Our *Promise* to Clients

*W*e are anything but just another Wall Street firm, and therefore not everyone who knocks on our door is an appropriate client for us.

*O*ur clients are our partners, and just like partners in a marriage, we need to share the same values. Our values are spelled out in Six Commandments of Value Investing (read, listen).

*W*e promise to be honest and transparent with our partners. We will invest their money with the same thoughtfulness, care, diligence, and slight hint of paranoia that we employ in investing our own (easy for us to do, as nearly all the liquid net worth of our portfolio managers and their families is invested in the same stocks our clients own).

*W*e are a firm with a soul, and we'll never do anything that would put our interests before those of our clients.

*W*e're not trying to be the biggest investing firm, just the best one. In addition to striving to provide great true-risk-adjusted returns, we'll deliver excellent customer service and a one-of-a-kind client experience.

June 7, 2021

Dear Client,

We are going to divide this seasonal letter into two parts. This is part one. I am embarrassed to say it is 19 pages long and doesn't mention a single stock we own. Why? Because we are, quite simply, in the most unusual set of economic circumstances I've encountered in my investing career.

As I considered the complexities of inflation and macroeconomics today, I had a hard time switching back to a discussion of individual stocks. I inadvertently wandered into a discussion of cryptocurrencies, which, though they are of very little interest to me, do highlight the speculative mood of today's environment. I also touched upon market timing, international investing (we are going to introduce a new ex-US portfolio in a few months) and sideways markets (we might be staring at one).

A few quick thoughts about our portfolio: We are very happy with the companies we own. Their businesses have been humming along well and improving nicely as the virus dies out and the global economy reopens. We've made some tiny adjustments to the portfolio over the last few months; but overall, despite the market being somewhere between very-very and very-very-very expensive, our portfolio is still significantly undervalued (though less than it was a few months ago).

In the second part of the letter, which I'll start working on next, we'll discuss individual stocks and answer questions you sent in. Feel free to send more questions to pa@imausa.com.

Inflation?

This letter is going to be long. I blame word inflation, be it transitory or not, for inflating its length.

The number one question I am asked by clients, friends, readers, and random strangers is, are we going to have inflation?

I think about inflation on three timelines: short, medium, and long-term.

The pandemic disrupted a well-tuned but perhaps overly optimized global economy and time-shifted the production and consumption of various goods. For instance, in the early days of

the pandemic automakers cut their orders for semiconductors. As orders for new cars have come rolling back, it is taking time for semiconductor manufacturers, who, like the rest of the economy, run with little slack and inventory, to produce enough chips to keep up with demand. A $20 device the size of a quarter that goes into a $40,000 car may have caused a significant decline in the production of cars and thus higher prices for new and used cars. (Or, as I explained to my mother-in-law, all the microchips that used to go into cars went into a new COVID vaccine, so now Bill Gates can track our whereabouts.)

Here is another example. The increase in new home construction and spike in remodeling drove demand for lumber while social distancing at sawmills reduced lumber production – lumber prices spiked 300%. Costlier lumber added $36,000 to the construction cost of a house, and the median price of a new house in the US is now about $350,000.

The semiconductor shortage will get resolved by 2022, car production will come back to normal, and supply and demand in the car market will return to the pre-pandemic equilibrium. High prices in commodities are cured by high prices. High lumber prices will incentivize lumber mills to run triple shifts. Increased supply will meet demand, and lumber prices will settle at the pre-pandemic level in a relatively short period of time. That is the beauty of capitalism!

Most high prices caused by the time-shift in demand and supply fall into the short-term basket, but not all. It takes a considerable amount of time to increase production of industrial commodities that are deep in the ground – oil, for instance. Low oil prices preceding the pandemic were already coiling the spring under oil prices, and COVID coiled it further. It will take a few years and increased production for high oil prices to cure high oil prices. Oil prices may also stay high because of the weaker dollar, but we'll come back to that.

Federal Reserve officials have told us repeatedly they are not worried about inflation; they believe it is transitory, for the reasons I described above. We are a bit less dismissive of inflation, and the two factors that worry us the most in the longer term are labor costs and interest rates.

Let's start with labor costs.

During a garden-variety recession, companies discover that their productive capacity exceeds demand. To reduce current and future output they lay off workers and cut capital spending on equipment and inventory. The social safety net (unemployment benefits) kicks in, but not enough to fully offset the loss of consumer income; thus demand for goods is further reduced, worsening the economic slowdown. Through millions of selfish transactions (microeconomics), the supply of goods and services readjusts to a new (lower) demand level. At some point this readjustment goes too far, demand outstrips supply, and the economy starts growing again.

This pandemic was not a garden-variety recession.

The government manually turned the switch of the economy to the "off" position. Economic output collapsed. The government sent checks to anyone with a checking account, even to those who still had jobs, putting trillions of dollars into consumer pockets. Though output of the economy was reduced, demand was not. It mostly shifted between different sectors within the

economy (home improvement was substituted for travel spending). Unlike in a garden-variety recession, despite the decline in economic activity (we produced fewer widgets), our consumption has remained virtually unchanged. Today we have too much money chasing too few goods– that is what inflation is. This will get resolved, too, as our economic activity comes back to normal.

But.

Today, though the CDC says it is safe to be inside or outside without masks, the government is still paying people not to work. Companies have plenty of jobs open, but they cannot fill them. Many people have to make a tough choice between watching TV while receiving a paycheck from big-hearted Uncle Sam and working. Zero judgement here on my part – if I was not in love with what I do and had to choose between stacking boxes in Amazon's warehouse or watching Amazon Prime while collecting a paycheck from a kind uncle, I'd be watching *Sopranos* for the third time.

To entice people to put down the TV remote and get off the couch, employers are raising wages. For instance, Amazon has already increased minimum pay from $15 to $17 per hour. Bank of America announced that they'll be raising the minimum wage in their branches from $20 to $25 over the next few years. The Biden administration may not need to waste political capital passing a Federal minimum wage increase; the distorted labor market did it for them.

These higher wages don't just impact new employees, they help existing employees get a pay boost, too. Labor is by far the biggest expense item in the economy. This expense matters exponentially more from the perspective of the total economy than lumber prices do. We are going to start seeing higher labor costs gradually make their way into higher prices for the goods and services around us, from the cost of tomatoes in the grocery store to the cost of haircuts.

Only investors and economists look at higher wages as a bad thing. These increases will boost the (nominal) earnings of workers; however, higher prices of everything around us will negate (at least) some of the purchasing power.

Wages, unlike timber prices, rarely decline. It is hard to tell someone "I now value you less." Employers usually just tell you they need less of your valuable time (they cut your hours) or they don't need you at all (they lay you off and replace you with a machine or cheap overseas labor). It seems that we are likely going to see a one-time reset to higher wages across lower-paying jobs. However, once the government stops paying people not to work, the labor market should normalize; and inflation caused by labor disbalance should come back to normal, though increased higher wages will stick around.

There is another trend that may prove to be inflationary in the long-term: de-globalization. Even before the pandemic the US set plans to bring manufacturing of semiconductors, an industry deemed strategic to its national interests, to its shores. Taiwan Semiconductor and Samsung are going to be spending tens of billions of dollars on factories in Arizona.

The pandemic exposed the weaknesses inherent in just-in-time manufacturing but also in over reliance on the kindness of other countries to manufacture basic necessities such as masks or chemicals that are used to make pharmaceuticals. Companies will likely carry more inventory going forward, at least for a while. But more importantly more manufacturing will likely come back to the US. This will bring jobs and a lot of automation, but also higher wages and thus higher costs.

If globalization was deflationary, de-globalization is inflationary.

We are not drawing straight-line conclusions, just yet. A lot of manufacturing may just move away from China to other low-cost countries that we consider friendlier to the US; India and Mexico come to mind.

And then we have the elephant in the economy – interest rates, the price of money. It's the most important variable in determining asset prices in the short term and especially in the long term. The government intervention in the economy came at a significant cost, which we have not felt yet: a much bigger government debt pile. This pile will be there long after we have forgotten how to spell *social distancing.*

The US government's debt increased by $5 trillion to $28 trillion in 2020 – more than a 20% increase in one year! At the same time the laws of economics went into hibernation: The more we borrow the less we pay for our debt, because ultra-low interest rates dropped our interest payments from $570 billion in 2019 to $520 billion in 2020.

That is what we've learned over the last decade and especially in 2020: The more we borrow the lower interest we pay. I should ask for my money back for all the economics classes I took in undergraduate and graduate school.

This broken link between higher borrowing and near-zero interest rates is very dangerous. It tells our government that how much you borrow doesn't matter; you can spend (after you borrow) as much as your Republican or Democratic heart desires.

However, by looking superficially at the numbers I cited above we may learn the wrong lesson. If we dig a bit deeper, we learn a very different lesson: Foreigners don't want our (not so) fine debt. It seems that foreign investors have wised up: They were not the incremental buyer of our new debt – *most of the debt the US issued in 2020 was bought by Uncle Fed.* Try explaining to your kids that our government issued debt and then bought it itself. Good luck.

Let me make this point clear: Neither the Federal Reserve, nor I, nor a well-spoken guest on your business TV knows where interest rates are going to be (the total global bond market is bigger even than the mighty Fed, and it may not be able to control over interest rates in the long run). But the impact of what higher interest rates will do the economy increases with every trillion we borrow. There is no end in sight for this borrowing and spending spree (by the time you read this, the administration will have announced another trillion in spending).

Let me provide you some context about our financial situation.

The US gross domestic product (GDP) – the revenue of the economy – is about $22 trillion, and in 2019 our tax receipts were about $3.5 trillion. Historically, the-10 year Treasury has yielded about 2% more than inflation. Consumer prices (inflation) went up 4.2% in April. Today the 10-year Treasury pays 1.6%; thus the World Reserve Currency debt has a negative 2.6% *real* interest rate (1.6% - 4.2%).

