VALUE MATTERS / 2Q 2022

Certain Uncertainty

Weitz | INVESTMENT MANAGEMENT

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

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

The second quarter and first six months of 2022 were rough ones for stocks and bonds. The Fed finally made its first rate hike of 25 basis points in March and followed with a 50 basis point hike in May and 75 basis point hike in June. More increases are in prospect over the balance of the year. Debate rages as to how high interest rates will go, how soon inflation will be tamed, and whether the Fed can engineer a "soft landing" for the economy.

Rapidly rising rates had the predictable double-barreled negative impact on securities prices. Stock valuations (P/E ratios) declined and bond yields rose. And the possibility that rising rates would trigger a recession raised the specter of declining earnings for stocks and rising credit issues for bonds. By mid-June, the S&P 500 had declined by more than 20% and many stocks had fallen further. Bonds have suffered their steepest declines in decades.

The questions about inflation, interest rates and corporate earnings, not to mention wars, pandemics and politics, will be answered in time… but not right away. Then, of course, there will be more questions. "Uncertainty" is a permanent condition for investors.

Working Assumptions

We don't know what will happen in the short run, but we make working assumptions – and we hold them loosely. We believe that the era of zero interest rate policy (ZIRP) and monetization of the debt via quantitative easing (QE) – "free money" – is over for now. These policies inflated the prices of paper assets – stocks and bonds – and contributed to a strong bull market from 2009 to 2021. They probably also provided some of the fuel for the current inflation. The Fed has now reversed these policies and is in "inflation-fighting" mode. This means raising interest rates in order to cool off the economy, dampen demand for goods, and ideally, lower the inflation rate to their 2% target without causing a recession – i.e., achieve a "soft landing."

Inflation is complicated and the Fed's tools are blunt instruments. Our guess is that many of the causes of today's inflation (supply chain disruptions, labor shortages, and the war in Ukraine) will eventually resolve by themselves. On the other hand, some sectors of the economy, notably housing, are particularly sensitive to interest rates and will give clear signals to the Fed in real time. Nevertheless, even if their policy moves are effective and external events cooperate, we expect plenty of "head fakes" in the economic data that the press will report breathlessly and to which investors will react.

> *"...from the narrow point of view of investors, we believe that good long-term investment returns are, and will continue to be, available to patient, sensible investors."*

So, our expectation is that the general stock market will spend some time "consolidating," which is a gentle way of saying, moving in a choppy, sideways direction as stock valuations adjust to the new, higher interest rate environment and investors' moods vacillate.

Fortunately, Certainty is Not Required

What we have learned, over 50+ and 25+ years of investing, is that through the full range of imaginable (and some *un*imaginable) business conditions, entrepreneurs and business managers seem to find ways to cope with change and adversity. When things go wrong – at their companies or in the economy – they adapt and find solutions. This is *not* to say that *humanity* doesn't face some very serious challenges, *but from the narrow point of view of investors*, we believe that good long-term investment returns are, and will continue to be, available to patient, sensible investors.

If the economy slips into a recession, earnings will probably dip, but our businesses are likely to find ways to increase their future earning power and thus their business values. Most of our companies are acquisitive, and opportunities to buy great assets or whole businesses arise in periods of adversity. Our shareholders are familiar with the opportunistic investments that Berkshire Hathaway made during past financial crises. Danaher's 2020 purchase of the biopharma business of GE Healthcare was brilliant. Liberty Media rescued Sirius XM from impending bankruptcy in 2009 with a $530 million loan (which was repaid with interest) and received a virtually free option on 40% of Sirius XM. That stake is now worth over **$10 billion**.

If stock prices are depressed, companies with strong balance sheets and cash flows will be able to step up their stock repurchase programs. Great businesses generate lots of “free cash flow.” Their first choice of uses for that cash is usually reinvestment in the business. But if a company can buy back its own stock **at the right price**, the value per share goes up for the remaining shareholders.

Companies with strong competitive positions and creative managements make their own breaks. They build, expand, and acquire regardless of what the stock market is doing. They roll with the punches thrown by the Fed, Congress, regulators, competitors . . . *and* recessions.

We own a collection of what we believe are very good businesses. For the most part, their prices have come down considerably over the past six months to levels we see as fairly attractive. We think these stocks, from these prices, could generate very good returns over the next 3-5 years. In bear markets, though, when investors get scared and brokers issue margin calls, stocks can get surprisingly cheap. We don’t know how this bear market will unfold, but the good news is that, for truly high-quality companies, business value is the gravitational force that eventually pulls depressed stock prices upward to reflect their growth in earnings power. The next few quarters may test our patience, but we feel very good about our companies and their futures.

As of 06/30/2022, the following portfolio company constituted a portion of the net assets of Balanced Fund, Hickory Fund, Partners III Opportunity Fund, Partners Value Fund, and Value Fund as follows:

- Berkshire Hathaway Inc.: 2.1%, 0.0%, 9.7%, 6.6%, and 4.0%.
- Danaher Corporation: 2.1%, 0.0%, 2.0%, 2.6%, and 4.7%.
- General Electric Company: 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- Liberty Media Corp – Liberty SiriusXM: 0.0%, 5.7%, 5.1%, 4.9%, and 2.9%.
- Sirius XM Holdings, Inc.: 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.