a product of too much money chasing too few goods" may be regaining ascendancy over the Modern Monetary Theory (MMT) idea that "deficits don't matter." Our base case is that over the next year or two, the inflation rate will settle into a range above the Fed's 2% target but below the recently reported 8%. However, new pressures on agricultural and energy prices stemming from sanctions against Russia complicate the picture. Unfortunately, given lags in reporting and flaws in the construction of the Consumer Price Index itself, we may not know when or where the current spike actually peaks until well after the fact.

These are serious matters to real people as well as governments and businesses. We will be doing all we can to understand how these and other headline issues are affecting our companies and other potential investments. ***However***, our interest is ***not*** in how these factors will affect stock prices day to day. We invest in ***businesses***, and the value of a business is based on the cash it will generate for its owners over a very long period – decades. So we want to understand how the world will be different post-Covid and post-Russia/Ukraine. It is the longer-term evolution of the ways people live and work that our companies will have to adapt to.

Interest Rates and the Investment "Climate"

In our opinion, the most important investment event of the first quarter was related to the surge in inflation. That is the reversal of Fed policy and the first hike in the Fed Funds rate (the short-term interest rate that the Fed controls directly) since 2018. This change has been in the works for some time and has been well-telegraphed in hopes of keeping investors calm (generally an uphill battle).

For some historical context, from late 2008 through December 2015, the Fed maintained a zero interest rate policy (ZIRP) by holding the Fed Funds rate near 0% and using quantitative easing (QE), i.e., borrowing money to buy Treasuries and mortgage-backed securities, pushing bond prices up to keep yields low. These policies were originally designed to rescue the economy during the mortgage crisis in 2008. From December 2015 through 2018, the Fed slowly embarked on rate increases that finally reached 2.25%-2.50%. The Fed maintained this rate until July 31, 2019, when a series of three rate cuts ensued, ending in October 2019 with a 1.75% Fed Funds Rate. At the onset of the pandemic in 2020, the Fed doubled down on ZIRP to maintain liquidity in the capital markets. The Fed interventions of 2008 and 2020 were both necessary. During many of the intervening years, though, this stimulative policy was continued, arguably at times when it was not needed. The Fed apparently believed that the recovery from the Great Financial Recession was inadequate, and the logic was that cheap credit would encourage businesses to buy new plant and equipment to expand, and that low interest rates would push up the prices of consumers' stock portfolios, making them feel richer and more inclined to buy more things ("wealth effect").

As it happens, ZIRP's impact on business expansion has not been so great, but it has succeeded in super-charging stock prices. With bonds and other fixed income securities yielding what felt like nothing, many conservative investors felt compelled to buy stocks. (Naturally, Wall Street had an acronym for this, too, TINA – There Is No Alternative.) As a result, stock prices have risen faster in recent years than their earnings per-share, so valuations as measured by price-to-earnings (P/E) ratios have risen faster than underlying business values.

For most of the time since the Fed first adopted ZIRP, inflation has been very low. In fact, the Fed thought a "little" inflation would be a good thing and hoped its stimulative policies would help get inflation ***up*** to ***2%***. (This seemed a little bizarre to those of us who experienced the inflation of the 1970s!)

In 2021, however, supply chain disruptions, shortages of various commodities, and a very tight labor market triggered a burst of inflation that reached 8% (the highest in 40 years) during the first quarter of 2022. At this point, the Fed realized it had over-achieved and began to float the idea of raising rates to fight inflation. Investors began to visualize the benchmark 10-year Treasury yield rising from under 1% to a more normal 4-5% or higher. (A few grizzled veterans probably remembered that in 1981, then-Fed Chair Paul Volcker raised short-term rates to 20% and long Treasuries yielded 14%.)

> *" Business fundamentals are good now and will likely be favorable most years in the future, just as they were over most of the past 12 years. But the **climate** has changed. "*

The specter of rising rates triggered the "stealth correction" that started around the middle of 2021. The first victims were young, fast-growing companies whose stocks were most vulnerable to rising rates. The declines went relatively unnoticed (unless you owned those stocks) because the major indexes were still setting new highs. As 2022 began, though, the market heavyweights began to slip, and their prices impacted the indexes. By late February, the S&P 500 had dropped 15% from its January high, and the Nasdaq had fallen 21%.

This market move was reminiscent of the 20% dip in the fourth quarter of 2018, the last time the Fed raised rates. On that occasion, the Fed quickly reversed course and, to invoke the words of Gilda Radner's Saturday Night Live character Emily Litella, said "Never mind." We are guessing that the Fed will follow through this time, at least for a few more quarters. After that, they will be "data dependent" (or perhaps "politics dependent").

Fed policy is generally not a consideration in our investment process. Warren Buffett quipped years ago that if Alan Greenspan (Fed Chair, 1987-2006) whispered in his ear what the Fed's next move would be, Warren wouldn't do anything differently. We think that is good advice and the right attitude.

Today, though, we ***do*** think that something important has changed that will have a lasting impact. Business fundamentals are good now and will likely be favorable most years in the future, just as they were over most of the past 12 years. But the ***climate*** has changed. Zero interest rates and quantitative easing – ZIRP and QE – acted as ***tailwinds*** for stocks. Rising rates and quantitative tightening – selling off the bonds bought for QE – will likely act as ***headwinds*** for stocks. Higher bond yields pose stiffer competition for investors' capital, so higher rates generally mean lower P/E ratios.

Outlook

The transition to a tighter monetary regime has already caused the market to wobble, and we would expect more of the same, from time to time, as headlines rattle investors who have short investment horizons and who lack conviction in their holdings. The good news is that lots of stocks have already been marked down in anticipation of higher rates. The stocks in our portfolios are as cheap relative to their business values as they have been for some time. With stocks selling at more realistic prices, our opportunity set is much improved. Last quarter, we predicted that 2022 would be an "adventure." We think that is still the case, and ultimately, we believe the adventure will create opportunities that can benefit our investors over the long run.

IMPORTANT DISLCOSURES

The opinions expressed are those of Weitz Investment Management and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are current through 04/05/2022, are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon.

Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. This and other important information is contained in the prospectus and summary prospectus, which may be obtained at weitzinvestments.com.

Weitz Securities, Inc. is the distributor of the Weitz Funds.