These negative real (after inflation) interest rates are unlikely to persist while we are issuing trillions of dollars of debt. But let's assume that half of the increase is temporary and that 2% inflation is here to stay. Let's imagine the unimaginable. Our interest rate goes up to the historical norm to cover the loss of purchasing power caused by inflation. Thus it goes to 4% (2 percentage points above 2% "normal" inflation). In this scenario our federal interest payments will be over $1.2 trillion (I am using vaguely right math here). A third of our tax revenue will have to go to pay for interest expense. Something has to give. It is not going to be education or defense, which are about $230 billion and $730 billion, respectively. You don't want to be known as a politician who cut education; this doesn't play well in the opponent's TV ads. The world is less safe today than at any time since the end of the Cold War, so our defense spending is not going down (this is why we own a lot of defense stocks).

The government that borrows in its own currency and owns a printing press will not default on its debt, at least not in the traditional sense. It defaults a little bit every year through inflation by printing more and more money. Unfortunately, the average maturity of our debt is about five years, so it would not take long for higher interest expense to show up in budget deficits.

Money printing will bring higher inflation and thus even higher interest rates.

If things were not confusing enough, higher interest rates are also deflationary.

We've observed significant inflation in asset prices over the last decade; however, until this pandemic we had seen nothing yet. Median home prices are up 17% in one year. The wild, speculative animal spirits reached a new high during the pandemic. Flush with cash (thanks to kind Uncle Sam), bored due to social distancing, and borrowing on the margin (margin debt is hitting a 20-year high), consumers rushed into the stock market, turning this respectable institution (okay, wishful thinking on my part) into a giant casino.

It is becoming more difficult to find undervalued assets. I am a value investor, and believe me, I've looked (we are finding some, but the pickings are spare). The stock market is very expensive. Its expensiveness is setting 100-year records. Except, bonds are even more expensive than stocks – they have negative real (after inflation) yields.

But stocks, bonds, and homes were not enough – too slow, too little octane for restless investors and speculators. Enter cryptocurrencies (note: plural). Cryptocurrencies make Pets.com of the 1999 era look like a conservative investment (at least it had a cute sock commercial). There are hundreds if not thousands of crypto "currencies," with dozens created every week. (I use the word *currency* loosely here. Just because someone gives bits and bytes a name, and you can buy these bits and bytes, doesn't automatically make what you're buying a currency.)

"The definition of a bubble is when people are making money all out of proportion to their intelligence or work ethic." – The Big Short

I keep reading articles about millennials borrowing money from their relatives and pouring their life savings into cryptocurrencies with weird names, and then suddenly turning into millionaires after a celebrity CEO tweets about the thing he bought. Much ink is spilled to celebrate these gamblers, praising them for their ingenious insight, thus creating ever more FOMO (fear of missing out) and spreading the bad behavior.

Unfortunately, at some point they will be writing about destitute millennials who lost all of their and their friends' life savings, but this is down the road. Part of me wants to call this a crypto craziness a bubble, but then I think, Why that's disrespectful to the word *bubble,* because something has to be worth something to be overpriced. At least tulips were worth something and had a social utility. (I'll come back to this topic later in the letter).

But.

When interest rates are zero or negative, stocks of sci-fi-novel companies that are going to colonize and build five-star hotels on Mars are priced as if El Al (the Israeli airline) has regular flights to the Red Planet every day of the week except on Friday (it doesn't fly on Shabbos). Rising interest rates are good defusers of mass delusions and rich imaginations.

In the real economy, higher interest rates will reduce the affordability of financed assets. They will increase the cost of capital for businesses, which will be making fewer capital investments. No more 2% car loans or 3% business loans. Most importantly, higher rates will impact the housing market.

Up to this point, declining interest rates increased the affordability of housing, though in a perverse way: The same house with white picket fences (and a dog) is selling for 17% more in 2021 than a year before, but due to lower interest rates the mortgage payments have remained the same. Consumers are paying more for the same asset, but interest rates have made it affordable.

At higher interest rates housing prices will not be making new highs but revisiting past lows. Declining housing prices reduce consumers' willingness to improve their depreciating dwellings (fewer trips to Home Depot). Many homeowners will be upside down in their homes, mortgage defaults will go up… well, we've seen this movie before in the not-so-distant past. Higher interest rates will expose a lot of weaknesses that have been built up in the economy. We'll be finding fault lines in unexpected places – low interest has covered up a lot of financial sins.

And then there is the US dollar, the world's reserve currency. Power corrupts, but the unchallenged and unconstrained the power of being the world's reserve currency corrupts absolutely. It seems that our multitrillion-dollar budget deficits will not suddenly stop in 2021. With every trillion dollars we borrow, we chip away at our reserve currency status (I've written about this topic in great detail, and things have only gotten worse since). And as I mentioned above, we've already seen signs that foreigners are not willing to support our debt addiction.

A question comes to mind: **Am I yelling fire where there is not even any smoke?**

Higher interest rates is anything but a consensus view today. Anyone who called for higher rates during the last 20 years is either in hiding or has lost his voice, or both. However, before you dismiss the possibility of higher rates as an unlikely plot for a sci-fi novel, think about this.

In the fifty years preceding 2008, housing prices never declined nationwide. This became an unquestioned assumption by the Federal Reserve and all financial players. Trillions of dollars of mortgage securities were priced as if "Housing shall never decline nationwide" was the Eleventh Commandment, delivered at Temple Sinai to Goldman Sachs. Or, if you were not a religious type, it was a mathematical axiom or an immutable law of physics. The Great Financial Crisis showed us that *confusing the lack of recent observations of a phenomenon for an axiom may have grave consequences.*

Today everyone (consumers, corporations, and especially governments) behaves as if interest rates can only decline, but what if… I know it's unimaginable, but what if ballooning government debt leads to higher interest rates? And higher interest rates lead to even more runaway money printing and inflation?

This will bring a weaker dollar.

A weaker US dollar will only increase inflation, as import prices for goods will go up in dollar terms. This will create an additional tailwind for commodity prices.

If your head isn't spinning from reading this, I promise mine is from having written it.

To sum up: A lot of the inflation caused by supply chain disruption that we see today is temporary. But some of it, particularly in industrial commodities, will linger longer, for at least a few years. Wages will be inflationary in the short-term and will reset prices higher, but once the government stops paying people not to work, wage growth should slow down. Finally, in the long term a true inflationary risk comes from growing government borrowing and budget deficits, which will bring higher interest rates and a weaker dollar with them, which will only make inflation worse and will also deflate away a lot of assets.

How do we invest in an inflationary environment?

Thoughtfully and humbly.

We need to recognize that inflation in the long-term is a probability but not a certainty. Macroeconomics is a voodoo science; it appropriately belongs in the liberal arts department. The economy is an incredibly complex and unpredictable system.

Here is an example: Japan is the most indebted developed nation in the word (its debt-to-GDP exceeds 260%, while ours is 130% or so). Its population is shrinking, and thus its level of indebtedness per capita is going up at a much faster rate than the absolute level of debt. Anyone,

including yours truly, would have thought that this forest full of dry wood was one lightning strike away from a disastrous conflagration. And yet Japanese interest rates are lower than ours and the country has been mired in a deflationary environment for decades.

Admittedly, Japan has a lot of unique economic and cultural issues: Companies are primarily run for the benefit of employees, not shareholders (unproductive employees are never let go); there are a lot of zombie companies that should have been allowed to fail decades ago; and the Japanese asset bubble burst in 1991, when debt-to-GDP was only 60%. The point still stands: Long-term forecasting of inflation and deflation is an incredibly difficult and humbling exercise.

As investors we have to think not in binary terms but in probabilities. The acceleration of our debt issuance and our government's seeming indifference to it and to ballooning budget deficits raise the probability and the likely severity of inflation. At the same time, we have to accept the possibility that the economic gods are playing cruel games with us gullible humans and have deflation in store for us instead.

Inflation and higher interest rates are joined at the hip. The expectation of higher inflation will raise interest rates, as bond investors will demand a higher return. This in turn will result in larger budget deficits and more money printing and thus more borrowing and even higher interest rates.

Here is how we are positioning our portfolio for the risk – the possibility, not the certainty – of long-term inflation:

Valuation matters more than ever. Higher interest rates are an inconvenience to short-duration assets whose cash flows are near the present and devastating to long-duration assets. Here is a very simple example: When interest rates rise 1%, a bond with a maturity of 3 years will decline about 2.5%, while one with a maturity of 30 years will decline 25% or so.

The same applies to companies whose cash flows lie far in the future and who are thus very sensitive to increases in the discount rate (interest rates and inflation). Until recently they have disproportionally benefited from low interest rates. They are the ones that you will most likely find trading in the bubble territory today. But their high valuations (high price-to-earnings ratio) will revert downward. Value stocks will be back in vogue again. We have started seeing the rotation from growth to value recently.

Inflation will benefit some companies, be indifferent to others, and hurt the rest. To understand what separates winners from losers, we need to understand the physics of how inflation flows through a company's income statement and balance sheet.

Let's start with revenue. Higher prices across the economy are a main feature of inflation. We want to own companies that have pricing power. **Pricing power** is the ability to raise prices without suffering a decline in revenue that comes from customers' inability to afford higher prices or from the loss of customers to competitors.

Companies that have strong brands, monopolies, or products that represent a very small portion of customer budgets usually have pricing power.

If Apple raises prices on the iPhone, you'll curse Steve Jobs and pay the higher price. (A friend of mine curses him every time the iPhone frustrates him. I keep reminding him that Steve is no longer with us. Doesn't help.) Of course, if Apple raises iPhone prices too much and its products become unaffordable, consumers may just start buying iThings less often.

Tobacco companies have pricing power. I lived through a hyperinflation in Russia in the late 1980s and early 1990s, I was a smoker then. One day cigarette prices doubled. I experienced a price shock. I cursed at tobacco companies; cigarettes did not get any cheaper. A day later I was paying double again for my cigarettes. Smokers are very loyal to their brands, and cigarettes are an addictive product. We own plenty of these stocks, too. The same applies to beer and especially hard liquor. (If you think tobacco stocks are socially irresponsible investing choices, you are … just read my thoughts on this topic here).

