Staying Focused Through Changing Times

Weitz | INVESTMENT MANAGEMENT

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During the first quarter of 2023, the Federal Reserve continued to raise short-term interest rates in its quest to tame inflation. In response, the economy slowed, corporate earnings softened and a number of inflation measures moved in the right direction – lower.

Investors, having been conditioned over the past 20 years to expect relief from the Fed at the first sign of market weakness, appear to be positioned for a near-term policy "pivot." Fed Chair Jerome Powell, on the other hand, has cautioned that rate cuts are not in the cards for 2023. Our guess is that while rates may not be raised much higher, the Fed is likely to keep them high for longer than many expect, to be sure their mission of taming inflation is accomplished.

Meanwhile, after a relatively stable January and February, Silicon Valley Bank (SVB) experienced a severe "run on the bank." Regulators stepped in quickly to guarantee all SVB deposits in order to reassure depositors in all banks, but it was too late to save SVB. These developments both exacerbated fears of recession and raised hopes that the Fed would relent and lower rates.

Confusion and angst reigned as the quarter came to a close. To preview our working assumptions, we believe that the banking industry is sound and that good companies will cope successfully with the economic slowdown. We do not have predictions to offer, but we will try to answer some questions that our investors are likely asking.

Bank Failures – How Serious a Problem for Investors?

SVB has a colorful history, and the story of its failure is still being written. It was very different from most banks because of its concentration on the venture capital (VC) and technology startup industries. Deposits for all banks have risen sharply in recent years, reflecting stimulative fiscal and monetary policies, and SVB served an industry that was attracting lots of capital. A very large percentage of its deposits came from individuals and companies related to the VC world. Nearly all were held in accounts larger than the $250,000 FDIC limit and thus were ***uninsured***.

The red-hot market for tech stocks had cooled some time ago, but ironically, the trigger for the bank run was SVB's government bond portfolio. The bank had invested a large portion of its deposits in fixed-rate government bonds. As interest rates rose, the market value of those bonds declined. When it was disclosed that SVB's unrealized losses were very large relative to its required regulatory capital, doubts arose about the safety of the uninsured deposits. In this closeknit community, connected by social media and influenced by a handful of VC decisionmakers, fear spread rapidly, and demands for withdrawals overwhelmed the bank. The FDIC moved quickly to guarantee its deposits, but it was too late to save SVB. Silvergate Bank and Signature Bank (SBNY) faced similar runs and were also seized by the FDIC.

The regulatory fix for the banking industry was to provide liquidity to all banks that experienced serious deposit outflows. By the nature of "fractional reserve banking," all banks hold deposits and loans equal to many times their equity capital, so ***no*** bank can withstand a "run" on its deposits. But if depositors know their money is safe, there is no ***need*** for a run. The post-Great Financial Crisis (GFC) regulatory changes and disclosure requirements, especially for the largest banks, have made the banking ***system*** much sounder. It is all about confidence in the system.

A ***separate*** question for investors is the outlook for bank ***earnings***. Rising interest rates impact the value of loan and bond portfolios and raise the cost of deposits as alternative investments (e.g., money market funds) provide stiffer competition for savings. A slower economy increases the risk of loan defaults, and post-Covid changes in shopping and office use threaten to have a serious impact on commercial real estate lending. Further, every financial "crisis" seems to bring with it new rules and regulatory costs.

Bank earnings may face headwinds for a while, but interest rate and credit cycles are a normal part of banking life. Each bank is different, and generalizing is dangerous. Investors will need to reassess the outlook for earnings growth on a case-by-case basis, but the stocks of sound banks, at the right price, can still make very attractive investments. Our only bank stock holding as of 3.31.2023 is JPMorgan Chase & Co. in the Balanced Fund.

This will be, as they say, a "developing" story.

Will there be a recession in the U.S.?

We believe this question is a bit of a red herring. Whether the National Bureau of Economic Research labels this period a "recession" is not nearly as important as how our individual businesses perform. Interest rate sensitive industries, like housing, may already be in recession. Others that are less cyclical, or that are beneficiaries of a slowdown, are still doing well and may continue to grow despite a recession.

