VALUE MATTERS / 3Q 2021

Bring It On

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We recently reread the past seven *Value Matters*, beginning with the issue from January 2020, just before the start of the COVID-19 pandemic. At the time, our stock funds had just turned in a great year. Valuation levels had us feeling cautious about the near-term outlook, but we had no clue of what would happen a few weeks later.

As COVID emerged and the world reacted with various versions of shutdowns, the S&P 500 dropped by about a third in six weeks. The prices of some great businesses fell to silly price levels, and we did some buying (Fortive, CoStar, S&P Global, IDEX, Heico). We prepared to wait patiently for a gradual return to normal as medical researchers developed vaccines and our society tried to learn to deal with the pandemic.

While the economic recovery ***has*** taken some time, the stock market roared back quickly as the Federal Reserve (Fed) injected trillions into the securities markets via bond purchases and Congress began distributing additional trillions directly to individuals, companies and other organizations. Within about six months, the market indexes were hitting new all-time highs.

Our stock funds have benefited from this resumption of the bull market, and our bond funds have coped well with a very difficult bond market. So, from an investment return point of view, things have been good.

However...

Yes, as you may have guessed, there is a "however" to serve as the fulcrum between the bull run and reality. Our regular readers may think we sound like a broken record on this point, saying "things have been good, but they could get bad at any minute." Well, yes, it's true. We think the government's seemingly "unlimited free money" has inflated stock and bond prices and that investors may have borrowed some returns from the future. This is no tragedy, but it makes investors anxious about the near-term outlook.

Our take is that a return to more "normal" levels of interest rates and government stimulus (fiscal and monetary) will likely lead to a moderation of stock valuations and higher interest rates (lower bond prices). This transition may have begun in the third quarter. Inflation indicators have perked up, and the Consumer Price Index (CPI) was up 5.3% year-over-year as of August 31, 2021. "Base effects" (comparisons against unusually depressed year-ago levels) and supply chain disruptions are at play. And at least until recently, the Fed had been predicting that the current spike in inflation would be "transitory." The bond market has reacted by selling off, so yields on bonds have been rising. As a result, the stock market was choppy in the third quarter, with September being downright weak.

> *"...the transition to 'normal' might be a little bumpy."*

We are not predicting anything catastrophic, just the normal ebb and flow of valuations. If the Fed is right about inflation and it settles back to their 2% target, *and* if they stop buying bonds and mortgage-backed securities (currently a big part of its quantitative easing program), it seems plausible that Treasury and corporate bond yields might drift up to levels at which investors could earn real (inflation-adjusted) returns. Bond yields would then offer a little stiffer competition to stocks than in recent years, and price-to-earnings (P/E) multiples might shrink. A gradual return to "normal" capital markets would represent a healthy change, in our opinion, even though it would create some headwinds for stock and bond prices.

On the other hand, the transition to "normal" might be a little bumpy. Speculation is rampant and traders are making liberal use of borrowed money. There is also a new generation of investors communicating over social media (Reddit, WallStreetBets) and trading on new "FinTech" platforms like Robinhood, who have collectively impacted stock and crypto markets. (For those interested in one author's version of the market fireworks that took place earlier this year as retail traders in GameStop, AMC Theaters, and other social media-hyped "meme" stocks clashed with hedge fund short sellers, we would recommend *The Antisocial Network* by Ben Mezrich.)

Leverage is often the ingredient that turns a mild correction into more serious volatility. If an investor pays for a security and it goes down – sad for him, but end of story. When borrowed money is involved, one investor's loss can be transmitted to others if he can't repay his loan. This can trigger the "contagion" that causes liquidity crises from time to time (e.g., September 2008 and March 2020).