What the pandemic showed us is that humans are adaptable creatures – you throw adversity at us, we'll indulge in angry outbursts but we'll adapt. The rate of change of inflation matters even more than absolute rate of inflation. If inflation remains predictable, even at a higher level, then businesses will plan for and price it into their products. If the rate of growth is highly variable, then there is going to be a war of pricing powers for shrinking purchasing ability of the end customer. We want to own companies that are on the winning side of that war.

Let's go to the expenses side of the income statement. Companies whose expenses are impacted the least by rising prices do well, too. Generally, companies with larger fixed costs do better.

But.

It is important to differentiate whether the capital intensity of a business lies in the past or in the future. A business whose high capital intensity is in the past benefits from inflation. Think of a pipeline company, for instance (we own plenty of those). Most of its costs are fixed, and they have been incurred in yesterday's pre-inflation dollars. The cost of maintaining pipelines will go up, but in relation to the total cost of constructing pipelines these costs are small. However, companies that operate pipelines have debt-heavy balance sheets, which can become a source of higher costs. Pipeline companies we own have debt maturities that go out many decades into the future. They'll be paying off these debts with inflated cash flows.

I've seen studies that looked at asset prices over the last few decades and declared "These assets have done the best in past inflations." Most of these studies missed a small but incredibly important detail: The price you pay for the asset matters. If we are entering into an inflationary environment today, it is happening when asset prices are at the highest valuation in over a century. (This was not always the case during the period covered by these studies.)

For instance, one study showed that REITs have done well during past inflations. This may not be the case going forward. Aside from its being a very broad and general statement (not all REITs are created equal), low interest rates brought a lot of capital into this space and inflated

valuations. Investors were attracted to current income, which was better than from bonds, and they paid little attention to the valuations of the underlying assets. Buying REIT ETFs may do more harm than good.

I cannot stress this point enough: Whatever landscape is ahead of us, we are entering into it with very high valuations and an economy addicted to low interest rates.

We have to be very careful about relying on generalized comments about past inflations. We need to be nuanced in our thinking.

We get asked about gold and cash

Gold: We don't have a great love for gold. We have a position through options as a hedge. We discussed it in the past in great depth, so I won't bore you with it here.

Cash: I am basically referring to short-term bonds, which seem like the most comfortable asset to be in today. However, their ability to keep up with inflation has been spotty in the past. It is okay in the short term but likely to be value-destructive in the long term. Our view on cash has not changed: In a portfolio context cash should be a residual on other investment decisions. In our portfolios cash is what is left when we run out of investment ideas.

Going ex-US

The US government was not the only one borrowing and paying people to stay at home. But the US has done it to a much greater degree than others. Most importantly, we are not slowing down our spending (and thus borrowing), which will likely lead to a weaker dollar. If nothing else, a declining dollar makes foreign securities more valuable in US dollars. The probability of a stronger dollar is low.

But there is more.

The next decade will likely belong to ex-US investing. If you invested outside the US over the last decade, your returns were overshadowed by the gigantic outperformance of the US markets. Today the US is the most expensive developed market. Take Europe, for instance; most European stocks are still trading below 2007 highs. UK stocks trade at a half of the valuation of US stocks.

Our approach to investing is very simple: We are diehard value investors looking for high-quality companies that are significantly undervalued and run by great management. We do not change into flamboyant value-indifferent investors when we cross the border. International investing just gives us a greater palette with which to paint our investing canvas.

We've been doing ex-US investing for a long time. Today, about a third of our portfolio is in international stocks. In a few months we are going to roll out a new ex-US portfolio (some stocks from this portfolio will spill into our core value and dividend portfolios, but not all).

If you thought we had a silver bullet and easy answers, we don't. I know what I am about to say is going to fall on deaf ears, especially since we are in an apparently never-ending bull market. But *as steward of our clients' capital, our most important objective is survival (avoiding permanent loss of capital and maintaining purchasing power) in both inflationary and deflationary environments.*

Last decade this did not matter. Risks were only figments of our imagination, as money printing by the Fed, which was trying to fix a lot of sins and became the biggest sin of all – significantly distorting the price of money and thus the economy. But as Charlie Munger said, "If you are not confused about the global economy, you don't understand it."

A suddenly appearing iceberg is life-threatening to a speedboat (or cruise liner), but it is just an unpleasant inconvenience for an icebreaker. Our goal is to have a portfolio of icebreakers. We are playing a different game – we are not racing against the speedboats. We take comfort in knowing that, while the speedboats may outrace us for some time, they are bound to eventually hit an iceberg and sink. One iceberg that we have an eye on today is inflation (though we are prepared for deflation, too.)

Sideways Markets

I started writing my first book, Active Value Investing: Making Money in Range-Bound Markets, in 2005 and finished it in 2007. I published the second, an abridged version of the first (The Little Book of Sideways Markets), in 2010. In both books I made the case that there was a very high probability that we were in the midst of a secular sideways market – a market that goes up and down, with a lot of cyclical volatility, but ends up going nowhere for a long time.

Sideways markets happen not because the stock market gods play an unkind joke on gullible humans but because of human emotions. Historically, sideways markets have always followed secular bull markets. At the end of secular bull markets stocks become very expensive – their valuations (P/Es) get very high. Sideways markets are just a payback for all the fun and returns stock investors enjoyed during secular bull markets.

In 1999, after 17 years of incredible returns, the mother of all secular bull markets ended with valuations we'd never seen before. For this reason, in my first book I argued that the sideways market that started then might last longer than past ones. In the Little Book I went a step farther with the benefit of hindsight – it was written post-Great Recession. I argued that the economic growth rate going forward would be lower than it was in the past, and thus this sideways market might last even longer than I originally suspected.

Both books provided a framework for how to think about paths that might lie in our future.

Fast-forward a decade. The market we've been in was anything but sideways. Was I wrong? Yes.

What I failed to see was how the Great Financial Crisis would change the role the Fed would play in our economy, that it would continue to buy our debt while the economy was expanding.

Also, I was blindsided by our government's changed attitude toward debt (the US debt-to-GDP was at 60% in 2005, at 100% in 2019, and is 130% today). Most importantly, if you had told me that as that our debt pile was growing our interest rates would decline to near zero, I wouldn't have believed you.

This brings me to today.

In modern stock market history, since the 1890s, we've entered into sideways markets when market valuations were very high (check!) at the end of a long-lasting (secular) bull market (maybe; we'll only know in hindsight, but it's hard to deny that we've had one hell of a run). Price to earnings, not earnings growth, was the largest source of stock market appreciation (check! Stocks are making new highs because of the pandemic and the budget deficits. Think about that.) There was a lot of euphoria about stocks as they became a national pastime (check! Though now they are sharing the spotlight with crypto.)

As euphoria deflates, valuations stop expanding. Investors become disillusioned, bored with stocks. Price to earnings stagnates and then goes into a long-term compression cycle, from above average, through average, to below average. (It then spends plenty of time below average, turning investors away from stocks). Any gains you get from earnings growth are offset by price-to-earnings compression.

Today, stock market valuations are at an all-time high. Rising interest rates and inflation may serve as chilling factors to price-to-earning expansion; after all, declining interest rates were instigators of the price-to-earnings expansion on the way up.

I've written two books on this topic and don't have a burning desire to write another one here; however, here are our Active Value Investment Principles (straight from my books):

- Be an active value investor. Traditional buy-and-forget-to-sell investing is not dead but is in a coma waiting for the next secular bull market to return – and it's still far, far away. Sell discipline needs to be kicked into higher gear.

- Increase margin of safety. Value investors seek a margin of safety by buying stocks at a significant discount to protect them from overestimating the "E." In this environment that margin needs to be even more beefed up to account for the impact of constantly declining P/Es.

- Don't fall into the relative valuation trap. Many stocks will appear cheap based on historical valuations, but past bull market valuations will not be helpful again for a long time. (I cannot stress this point enough.)

- Don't time the market. Though market timing is alluring, it is very difficult to do well. Instead, value individual stocks, buying them when they are cheap and selling them when they become fairly valued.

- Don't be afraid of cash. Secular bull markets taught investors not to hold cash, as the opportunity cost of doing so was very high. The opportunity cost of cash is a lot lower during a sideways market. And staying fully invested will force you to own stocks of marginal quality or ones that don't meet your heightened margin of safety.

- Invest globally. "The larger the pool of stocks you can choose from, the higher the bar – the opportunity cost – that a new stock has to overcome to make it into the portfolio."

If you'd like us to mail you a copy of *The Little Book of Sideways Markets*, please let us know.

Fool's Gambit

Today the stock market is in a bubble; this is not a secret to most market participants. Most investors are ignoring it and just infatuated with the ride. They are playing *Fool's Gambit* - waiting for a greater fool to buy their overvalued stock from them. And why not, greater fools have been showing up in droves for years. Low interest rates inflated the prices of all assets forcing everyone to take greater and greater risks.

Then there is pure, unadulterated greed. This market bubble is filled with this "get rich fast" attitude and the fear of missing out; all bubbles are. This time the market has been further deformed by social media, which seems like an enormous amplifier and arguably prolonger of that behavior, bringing what seems an endless supply of incremental buyers (bigger fools).

Companies like GameStop make Tesla's valuation look rational (Tesla's valuation is anything but rational, as I wrote before, it discounts a temporal wormhole into the future). But at least Tesla is a company of the future. GameStop is a struggling retailer of video games where the future – digital downloads – make its business model obsolete one download at a time. As of this writing it is valued at $17 billion dollars.

Initially GameStop's ascent may have started as financial nihilism by "have nots" trying to blow up the haves ("greedy hedge funds") that were short the stocks. Short sellers left GameStop stock months ago.

Today GameStop's stock is completely divorced from the underlying business it is supposed to represent. If the company never files another financial report shareholders won't notice or care. It is just a meme, a speculative gambling instrument used by one fool in search of an even greater fool. Though it may seem that the supply is endless, at some point you are going to run out of fools. You just don't know when.