Our take is that the Fed ***does not know*** how hard it will be to bring inflation down to its 2% target. Ten-plus years of artificially suppressed interest rates, a pandemic that shut the country down for over a year, government spending of unprecedented scale, and three bear markets (20% drawdowns in the S&P 500) in five years (2018, 2020, and 2022) make references to financial history tenuous at best.

The Fed is taking action because it believes the economy is ***too strong*** and the labor market too tight. Its efforts to slow down activity and lessen wage and price pressures are ***designed*** to weaken the economy. Whether they "over-achieve" and cause a recession or get lucky with a "soft landing," ***our working assumption is that the companies we own will emerge from this period with their business value and future prospects intact***.

In fact, while it is hard to cheer for a recession, we believe that many great companies owe a measure of their success to opportunities that arose during tough economic times. Companies with cash at the right time can acquire great assets at good prices when sellers face financial distress. And they can buy back their own shares at attractive prices, which in turn increases the value per share for the remaining shareholders. Arguably, Berkshire Hathaway (BRK) would not have been able to acquire its largest subsidiary, BNSF Railway, in 2009 if not for the Great Financial Crisis.

Recessions are merely temporary interruptions in the very long-term trend of GDP and corporate earnings growth. BRK chairman and CEO Warren Buffett describes this in his company's 2022 annual report as the "American Tailwind." The financial media wins by creating anxiety among its audience. This increases "engagement" and sells more advertising. Investors lose by trying to anticipate and respond to near-term price movements. As we advised in another letter years ago, turn off CNBC and turn on the History Channel. (Or Ted Lasso.)

Our Game Plan – Focus on Long Term Business Value Growth

In some ways, there is nothing new under the (investing) sun. Human nature doesn't change, and emotions continue to drive asset price swings above and below "fair value" in recurring cycles. On the other hand, the last ten years have been quite extraordinary for financial markets and disorienting for investors. We are always working to understand what the "new normal" will be for office work, shopping, travel, hospitality, media, digital advertising, artificial intelligence, etc.

Over the course of 62 years of investing, we've learned to take grand pronouncements about change with grains of salt. Absolute terms like "never again" and "always" have a way of looking silly within a short period. Then again, extrapolating the recent past is also dangerous. The trick for investors is to stay calm and patient, remain curious about, and alert to, change, use common sense, and be realistic and intellectually honest with themselves.

It is disconcerting to face a murky near-term outlook for the economy, but really, "uncertainty" is a permanent condition. We are watching carefully as industries and companies evolve and government policymakers do their best to keep us safe and prosperous. Individuals and company managements are endlessly resourceful. Recessions, financial crises – and even pandemics – come and go. We are still firm believers that stock prices always find their way back toward underlying business value. As long as this is true, our version of "value investing" ought to serve us well.

For full portfolio results and information on individual companies' contributions, we would refer you to the portfolio managers' commentaries. We would also encourage you to read Tom and Nolan's "Fixed Income Insights." They have done a remarkable job of preserving shareholder capital in the midst of a severe bear market for bonds.

40th Anniversary of Weitz Investment Management

On May 24, we will celebrate the 40th Anniversary of Weitz Investment Management at Happy Hollow Club in Omaha. We are hopeful that a number of original clients from the partnership days will be with us and that as many shareholders as possible will be on hand. We will plan to minimize the formal presentation and maximize the time for your questions. We look forward to seeing you then.

May 24, 2023, 4:30 pm CT

Happy Hollow Club, Omaha

View Agenda & Register Here

IMPORTANT DISCLOSURES

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 04/02/2023, 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.

As of 03/31/2023, the following portfolio companies constituted a portion of the net assets of Balanced Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows:

- Berkshire Hathaway, Inc: 2.6%, 10.1%, 5.9%, and 4.6%.
- JPMorgan Chase & Co (JPM): 1.3%, 0.0%, 0.0%, and 0.0%.
- SVB Financial Group: 0.0%, 0.0%, 0.0%, and 0.0%.
- Silvergate Capital Corp: 0.0%, 0.0%, 0.0%, and 0.0%.
- Signature Bank: 0.0%, 0.0%, 0.0%, and 0.0%.

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.