VALUE MATTERS / 3Q 2022

Don't Wait for the Robins

Weitz | INVESTMENT MANAGEMENT

The Fed's campaign against inflation continues. U.S. Treasury yields in the area of 4% are dramatically higher than any we have seen in recent years. Mid-single-digit interest costs are moderate by historical standards and should pose no major issues for individuals and companies over the next few years, but the "sticker shock" of 7% mortgage rates and the squeeze on borrowers who must refinance at higher rates is real.


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The economy is slowing, with housing being the most visible example. Many companies' earnings have held up fairly well so far, but with each earnings report, managements are issuing very cautious/negative "guidance" about business prospects for the next few quarters.

Investors tend to obsess over near-term prospects – the next data point, the trend and even the "rate of change" within the trend. The financial media fan their fears because, as with weather reports, raising anxiety levels is good for business. This leads to active trading and volatility in stock and bond markets.

So, fear is driving markets these days. The third quarter began with a strong rally off the June lows but resumed its slide in mid-August and ended the quarter at new lows for the year. The S&P 500 was down nearly 25% as of September 30, and gloom was very thick.

How serious is this for investors?

The Fed is getting what it wanted. Fed Chair Jay Powell seems to have channeled his inner Paul Volcker (the former Fed Chair who raised rates to a peak of 20% to combat rampant inflation in the early 1980s), so we would ***not*** expect Powell to relent any time soon. Interest rates are expected to rise further, and the money supply, which has already contracted considerably, is likely to shrink further. These credit tightening moves will continue to slow the economy. Even the very strong labor market is showing some signs of cooling. Whether the National Bureau of Economic Research eventually defines this period as a recession isn't really important. The fact is, it ***feels*** like a recession, and companies and investors are acting accordingly.

Nothing is ever simple in global economics, but there is an extra wildcard this time – the war in Ukraine. The war has exposed Europe's dependence on Russian energy. Western sanctions and Russian countermoves have caused disruptions of supplies and an energy crisis in Europe. Less visible, but perhaps more important, is a global food crisis that has been exacerbated by the war. The inflationary impact of these supply disruptions complicates the roles of central banks in fighting inflation.

A by-product of higher U.S. interest rates and spiking global energy prices has been a big move up in the value of the dollar relative to other major currencies. There are positive aspects of a strong currency, but it can be negative for domestic companies because our exports are more expensive/less attractive to foreign buyers and profits earned abroad in other currencies translate back to fewer dollars/lower reported earnings.

So, the headwinds for stock and bond prices are real, but the ***outlook*** for investments is always about the ***value of future cash flows relative to the current price***. If bonds default or a company's competitive position is permanently impaired, investors can incur permanent loss of capital. But a temporary slowdown in the economy and lower earnings per share for a few quarters do ***not*** impair the business value of a strong company. Bonds trade lower when new investors have higher-yielding alternatives, but sound bonds mature at par value – 100 cents on the dollar – and in the meantime, interest payments can be reinvested at higher rates (this "interest on interest" is a significant component of total return for bonds).

Back to the Future – A Return to "Normal" Capital Markets

Over the decades, the Fed and Congress have occasionally intervened to stimulate or cool down the economy. In our experience, those fiscal and monetary moves didn't last long, and investors learned what to expect and how to respond.

Since the Great Financial Crisis (GFC) of 2008-09, though, it has seemed that the government has felt the need to protect investors from any financial pain. Near-zero interest rates for over ten years and very aggressive fiscal stimulus in response to Covid inflated stock and bond prices and taught a new generation of investors that valuation did not matter. We responded to this surreal environment by placing even more emphasis on business quality and by holding onto great businesses, even as they reached fairly full valuations.

Last year the Fed recognized that we had an inflation problem and made a 180-degree shift in policy. This is the Fed we remember, and if they stick to their plan and bring inflation under control, we think the return to "normal" will be positive for long-term investors. Weak, over-indebted companies will not be subsidized with "free" money. Bonds will provide competition for investment dollars, and savers will be rewarded again. Stocks can still be great long-term investment vehicles, but to paraphrase an old commercial for the brokerage company Smith Barney, they will have to win the old-fashioned way, they will have to ***earn*** it. (Can those of a certain age hear John Houseman snarling the punch line?)

In the Meantime – Business Values Are STILL Our North Star

At this stage of a bear market, most stocks are falling just because sellers are motivated and buyers are not. We can protest that our stocks are misunderstood and "cheap," but the flow of investment funds is ***out*** for the moment, and that is what matters in the short run.

In the longer term, though, we believe that a stock's price will eventually be determined by the value of the business. Covid disruptions and potential recession may temporarily impact the path of earnings, but it is the long-term ***future*** cash flows that matter.

We think there is also some confusion about the value of "long-duration" stocks. The criticism relates to rapidly growing companies with little or no earnings ***today*** but promises/hopes of lots of earnings in a (perhaps somewhat distant) ***tomorrow***. It is fair to note that rising rates are especially hard on these companies' valuations because of the math of discounted cash flow analysis. These stocks may have been very overvalued going into the higher-rate environment. However, many investors seem to have made the incorrect generalization that rapid growth ***itself*** is a negative in the new environment. We would contend that some great businesses (e.g., Google, Visa, Mastercard) have lots of earnings ***today*** and will have even more ***tomorrow***. This makes for ***very*** valuable businesses, and we own a number of them.

While this bear market runs its course, we continue to monitor our current holdings and look for others that offer solid business value at attractive prices. This requires patience, and investors who have been through distressed times know that holding, or even adding to, positions can be the key to long-term compounded returns. We are grateful for the long-time shareholders who have stuck with us through times like this before.

The Gloom is Thick—But Bear Markets End When You Least Expect It

The bad news for corporate profits is likely to continue for a while, and the bear market may have further to run (drop). But after the selling has run its course – after desperate sellers stop accepting distress prices and buyers regain some courage – the bear market ends. There is no way to predict with any certainty when this will happen, but the turn will probably ***not*** come because the news has turned positive – it will come ***before*** the coast is clear. As Warren Buffett said in late 2008, "If you wait for the robins, Spring will be over."

Our companies have been going about their businesses, generating cash and growing their future earning power. They are taking market share at the expense of weaker competitors and buying productive assets from others that need the money. It may seem counter-intuitive, but long-term growth in earning power and business value is very often ***enhanced*** by periods of adversity. Market drawdowns can be painful in the moment. But over the long history of the stock market, bears – even deep ones – have tended to disappear into the steady, upward-sloping pattern of long-term stock charts.

IMPORTANT DISLCOSURES

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As of 09/30/2022, 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:

- Alphabet, Inc.: 1.8%, 0.0%, 6.5%, 7.0%, and 7.2%.
- Visa, Inc.: 1.6%, 0.0%, 5.6%, 4.3%, and 4.2%.
- Mastercard, Inc.: 1.6%, 0.0%, 4.4%, 3.8%, and 4.2%.

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.

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