Today the market is filled with people who want to get rich fast. **You cannot use logic and reason with a person who wants to get rich fast.** The allure of winning a stock market lottery overnight is too strong.

This speculative behavior doesn't stop with main street.

As a professional money manager if you don't play the fool's gambit then you are taking career risk. God forbid, you dare to hold cash or don't buy stocks that you believe are overvalued, but which are going up today and may even go up tomorrow, but could also collapse when the music stops.

Not playing this game is a non-decision decision for us. It is an easy choice because clients entrusted us with their life savings, all the money they are ever going to make. After you look them in the eyes and understand the gravity of what you are doing, playing fool's gambit stops being a choice. As you look through your portfolio, you'll clearly see that we don't play fool's gambit. This is why we are blessed with the clients we have and are very diligent in *not* accepting clients whose approach is antithetical to our investment principles.

Market Timer's Gambit

Rational people not drunk on greed, who are fine with getting rich slowly, may want to avoid this market altogether. They may play *Market Timer's Gambit*. Their argument (on the surface) is very logical. It goes like this: "I am going to stay on the sidelines for now and will go in after the market dips".

We are very sympathetic to this view. However, there are two problems with this strategy. First, market irrationality can last a long time. And second, though it sounds good in theory, in practice it is very difficult to execute.

Here is an example: Let's say you went 100% in cash waiting for the market to correct.

You waited for a long time and then the market declines 10%. You feel slightly vindicated, but the market really just settled to where it was a few months ago.

You have a decision to make: Get in or wait? You are of course prudent, and the market is declining, so you decide to wait.

The market is down another 10%. You feel a bit more vindicated. Now you feel rewarded for your patience and for the last few years of return you've missed out on.

But your gut tells you if the market declined 20% and it can go down lower. You wait.

You were right. The market declines another 10%. Economic news is ugly. The market decline may send the economy into a recession. Or the economy is already in a recession.

Now you are worried. You decide to wait.

The market declines *another* 10%. This cash now feels so dear you don't want to part with it. You feel like you've got this figured out. You tell yourself you'll invest when the news gets better.

The news is not getting better. But a strange thing happens. The market has a few strong days. Commentators call them a dead cat bounce, expecting further declines. These few strong days are followed by a few more. Suddenly the market has retraced the last 20% of the decline. You feel bad that you didn't invest two weeks ago (at the now "obvious") bottom.

I can continue but I won't. You get the point.

Once you are completely out, it is incredibly difficult psychologically to make a binary decision to dive back into the market. I've met quite a few people that have stayed out of the market since 2000 and are still waiting for their chance to get in. Just imagine the psychological rollercoaster they went through and the returns they left on the table.

Even if you got the market timing right once, putting it into a repeatable process is impossible. In addition to getting the timing of the economy right, you have to time the stock market response to the economy. I know many people who timed the market successfully once; I don't know any who've done it twice.

One Stock at a Time

Investing in the stock market doesn't need to reside in the binary extremes of Fool's Gambit and Market Timer's Gambit. There is a different game available: *One Stock at a Time*. That is the game we play.

Even in this insanely overvalued market not all stocks are overvalued and in search of a greater fool. Armed with patience, a long-term time horizon and our time-tested value investing process, we patiently look for high quality companies, run by great management, that are significantly undervalued (i.e., have a margin of safety). This process is not fast and furious and won't get you rich quickly. It requires a lot of mundane work and turning over a lot of rocks. We read company financial filings, talk to management, competitors, build our own financial models, debate these investments among ourselves and with our global network of investors.

We only need 20 to 30 stocks – there are tens of thousands of stocks globally. When we cannot find enough stocks that meet our stringent investment criteria our cash balances go up and then they'll decline as we find new stocks. We don't time the market; we value individual stocks, buy when they are cheap and sell when they are dear.

Let's just sum it up. The market today is a $1 bill trading for somewhere close to $2 or more. Many stocks in the market today are $1 changing hands for $4, $6, $20. But *we don't own the market; instead we have humbly assembled a portfolio of $0.30 to $0.60 dollars.* One stock at a time.

Curmudgeon on Cryptocurrency

In mid-April I picked my 15-year-old daughter Hannah and her friend Sarah up from school and took them to Barnes & Noble. Sarah found out that I "do stocks" for a living and immediately

asked me about crypto. She wondered what cryptocurrency she should buy and if she should open a Robinhood account.

I'll tell you about the advice I gave her in a bit. But a few days later I got three calls in one day from my wife's side of the family – from my sister-in-law (a pharmacist) and my wife's cousins (both are barbers). They were all asking me about crypto. I told them, you don't ask my advice on which number to put your chips on when you play roulette in Vegas; cryptocurrencies fall into the same category.

No matter what asset class you are discussing, it feels a bit "toppy" when people far removed from investing start asking you for advice about it, all at once.

I feel like an old curmudgeon writing this. I know "I don't get it." Crypto lovers look at me as if I am defending silent movies and treating "talkies" as unwelcome, short-term imposters. Curmudgeon I am.

When we discuss crypto, we need to separate blockchain technology from the so-called currencies. Though I have yet to see a mainstream application of blockchain, I get a feeling they are coming. However, just because a technology is useful, has a lot of applications, and is widely accepted doesn't automatically mean that you can use it to create a genuine currency.

Here is an example. Venmo, which is owned by PayPal, is a very useful technology that many Americans use weekly or even daily. The benefits of widespread usage of Venmo, however, accrue to PayPal's shareholders and don't lead to appreciation of the US dollar or whatever other currency it transacts in.

When we talk about cryptocurrencies we have to make clear which one. Many consider Bitcoin their god and savior. However, there are thousands of these "currencies" out there, with dozens created every week.

Until recently Bitcoin looked like a clear winner; even Elon Musk was touting it, and Tesla bought $1.5 billion worth of it. Then Musk also shared with us his love of Dogecoin – a joke of a currency (literally, it was created to mock cryptocurrencies), and Dogecoin exploded in price. A few weeks later Musk realized that Bitcoin is "Beanie babies powered by coal." Because of Bitcoin's decentralized nature, solving useless math problems to mine more bitcoins consumes more electricity than Argentina. Musk announced that until Bitcoin starts consuming less energy, Tesla will not be accepting it as a payment for cars. If you are an ESG-oriented pension and don't want to own Exxon ("evil Big Oil"), I want to see how you justify owning Bitcoin.

Arguably, Bitcoin is worse for the environment than internal combustion engine cars if you adjust for CO_2 production in relation to societal utility (at least cars get you places). For the energy cost of processing one bitcoin, VISA can process 810,000 transactions, about 370 times faster.

I've spilled a lot of ink explaining that one of the biggest assets the US government has in its arsenal is the US dollar being the world's reserve currency. Control over our own currency gives

politicians the ability to make promises and not keep them, by constantly running budget deficits and printing and borrowing money to pay for these promises. We are able to run trillion-dollar deficits because the US government has a dollar-printing press. The US government will not give it up without a fight. We've started wars over less.

Cryptocurrencies are a clear and present danger to the US dollar. There is a very high probability that the US government will outlaw the use of cryptos as currencies. Sounds far-fetched? The US government did this in 1933 with gold. That was less than 100 years ago. India is threatening to ban Bitcoin. South Korea already did.

I am sympathetic to some cryptocurrency investors, especially after seeing what we are doing with our fiat currency. However, for most people they are just speculative vehicles. My wife's relatives pay little attention to the US Government's or Fed's balance sheets. They are interested in bitcoin for one reason only – it is going up. Cryptos present these "unique" opportunities for people to pour their life savings into bits and bytes on servers far far away with a hope that they'll magically turn their lives into paradise on the beach.

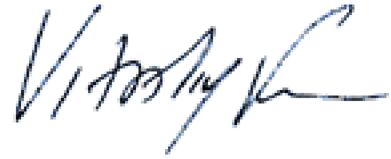
When you go to the casino you are not cashing out your life savings and borrowing from your mother-in-law, unless you are a degenerate gambler. You don't do that because the casino doesn't try to masquerade as a place where you invest. If you have an ounce of common sense, you know you are in a casino, a place where people gamble, the air is pumped in, you hear the unending ring of slot machines, and you can't readily find an exit. A reasonable person will only take as much money to Vegas as he can afford to lose.

Cryptocurrencies are a different beast. You buy them on platforms that resemble your brokage account, where (hopefully) you invest. Also, you're not gambling with casino chips, you are buying "currencies." Suddenly, crypto is competing not with your Vegas purse but with your 401(k). This domain confusion is dangerous. My advice on crypto has been consistent: Gamble with as much money as you can afford to lose. But remember, even when you are winning – actually, especially when you are winning – you are not investing, you are gambling, and thus approach it as a trip to Las Vegas, not a visit to your 401(k).

Now to the advice I gave to Sarah (my daughter's 15-year-old friend). I told her, first of all, don't open an account on Robinhood. This platform has merged the worst that social media and the casino have to offer into one interface. You are too young to gamble. If you'd like to invest, then you have to accept that it's not a get-rich-fast but rather a get-rich-slow activity. Once Sarah heard "get rich slow," I think she lost interest in whatever advice I had to offer. Luckily we arrived at Barnes & Noble, so she did not have to go on listening to this curmudgeon.

I'll leave this discussion with a quote by one of my favorite thinkers, Nassim Taleb: "[Investing/speculating in cryptocurrencies is] the idea that a collection of people would get rich at the expense of society for the sole privilege that the world is adopting their currency and not another."

Enjoy and Prosper,



Vitaliy N. Katsenelson, CFA
Chief Executive Officer

And

Michael L. Conn, CFA
Chairman

July 14, 2021

Dear Client,

I've been with IMA since August 1997. I started as an analyst, then transitioned to being a portfolio manager and CIO. Then in 2011 I became IMA's unofficial CEO and in 2013 official CEO. The most important lesson I've learned running IMA is the importance of people and culture.