By some measures, and certainly in absolute terms, use of leverage is at record levels today. Traditional margin debt, brokers' loans to clients, recently stood at $882 billion. Banks hold record levels of deposits and are motivated lenders. Unregulated lending by hedge funds and other members of the "shadow banking system" has also grown enormously. The crypto market includes thousands of different "tokens" with an aggregate market value in the neighborhood of $2 trillion. A significant proportion has been bought with borrowed money and is being held as collateral by lenders – an interesting situation given that the "value" of crypto is a function of crowd psychology. Leverage has always been a feature of the real estate market, and there are signs of distress among borrowers nationally and globally. A prominent example from today's headlines is the Chinese property company Evergrande which has defaulted on some of its $300 billion of debt. The implications for global real estate lenders are unclear (but not positive). Credit "accidents" seem inevitable, and fear of another crisis among lender "dominos" could affect capital markets from time to time.

Game Plan

We are not cheering for a bear market nor pain for other investors. But a little market chaos and a temporary sinking spell for stocks could actually turn out to be positive for our long-term returns. On the investment team, we spend most of our time studying the businesses we currently own as well as the "on deck" list of companies we would love to own if, and when, the price is right. In times of market stress, while index investors have no flexibility to adjust their portfolios, we can pick and choose among the bargains.

> *"...we think it is impossible* ***– and unnecessary*** *– to try to sidestep temporary drawdowns in our long-term investments."*

Weak stock markets can also be helpful to some of the companies we currently own. Some of our favorites may even be cheering for a bear market. Berkshire Hathaway, with over $150 billion in cash reserves, made some of its best investments during the 2008-2009 financial crisis. Berkshire "helped out" Bank of America, Goldman Sachs, and others that needed liquidity...badly. Danaher and Comcast were able to buy some of GE's best assets at attractive prices when GE needed liquidity. Most of our companies would like to make acquisitions and/or buy back their own shares, and a weak stock market can provide golden opportunities.

We have believed that stock prices were on the high side for years, so we make no pretense of knowing when the market may take a breather. Strange things have been happening lately – negative interest rates, "moonshot" moves by stocks of bankrupt companies, emergence of a truly enormous crypto market created out of thin air via computer code, non-fungible tokens (NFTs) (don't ask!), and the markets seem ripe for an "emperor's new clothes" moment. We won't participate in what seem like "greater fool" speculations, and while it would be nice to be "out" during a market correction, we think it is impossible – ***and unnecessary*** – to try to sidestep temporary drawdowns in our long-term investments.

Our plan is to own stocks that we think will be worth considerably more in five years than they are today. If the market runs into turbulence, and we have to wait a while for our stocks to realize their potential, we will sleep comfortably knowing that our businesses are growing, have staying power and will be able to play offense when the time is right. As we've said before, ***volatility*** is the friend of the investor who understands what she owns and has the temperament to take advantage when assets are mispriced. ***Bring it on.***

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As of 09/30/2021, 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:

- AMC Entertainment Holdings, Inc. (AMC): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- Bank of America Corp. (BAC): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- Berkshire Hathaway Inc. – Class B (BRK.B): 2.1%, 0.0%, 9.5%, 5.1%, and 4.5%.
- Comcast Corporation (CMCSA): 1.5%, 0.0%, 0.0%, 0.0%, and 2.8%.
- CoStar Group, Inc. (CSGP): 0.0%, 3.3%, 2.4%, 3.5%, and 3.8%.
- Danaher Corporation (DHR): 2.1%, 0.0%, 0.0%, 0.0%, and 4.2%.
- Fortive Corp. (FTV): 1.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- GameStop Corp. (GME): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- General Electric Company (GE): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- Goldman Sachs Group, Inc. (GS): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- HEICO Corp. (HEI): 0.0%, 2.9%, 0.0%, 2.7%, and 0.0%.
- IDEX Corporation (IEX): 1.0%, 1.7%, 0.0%, 1.6%, and 0.0%.
- Robinhood Markets, Inc. (HOOD): 0.0%, 0.0%, 0.0%, 0.0%, and 0.0%.
- S&P Global, Inc. (SPGI): 1.2%, 0.0%, 0.0%, 0.0%, and 2.6%.

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

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