As a young analyst I did not have much appreciation for people and did not really think about IMA's culture. I have a feeling this is true for most young analysts. When you are starting out, you are focused on things that are quantifiable – return on capital, return on equity, various growth rates and valuation metrics. You can look backwards and analyze numbers and then you can model them going forward.

Even when you mature as an analyst and start spending time on the company's competitive advantages, you are still thinking about abstracts like the firm's distribution strategy versus its competitors, the stickiness of customers, the size of the potential market, etc.

I don't want to dismiss the importance of these factors. But as I started to manage people, after many painful experiences I realized that the success of IMA as an investment manager and a business was tied to people – human capital. Great employees push you forward; not so great ones drag you down.

Then there is culture. Let me tell you two stories.

In 2008, Michael Conn, IMA's co-founder, was CEO of the company. IMA's operational folks were reviewing investment management agreements, comparing them to the fees that were actually encoded in our portfolio management (billing) system. They found that one account was mistakenly miscoded. IMA had been overcharging a client for 20 years. The difference in any particular quarter was not grotesque, but over the 20-year period it had added up to a large sum. Let me remind you that this happened during the financial crisis; the market was quickly melting down.

Once the operations folks brought this problem to Mike, he said, there is only one thing to do, let's calculate the interest accrued over this time period and refund the client the fee with interest. Mike called the client and apologized for the mistake. The fee was refunded. That was it.

And then there is another story.

When I took over running IMA we had no marketing strategy. Mike's original partner, Merv, was the marketer. IMA's marketing went away when Merv retired in the early 1990s. I was running the firm and I had to come up with a marketing strategy. My education was in finance, not in marketing. I experimented a lot.

Let's pause and fast-forward. Today we do only very passive marketing and no sales. People subscribe to my articles. When the need to hire a money manager arises, prospective clients reach out to us (this usually happens after they've read my articles for years). We ask them to read our 31-page brochure. We don't employ a salesperson. I am a horrible salesman and hate selling. Only after they read this brochure, I'll get on the phone with them and answer their questions for about 20 minutes. That's it.

When I became CEO back in 2013, one of my not so brilliant ideas was to do cold calls. I was not going to do cold calls myself; I hired an assistant, Slavcho, who lived in Macedonia. His task was to call prospects and ask if they want to have a call with me.

I thought Slavcho might face some awkward conversations – "Hi, my name is Slavcho, would you like to schedule a call with Vitaliy?" Too many Eastern European names in one sentence. I asked Slavcho, how would you feel about going by "Steve" instead. He didn't care. In fact, he kind of liked Steve.

One day Slavcho calls me and says "Vitaliy this guy John is going to call you. I told him that I was born in Macedonia and moved to San Diego ten years ago. I went to college in LA and then moved to Denver." I was confused. I couldn't understand what was happening. Slavcho said, "Well, you didn't want people to know that I live in Macedonia, so I created a cover story."

I was shocked and embarrassed. This was a wakeup call for me.

What had just happened was completely on me. I had inadvertently asked my subordinate to lie. My little white lie almost created a culture of deception at IMA. I told Slavcho that from now on he could use his real name and if anyone asked, just tell them the truth. (I ended the cold calling idiocy a few months later).

In contrast, Mike's behavior taught everyone at IMA a lesson of integrity. Not just when it's convenient but when it hurts. (Mike had to forgo his paycheck during the financial crisis.) My inadvertent behavior threatened to turn good people into liars. The little things management does matter. As a parent I learned that my kids pay much closer attention to my actions than to my words. I don't want to be condescending and compare employees to kids. But I was an employee once. I paid more attention to what the management did than what it said. Yes, management actions matter a lot more than their words.

Warren Buffett told a story about an insurance company where people were screamed at by senior management when they brought bad news. They stopped bringing bad news. Nothing good happened to that company.

The culture in most companies, especially small ones, comes from the top. People emulate the

management (rather than just the founder and CEO). Culture is what people do when no one is watching. It is the mutually agreed set of principles that aligns everyone's behavior. But it is much more than that. It is a positive, negative, or inert charge. A positive charge makes the sum of individuals in the company exceed their mathematical sum. It is synergistic. A negative charge, caused by a sluggish bureaucracy or internal power struggles, causes friction and ultimately harms business performance. An inert charge neither adds nor subtracts.

And there is one more thing – incentives. During the 2021 annual Berkshire shareholder meeting Warren Buffett was asked if Berkshire would insure Elon Musk's trip to Mars, to which Buffett replied, "Sure; it will depend on price." Then he thought some more and added, "There will be one price if Musk is on board the ship, and another if he is not." It is programmed into our genes to put our self-interest above that of others. It would be impossible for Elon Musk to care more about the safety of a ship taking strangers to Mars than about one carrying him and his family.

If you have great people and a healthy culture and add proper incentives, a company is unstoppable. When management owns a lot of shares in the business, they will behave like owners; they'll have skin in the game. They won't do acquisitions or overpay for them just to grow the size of the company. Their interests will be aligned with those of the other shareholders.

Being CEO of IMA made me a better investor. Today, when we analyze companies, in addition to doing everything else we've done before, we also think a lot about the management that runs them, their culture, and incentives. In fact, if I look at my biggest investment mistakes in the past, most of them have one thing in common: bad management.

Life is so much easier when companies you own have a great culture and are run by top-notch, properly incentivized management teams with skin in the game.

Life is definitely too short to own companies run by bad management. Warren Buffett said that he'd like to own "businesses that an idiot could run, because one day they will be." I can definitely see this being true in the past. I am not sure if it is true today. The rate of change is much different today.

Some businesses can definitely withstand more abuse by management than others. But there is no business great enough that it can withstand endless abuse by management. I am thinking about Microsoft as I am writing this. Under Steve Ballmer, Microsoft's culture decayed. Toxic HR policies turned the internal culture within the company into a version of the Hunger Games. Microsoft was setting cash on fire with mindless acquisitions. Microsoft's business was so strong (it was a monopoly) that Ballmer didn't kill it, but we don't know where Microsoft would be if the new CEO hadn't changed the company's course and revitalized its culture. Companies with wide moats are not impervious to destruction by management; it just takes longer for them to die.

In this letter we'll add another angle to how we look at companies in our portfolio – the human capital one.

Purchase of Dropbox (DBX)

We looked at Dropbox a few times. I could not understand why it had a reason to exist. Dropbox invented storage in the cloud more than a decade ago. But today Microsoft and Google give away gigabytes of free storage with their productivity software. What we discovered in our research is that Dropbox brings to storage neutrality and specialization – it works with all applications. For its competitors, storage is a small part of a big suite of products; for Dropbox it is its single focus and so it does it better.

These are the notes on DBX I wrote in our Research Management System. I approached the company from our QVG (quality, valuation and growth) framework.

Quality (Q)

Drew Houston, CEO and founder, owns 25% of the company. Ambitious and driven but humble. Recognized important points of change and pivoted the company. Good (net cash) balance sheet. Product is very sticky – once you start using it, the more devices you connect to and sync with it, the less likely you'll switch. Very high recurrence of revenues. Customer retention is in mid 90%s or so – this number will go up with introduction of new products.

Growth (G)

The are several sources of growth:

> Dropbox only has 15.8 million paying subscribers today; about 700 million have been using a free version. Upselling already paying subscribers to higher end plans because they use more storage.
> Introduction of new products that sit on top of Dropbox will become a meaningful source of growth. It is already upselling Passwords and Hellosign (a company it acquired recently).
> Raise prices – they usually do this when they add a lot more features to the product and space.
> Dropbox growth has been slowing down, from 20% a few years ago to 10% today. We are modeling 5% from growth in users and 5% from higher ARPU (average revenue per user). Their focus is small businesses that are ditching their servers and transitioning to cloud file hosting (just like we did).

Valuation (V)

> This will depend on "G". If DBX can grow revenues at 10% then it will achieve its guidance of $1 billion of free cash flows. Market capitalization today is around $10 billion. At 18-20x FCF we are looking at a $45-50 stock.
> If DBX can grow revenues at greater than 10% then operating margins will be greater than 28-30%, earnings will be much higher, and the multiple granted by the market will be much higher as well.

If revenues grow 5% a year (1% from new subscribers, 4% from pricing), we get $1.50 of earnings. This assumes that they are not cutting R&D, which is $700mm. At 15-17 earnings, we get very little downside at a $26 stock price today.
But at the same time, at $18 there is almost no downside at all.
Transition of storage to the cloud is a nice, long-term tailwind for Dropbox, which gives us comfort that 10% revenue growth is achievable.
DBX cut costs during the pandemic. Its costs should grow at a slower rate than revenues; margins should expand.

Risks: The biggest risk is competition outperforming DBX, or it stops being innovative. Massive R&D spending reduces this risk substantially. Nevertheless, we have to continue to monitor and make sure that the company is innovating. The good news is that due to stickiness of customers we'll have plenty of time to react to stagnation in innovation. Drew Houston, CEO and founder, who runs the company and owns 25% of it, is the reason we are in this mostly single-product stock.

DBX has been giving stock options to its employees too promiscuously, but we have modeled this share-count dilution expense declining in relation to revenues over time. Another item we have to monitor.

After we bought DBX, Elliot – a large activist hedge fund – took a 10% position in DBX. We don't have any strong thoughts on Elliot's involvement here. Elliot may try to push for a larger stock buyback or sale of the company.

Purchase of Ambev (ABEV)

Ambev, formerly known as Americas' Beverage Company, is one of the largest beer companies in Latin America. It has almost a 60% market share in Brazil, the third largest beer market in the world. There are a lot of things to like about this company: emerging (growing) markets, dominant business, high return on capital (almost double the return of US compatriots), net cash balance sheet (cash exceeds debt), good management, and a 3.5% dividend at our cost.

Ambev is run by 3G Capital, a company started by Brazilian billionaire Jorge Paulo Lemann. 3G Capital incentivizes its people well to squeeze out unnecessary costs and grow its businesses. You may have seen 3G Capital in the US headlines, as it also runs Anheuser-Busch InBev (the largest shareholder of Ambev) and Kraft Heinz.

Initially when we bought the stock, we were forecasting ABEV to earn about 26 cents per ADR share in 2025. Upon further analysis, we revised the company's earnings power down significantly, to 19 cents per share. In other words, instead of buying Ambev at 10 times 2025 earnings, we were paying closer to 13 times.

We may have made a mistake in our initial analysis. We confused high *nominal* (before-inflation) revenue growth in Brazil for *real* (after-inflation) growth. In emerging markets, where inflation often runs 10%, any revenue growth below 10% is not *real* growth, as any gain you

receive in increased earnings, as a foreign investor, you'll lose in currency decline. Over the last decade Ambev put up great revenue and earnings growth numbers. However, what we missed is that the company's volumes (hectoliters of beer shipped) in Brazil actually declined as it lost market share there to Heineken, a new entrant. (It did grow in volume in the rest of Latin America.) For now, we have revised down our estimate of what the company is worth and are in the process of reanalyzing it.

The stock has appreciated nicely in the short period of time since we bought it and has approached our revised fair value. Unless our additional research leads to a higher assumption of fair value, Ambev will become a source of capital for new buys.

Purchase of Melrose Industries (MRO in London)

Melrose is a private equity firm out of the UK, but it is anything but a traditional private equity firm. It uses very little leverage, buys only one asset at a time, and focuses only on industrial companies. It buys high-quality but undermanaged businesses and improves them (usually after three years). They then sell the now improved company, and distribute a large portion of the proceeds to shareholders. Then it buys another one and does the same thing all over again.

We like MRO's narrow focus. It de-risks execution, as the management operates in its niche circle of competence. MRO management has a great track record of doing "buy-improve-sell." It has done four of these transactions since 2003 and achieved a rate of return of over 20%. MRO's management is highly incentivized to succeed, and its interests align with ours. They get 7.5% of value they create, after shareholders receive a 5% annual return. That is the main reason why we bought the stock.

Today Melrose owns two businesses. It purchased Nortek in 2016 and just announced its sale for a 73% gain (the pandemic delayed the sale by a year or so). The other business it owns is GKN, a very respectable British industrial firm and the largest of MRO's purchases so far, with 8 billion British pounds of sales.

GKN has three segments: auto parts (45% of sales), aerospace (40%) and powder metallurgy (15%).

In the auto segment it makes parts that transfer power from the engine to the wheels. It is a dominant player with factories located strategically close to automakers. Every second car on the road has GKN parts. When we were analyzing this business, our concern was changes that will come with the upcoming revolution in electric cars. GKN management, in a recent presentation, explained that only 13% of their parts business is exposed to internal combustion engine cars and that GKN is a leading supplier of electric engines to the automotive industry. The electrification of the auto industry should be a net positive to this business.

In its aerospace business GKN makes aerostructures and engine parts that go into civilian (Airbus and Boeing) and military planes (about a quarter of the business). As you can imagine, this business was not doing great during the pandemic. Usually there is a lot to like about the

aerospace business. The barriers to entry are incredibly high. A plane is as safe as the smallest part that goes into it. Once a supplier gets engineered into a plane, it rarely gets replaced – the risk is too high.

Before the pandemic, global travel demand was growing a few points above global GDP. By buying MRO we are making a calculated bet that once the global economy opens up, the aerospace segment, and the rest of the company, will return to its pre-COVID normal. This virus, just like a flu, may never go away, but we'll learn to manage it.

GKN is also a leader in its powder metallurgy segment, with a lot of optionality (possible positive surprises that we are not paying for) in 3D printing and hydrogen storage.

At today's price we see very little downside in Melrose's stock. We are paying for GKN without factoring in any improvements in the business. Before the pandemic MRO management guided for a significant improvement of operating margins and thus a substantial increase in earnings.

If the management achieves previously given targets, we are paying 7 times earnings for MRO. Our fair-value estimate for MRO in a few years is about 3.70–4.20 British pounds (our purchase was at around 1.70). Looking at MRO's management's impressive track record, they'll likely exceed these targets. During a recent investor day presentation, management confirmed that the pandemic may have pushed their targets out but has not changed them.

This is the second time we have owned MRO. The first time our ownership was not successful. We bought it in 2019 and sold it in late March 2020 in the midst of the lockdown. We are not in the business of buying high and selling low. Especially selling low during mass panic selling.

Was our original sale a mistake?

Today we look at the last 18 months and we see only one version of history, the version that played out. But there could have been so many other possible versions, ranging from the virus having burnt out in the summer of 2020 to vaccine attempts that could have failed for years. In March 2020 we could not even vaguely assign probabilities to either scenario and thus wanted to make sure our portfolio got through the worst imaginable one.

Things played out differently and much better than we feared. Though the virus did not burn itself out in the summer, vaccines came much sooner than our best-case scenario (thank you SCIENCE!). Global governments stuffed the pockets of consumers, so they are stronger today than before the pandemic. Government debt is high and is still growing. (I addressed this point in part 1 of the letter.)

Melrose, too, has survived COVID-19 much better than we feared. It actually paid down debt significantly over the last year. The auto business came back strong as people chose to drive personal vehicles instead of taking public transportation. The pandemic has cost the company foregone profitability in aerospace and pushed operational improvements out by a year or two. But it did not have a structural impact on the business. Unlike other companies in its space,

Melrose did not have to issue equity at low prices and dilute its shareholders (the core of our fear).

Though investing is very different from gambling (as I keep explaining to my father), there are some lessons we can port from one discipline to the other. The one that comes to mind here is that you need to forget whether you won or lost in the previous hand. Each hand is independent. They don't know each other. You don't want the (positive or negative) outcome of a previous hand to impact your decision making regarding the one you are now holding.

We want to stress this point: Buying the stock today has absolutely nothing to do with our trying to make up for the original loss. We spent hundreds of hours analyzing MRO before our first purchases. We understand it well. We like the company's competitive position. We love the management. Today we have an opportunity to buy it even cheaper than at the time of our original purchase.

So did we make a mistake selling Melrose in April 2020? Given the set of facts we had then, selling it was the right decision. More importantly, given the new set of facts we have now, buying is the right decision today.

Purchase of Black Stone Minerals (BSM)

Black Stone Minerals is not related to the Blackstone Group – a Wall Street firm out of New York. Black Stone Minerals was started in Texas as a timber company by the Carter family in 1876. About 100 years after its founding, Thomas Carter, a descendent of the founding family, changed the company's course. The company sold its interests in timber but kept mineral royalty rights and went on to acquire mineral rights from other timber companies, eventually becoming the largest mineral natural rights holder in the US (it owns 20 million acres). It's structured as a master limited partnership (MLP).

BSM doesn't drill for oil and natural gas; it allows oil companies to extract oil and natural gas from its land, and in exchange for that privilege it receives about 25% of their *revenues*. We love this business model. BSM's costs are fixed and are relatively low. It doesn't have to spend a penny ever on capital expenditures, and it can just keep milking its reserves for generations. It has a debt-light, conservative balance sheet (it can pay off its debt with one year's cash flows). About 40% of its revenues come from natural gas and 60% from oil.

When we analyzed BSM we modeled three scenarios: bear case – oil and gas volumes and prices stay at pandemic lows; base case – they return to pre-pandemic levels; and conservative bull case – they rise above pre-pandemic levels. In each scenario our goal was to forecast BSM's free cash flow per share. Our free cash flow per share is $0.90 in the bear case, $1.70 in the base case, and $2.40 in the conservative bull case. BSM is a $10 stock, and the company pays out 80-90% of its cash flows in dividends. We expect BSM to provide us a dividend between 7% and 20% going forward, depending on what the future holds.

We were very optimistic about oil and natural gas prices before the pandemic. Our thesis is very simple: Low commodity prices reduce exploration and production and eventually cause high commodity prices. The pandemic only made the supply situation worse. As the global economy comes back online, so will the demand. It will take years for supply to catch up with demand, and thus in the interim we'll likely see much higher oil and natural gas prices. We view BSM as a perfect hedge against inflation and a weaker dollar. At this price we see little downside in the stock.

One last thing: Thomas Carter owns 6% of the company. We don't have to worry about him making a dumb, value-destructive acquisition.

Diamond Hill (DHIL)

Diamond Hill is a relatively small ($30 billion in assets under management) value investment firm out of Columbus, Ohio. There are a lot of things we love about DHIL. Unlike many traditional investment firms, which usually have a marketing culture, DHIL has a research culture. It puts the interests of its clients ahead of its financial goals. For instance, it caps the size of its products. It doesn't want them to grow too large and have size (AUM) impact performance. Its goal is not to be the biggest investment firm but to be the best at what it does. Being in the investment management business ourselves, we see a lot of qualities we admire and share in DHIL.

We love how the company is managed. It has a cash-heavy balance sheet and no debt. Insiders own 17% of DHIL stock (speaking of skin in the game). DHIL has an impressive growth record: Its earnings grew from $2 in 2005 to $15 in 2021. Earnings growth has stagnated over the last five years as its value strategies have faced all the familiar headwinds faced by value investors, including yours truly. In 2020 the gap between growth outperformance of value reached a 100-year high. As the irrationality of the markets mean reverts and the flows come back, the value investing headwind will turn into a tailwind.

In our (conservative) base assumption we are forecasting 2% growth in DHIL revenue. The company has committed to return its capital to shareholders through share buybacks and dividends (it bought 14% of its shares in 2019-2020). Half of cash flows come back to us as dividends (giving us a yield of about 5%) and another half as buybacks. Our fair-value estimate for DHIL in a few years fluctuates between $300 and $375. Today the stock is around $170.

Viatris (VTRS)

I made a mistake in buying Viatris. Actually, let me clarify that the original sin was buying Mylan, Viatris' predecessor. Mylan later merged with Pfizer's Upjohn and became Viatris. We were attracted by the cheapness of Mylan's business.

We – actually, not we but I – went into buying Mylan knowing that I was not a fan of its management. They were what we call "professional management" – no skin in the game (own little of the company's stock), well-polished, speaking on-script with the phrase "maximizing

shareholder value" occurring at least five times during every earnings call. Focused on non-GAAP numbers that exclude supposedly "one-time" items that somehow appear every quarter because of endless restructurings and write-offs due to past acquisitions that were ill-conceived and poorly integrated.

What is unsettling about this mistake is that ***I*** (this mistake lies solely with me) went into it with my eyes open. Sometimes we discover that management is not as good as we thought they were (that was the case with our original purchase of DXC, though it's not the case today) or that parts of the business are not as strong as we thought. Mylan was a bet that Mylan and the generics industry as a whole were on the wrong side of the capital cycle. Let me explain: a few years before we bought Mylan, sales and margins for businesses in the generic drug industry were making new highs. This attracted a lot of new capital which brought additional supply and decreased profitability. This decrease in profits impacted Mylan, along with other players in the space, and its stock fell. When we were buying Mylan I was betting that its profitability would mean revert, like it has in the past. My mistake was that I was too blinded by the statistical cheapness of the business and ignored the questionable quality of management and the poor quality of Mylan's earnings.

Our process protected me from making Mylan a large mistake. Here's how: We rate each company's quality in our portfolio from A to D. Mylan's rating was never above C, for the aforementioned reasons. We allow only one or two C-quality companies in our portfolio and limit each to a small position size, typically 2% to 3% at cost. Why bother with C companies? We keep asking ourselves that question, too. Our answer used to be that they offer greater risk (permanent loss of capital) but significant potential rewards (a 40% or greater annual return).

Today I am questioning whether C companies are worth the mental real estate they occupy in my mind. Or at least when the C is a source of both questionable earnings and shaky management. Experience is a collection of bad judgements and, well, experience has taught us not to go to bed with bad management. Badly managed companies produce more negative than positive surprises. Mylan's problems got amplified by the FDA questioning manufacturing safety in one of its largest plants.

Why do we still own Viatris and have actually increased our position? The merger with Pfizer's Upjohn brought in new Pfizer management. The old management is gone. We are not sure it is an A management team, but they are focusing on free cash flows (higher quality of earnings); have promised to pay down debt, not make "transformative" acquisitions; and once debt is reduced (in about a year), to return a greater portion of capital to shareholders as dividends.

There are still a lot of things we like about Viatris. It is one of the largest generic drug manufacturers in the world – it has scale. It has a significant pipeline of biosimilar drugs (we wrote about that in the past), which will result in more stable and growing cash flows. Two thirds of its business is outside the US, giving it a healthy tailwind.

Current Viatris management reset the bar lower after the merger – they blamed the virus for that. At first, we were a bit skeptical of their reasoning (we might have turned into cynics when it comes to Viatris). But we listened to earnings calls and presentations with drug distributors McKesson and Cardinal Health, and they confirmed that volumes in the US are down due to COVID-19. People could not go see doctors, and the number of medical procedures was down. Viatris' business is global, and many foreign countries are still in lockdown.

Management is beating their chest and promising that 2021 will be the trough year for the company. This is what caused recent weakness in the stock. Our gut feeling is telling us that they reset the bar low so they could beat it with a greater margin and then thump their chest.

Viatris has a $17 billion market capitalization. Lowered free cash flow estimates for 2022 are $4 billion, growing to $4.6 billion by 2024. We think there is a good chance these numbers are too low (sell-side analysts are as jaded with Viatris as we are). However, when the market actually sees these free cash flows on Viatris' financial statements (not just in endless promises), then it will believe them and likely slap on a 10 times multiple. The stock could double. If Viatris dares to show some growth of cash flows, then it may start trading at 12-14 times free cash flows. At today's price we see very little downside and ample upside in the stock.

Viatris taught me many lessons, the most important one being that even if I take a very small position in a business of questionable quality, I should at least make sure it comes with A+ management. Or even better, stick to high quality and don't waste brain cells.

DXC Technology Company (DXC)

We are incredibly happy with progress at DXC. Mike Salvino, DXC CEO, who joined the company from Accenture a year and a half ago, replaced literally three quarters of old DXC management with folks from Accenture (the company DXC is aspiring to become).

DXC held an investor-day presentation in June, and here is what we learned from it: Employee morale at DXC is hitting new highs. We have heard from its largest customers, too, and they are very happy with the improvements they see at DXC. DXC services half of Fortune 500 companies in the US.

DXC guided for $3.55 in earnings for this year and $5.25 in 2024. Long-term, we think DXC can achieve at least $8 of earnings per share through a combination of slight revenue growth and margin expansion toward the industry average. We estimate the company is worth somewhere around $65–$120 (13 times 2023 earnings, or 15 times $8 of earnings a few years out). That is a very wide range that will narrow, likely toward the higher end, as time progresses and we get more data.

Tanger Outlets (SKT)

Tanger went into COVID with an overhang of a large number of its customers (retailers) going bankrupt. But customers going bankrupt is just business as usual for Tanger (that is what retailers

do). Except, in 2020 several years of bankruptcies were compressed into one year. The pandemic added additional pressure on this front.

We are not worried and are actually excited about SKT's future. Here is why. Retailers want to be where customers are. Customers love (discount) outlet malls. Tanger has done a great job maintaining its malls and attracting great retailers; thus traffic at SKT malls is back to 2019 levels. As we have previously written, the retailer footprint has shrunk significantly during the pandemic, which is a net positive for SKT. Once things normalize, mall traffic will likely exceed pre-pandemic levels. The pandemic destroyed low-quality malls and shrank the footprint of department stores. As SKT fills the hole created in its occupancy by the pandemic, it will be able to start raising rents again (rents have been under pressure in 2021).

Our thesis, though it was postponed a bit by the pandemic, is still on track. In the not-so-distant future, as SKT occupancy reaches 97% and rents go up, free cash flows will reach circa $1.80–2.00 per share, and SKT's dividend will follow free cash flows. Our fair-value estimate for SKT today is a bit below $30.

Steve Tanger, the son of the company's founder, has recently retired from the CEO position to become the chairman. Steve still owns $40 million of the stock. He has done a phenomenal job running the company, and we are glad he is still involved, though in a less day-to-day role.

Tesco (London: TSCO; American Depository Receipt: TSCDY)

Tesco may have confused you a bit in 2021. It sold its Thailand business at a very high price and paid a huge dividend. The stock declined to reflect the dividend payment. The company then did a reverse stock split, so the price in British pound terms did revert back to the pre-dividend level, except now you owned fewer shares. This reverse stock split has zero impact on the economic value of the shares you own. This reverse stock split business is a British thing.

We've been extremely stubborn with Tesco shares (maybe too stubborn). The business went through a turnaround – and has been turned around. Revenues are growing and so are earnings. TSCO is trading at 11 times earnings (10x free cash flows), and we are getting paid a 4.1% dividend. Tesco is the dominant grocery chain in the UK, double the size of its nearest competitor. It still has an opportunity to improve its efficiency and increase its margins. The UK market is one of the cheapest developed-world stock markets today. Tesco's US counterparts that have a lower return on capital and generate significantly less cash are trading at a 30-70% premium to Tesco. So we'll maintain our stubbornness, for now.

Qualcomm (QCOM)

Qualcomm has positioned itself beautifully to ride the many technological tsunamis that are about to come on shore. It is the primary beneficiary of 5G, the internet of things (IoT), self-driving cars, and the ongoing increase in demand in computing. Let's start with 5G. QCOM owns essential patents on 5G and receives around $5-15 or so for each mobile phone sold globally (this is an 85% gross margin business). Now, you combine 5G and IoT and the number

of devices ("things") connected to the wireless network will skyrocket, and QCOM will collect a small fee on those devices, too.

Qualcomm is also one of the largest semiconductor designers in the world (it designs but doesn't manufacture), its modems power most high-end phones today, and its processors run one third of our phones. Qualcomm is designing software and hardware for self-driving cars. In addition, it is aiming to push its chips into data centers and PCs.

All of Qualcomm's legal problems seem to be behind it. We are keeping our fingers crossed here a little, since in the last five years every time we thought Qualcomm was out of legal hot water, it got pulled back in. We'd like to note that Qualcomm has won every patent lawsuit it has faced. QCOM generates significant cash flows, has a strong balance sheet, and has very competent management. It is very hard to have great clarity as to what QCOM is going to earn in four years (our default period of analysis). Our estimate is between $11-15 (its earnings in 2021 are around $8). Our fair value for QCOM is around $190-$270 per share.

Babcock International (BAB in London)

It seems that the value investment gods want to keep us humble. They want us to never get too cocky and thus consistently send us a stock or two that keeps us on our toes. BAB is one of those god-sent stocks. On a very simple level, BAB has two businesses: defense and civil aviation. In the defense business it maintains and builds her majesty's submarines and trains her majesty's forces. In the civilian business BAB flies fire and rescue helicopters and planes. The defense and civilian businesses are about ¾ and ¼ of profits, respectively.

Late last year BAB got a new CEO, David Lockwood. Mr. Lockwood came from the defense industry. He was CEO of Cobham, a very large defense company, where he completed a successful turnaround in just a few years.

In the process of reviewing BAB's business units, Mr. Lockwood determined that BAB's long-term contracts in the civil aviation business might not be profitable. The company had underestimated the costs of providing services in this business. BAB bought this business seven years ago, looking for an additional growth runway. In April it basically took a 1.7-billion-pound writedown of this business and stated that it may put it for sale. It has overpaid for it and signed unprofitable contracts. Today we are putting zero value on this business (though it is worth more than zero).

That is the bad news.

The good news is that three quarters of BAB's business is intact. The pandemic has been an inconvenience to its defense business (it's hard to socially distance on a submarine). Once things normalize, we expect the defense business to produce about 200 million pounds of free cash flows (this number may prove to be conservative under the new management). BAB has a market capitalization of 1.4 billion pounds, and today it is trading at 7x times defense business free cash flows.

Once things start humming again, which under the new management we expect they will (BAB's position in the defense business is very strong), the stock should get rerated and trade at 10-15 times free cash flows. Despite the value investment gods humbling us with BAB, we still believe it will turn out to be a profitable investment, though less profitable than we expected. This is why we require a margin of safety when we buy stocks – the future may not turn out as bright as we hope it to be.

Qurate (QRTEA)

Qurate has delivered a phenomenal quarter – sales were up 14%, earnings 35%, and customer count grew 35%. Qurate has been a great performer since our purchase in August 2020; the stock price is up about 30%, but this doesn't really tell the full story. Since our purchase we received $6 of dividends ($3 of cash dividends and preferred stock). In other words, we got 60% of our capital back in less than a year.

We are cautiously optimistic about Qurate's future. It has benefited from people being locked up in their houses and being stuffed with cash by Uncle Sam. Lockdowns brought a lot of new customers to the company, and they usually stick around for a long time. The biggest risk to Qurate is people ditching their cable for online TV. The company is not sitting still and is moving to where its customers are (online). It has a good chance of making a successful transition. In the worst case, the pandemic has extended how long it will take this ice cube to melt.

We are comforted by management's high ownership of the shares and its thoughtful stewardship of the company's capital (returning earnings in the form of dividends). Today's valuation is still undemanding. Qurate is a $13 stock and is expected to earn around $2.20 of free cash flows in 2022. If it turns into a melting ice cube, it will melt over a long period of time while returning capital back to us. On the chance it is not a melting ice cube, the stock could double from here.

Bollore (BOL in Paris)

Our thesis about Bollore has been proving out. Its largest holding, Vivendi, is spinning out its UMG music label business (its crown jewel). At the current (appreciated) price we are paying for the UMG business and getting the rest of Vivendi and Bollore's other businesses (ports and solid-state batteries) for free. Bollore is a 4.6-euro stock that is worth somewhere around 10–12 euros.

Svenska Handelsbanken (Stockholm: SHB-A)

Once the pandemic is behind Svenska it will resume paying out its normal dividend. Other than pausing its dividend at the request of European regulators, Svenska saw no impact on its business from the pandemic. Banking losses actually declined.

In fact, Svenska may turn out to have benefited from the pandemic in the long run. Svenska is transitioning to become more of a digital bank by boosting its services in its digital app and

shrinking its branch footprint. COVID social distancing forced usage of its app and may have made this transition smoother. Svenska's stock is trading at 10 times earnings and has a 7% dividend yield (now that dividends have resumed). We still see at least 40–50% upside in the shares.

Dassault Aviation (Paris: AM)

There is little to report regarding Dassault Aviation and its largest holding, Thales (which is a public company, too). There is plenty of demand for Dassault's fighter and civilian jets. Thales' business is trading at about 10 times (a few years out) earnings. Thales is a well-run French defense company with a high return on capital and an impressive track record of earnings and dividend growth. At some point it will be trading at 15-17 times earnings. We think both stocks have a 50-70% upside once things normalize.

Camping World (CWH)

CWH is a better company today than it was anytime in its history. The pandemic allowed it to rebuild its balance sheet. The management, more specifically its CEO Marcus Lemonis, made a costly mistake when CWH bought Gander Mountain out of bankruptcy. We are not sure the purchase was a mistake, but we know that CWH fumbled the integration of Gander. Even good management that owns a lot of shares of a company makes mistakes. We have to give Lemonis credit: Once he realized that Gander was a blunder, he did not dig in but cut his losses and moved on.

The pandemic injected CWH with enormous cash flows and allowed it to put the Gander story in the rearview mirror. We are back to our original thesis – dominant company in a very fragmented industry, great (though not flawless) management, a cyclical business but with a tremendous growth runway. CWH expects to earn $5-6 this and next year (the stock is trading at 7-8 times earnings).

We know if we close our eyes and ignore the volatility of CWH's business, in a few years this earnings power, though it may have ups and downs in the interim, will only increase and so will the stock.

British American Tobacco (BTI)

We have consolidated our tobacco holdings into two stocks, Altria and British American Tobacco. BTI is one of the best-run tobacco companies in the world. We are very impressed with its management; it is both thoughtful and aggressive. The next frontier for tobacco companies is what are called next-generation products (NGP). NGP will come mainly in three forms: vaping, heated tobacco, and pouches you put under your tongue. Heated tobacco products are very popular in Europe and Japan. Instead of tobacco being burned, it is heated in a device that looks like a pen. Smokers still get a hit of nicotine but no carcinogens. BTI has the management and resources to succeed in the NGP category. BTI is trading at about 8-9 times growing earnings and pays us a 7.13% dividend that it can fund from free cash flow with its eyes closed.

Sale of Gilead Sciences (GILD)

We sold GILD at a small loss (we probably broke even after dividends). Our thesis on Gilead was simple: We were paying for the HIV business, in which it dominates, and were getting the rest of the company, including hepatitis C (HVC) for free. The HVC business ended up being not worth very much. Gilead did what successful pharmaceutical companies should do: It cured hepatitis C, and once it did so its revenues declined from $20 billion to $1 billion. In our analysis we overestimated the size of the HVC market.

GILD has an antiviral medicine that is used to fight COVID. Though at first we were hopeful about its potential, as more data came out we learned that it is marginally effective in only very severe cases, if administered early (usually for someone with comorbidities).

Gilead to some degree showcases our value investment process. We bought it cheap enough, with enough margin of safety, that when the future turned out a lot less bright than we expected, it resulted in only a small loss.

Q&A Section

Question: Is Melrose Industries a penny stock? (We paraphrased the question a little).

Answer: Melrose is listed in London under MRO. The shares you see on your statement are a proxy and not the shares we buy and sell. An American brokerage firm converts MRO shares denominated in British pounds into US dollars. Also, the UK has a tradition of keeping share prices "low" – the MRO price in the UK is 2.15 pounds. French companies love to keep their share prices "high" – Dassault Aviation is trading at 1,000 euros. The absolute level of share price has zero impact on what the company is worth. We pay little attention to it, and we advise you to do the same.

We don't usually buy "penny stocks." But if we see a company that meets our Quality, Valuation, and Growth (QVG) criteria and it is trading for pennies, we'll buy it.

Question: What is the potential impact on our current portfolio once the Fed runs out of levers to prop up the market and investors decide the party's over and the economy drags the market down to a more appropriate level? Will our portfolio as it stands simply fall with the market? Will you move to cash in an attempt to time the market, or what?

Answer: We are investing as if the Fed has run out of levers. There is a lot of craziness going on in the market today – we've mentioned some of it in past letters. We've seen everything from a "currency" named after a dog gathering a market capitalization of $50 billion to meme stocks (of impaired businesses) going sky-high because armchair revolutionaries (have-nots) want to stick to the haves, those greedy hedge funds. Something insane is always going on in the market, though this time around there is more insanity than usual.

As you read about this craziness, remember, we don't own it. If you carefully look through your portfolio, have read this and our past letters, you'll have noted that we carefully sidestep market insanity. That is the beauty of curating a portfolio of individually picked stocks.

On the question of market timing: We don't believe we can successfully time the market, but we can successfully value individual stocks. We answered this question in detail in the part 1 of this letter.

Question: How is your investment approach affected by the coming inflationary environment?

Answer: We answered this question in part 1 of the letter.

Question: What is your opinion of the preferred issue we now own? While I realize that it does not have much appreciation potential, the 8% yield looks pretty attractive. I realize that it will get a junky rating, but in light of the yield it looks like an interesting bond proxy.

Answer: We received a dividend from Qurate in the form of preferred shares. We have sold them in most accounts because we were running low on cash. However, we own them in dividend accounts. We are highly confident in the company's ability to pay the preferred dividend (otherwise we'd not own the common stock). We also like the fact that, unlike other preferred stocks that are often perpetual (don't have defined maturity), this one has a maturity of 10 years. If interest rates rise, this one will be impacted a lot less and only temporarily.

Please keep sending us your questions; we'll answer them in the next letter.

<u>Conclusion</u>

In this letter we have covered most of the businesses we own, but not all. For the ones we did not cover, we had little new to say. We skipped some small ones to spare your eyes.

We have made some small tweaks in the portfolio over the last few months, simplifying it and consolidating it into fewer positions. We have not made new purchases lately for obvious reasons, but we are not sitting on our hands and doing nothing. We are studying companies we own (it's a never-ending learning process). We also keep looking for new companies that are run by great management teams and adding them to our watch list.

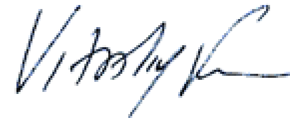
There are a lot of things we don't like about the market and economy today. We don't like how speculative it is. We don't like growing government debt. We are worried about Chinese ascendancy and the geopolitical risks that come with that (that is why we have a lot of defense stocks). We are guessing that the virus will not totally go away but will be with us for a long time (like the flu) with different variants coming and going. Even if cases pick up, there is little political will to shut down the economy, especially when half of the country is vaccinated. The number of deaths will likely stay low, as the at-risk population has a very high vaccination rate. Eventually the populace and the media will lose interest in COVID. We'll get used to living with it.

This market feels very similar to the 1999 tech bubble. Most people remember the tech bubble burst and sensational decline that followed. What many don't remember is that value stocks actually went up when dotcoms crashed and had a great run for almost a decade (it was interrupted by the financial crisis). History doesn't repeat, but it rhymes. We are staying patient, vigilant, and prefer a good beer (or wine) instead of "this time is different" Kool-Aid.

We keep reevaluating our positions to make sure that we practice what we preach – being *buy and sell* investors. We may trim things a little around the edges (reduce some positions, sell some small holdings), but at the core we are mostly making *do nothing* decisions, as most of our stocks are still undervalued.

As always, should you have any questions or require any additional information, please do not hesitate to contact us.

Enjoy and Prosper,



Vitaliy N. Katsenelson, CFA
Chief Executive Officer

And

Michael L. Conn, CFA
Chairman