Building long-term relationships with long-term investors

July 15, 2021

Dear Client,

What a difference a year makes. In our letter one year ago today, we were in the midst of the worst economic downturn since the Great Depression. Yet here we are today and economically it feels like the rain clouds have parted to give way to the sun. While we have not reached herd immunity, the number of individuals vaccinated in the US has caused new COVID cases to be minimal and we are slowly returning to our old ways of living. In most states people can go shopping without wearing a mask. We can once again embrace family and friends that we may not have seen in months if not a year. Bars and restaurants are back open and bustling suffering labor shortages rather than laying people off. And with the reopening of the economy comes the unfortunate return of traffic and crowds.

As with much of economics, what is good on one side of the ledger is not so good on the other and COVID has been replaced by inflation as the next "crisis de jour." Businesses that had to cut their production a year ago are scrambling to build it back up but are being hampered by their inability to find workers and broken-down supply chains. Combine these with a pent-up consumer desire to get out and spend and we are seeing demand outpace the supply of goods, driving up prices.

We are not dismissive of inflation, quite the opposite in fact, it is a real threat to long term financial wellbeing and there is no question short term inflation measures are up. The consumer price index for June rose 5.4%, the largest jump since August 2008. Shortages of commodities ranging from lumber to computer chips directly impact supply chains increasing inflationary pressure.

Like so many topics we discuss, the inflation phenomenon is not as simple as the headlines suggest. A simple example, the 5.4% jump is a startling amount, but it is also impacted by the base effect. A year ago, the US economy was dormant with the outbreak of the pandemic, so this calculation has a low starting point. If we look at the increase over 2 years, it is a much more tempered increase of 3%. The economy is complex and unpredictable. Charlie Munger, Warren Buffet's longtime partner, said, "if you are not confused by the global economy, you don't understand it." Our nation's ballooning budget deficit along with the fed's focus on raising inflation increases the probability of inflation but it does not make it a certainty.

Many believe the inflation we are seeing is transitory and eventually supply will catch up with demand and prices will fall. We have already starting to see this with lumber which has caused some to wonder if we are heading toward a deflationary period, not inflationary (we read plenty of material on both sides of this fence). Inflation was anticipated in 2009 when the government last opened its wallet to revive the economy during the global financial crisis. That inflation never arrived. However, this time around, in 2020 the government pumped $5 trillion into the economy. This represents 25% of all US dollars in

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circulation and is about 2.5 times bigger than the relief provided during the global financial crisis and with the possible passing of the infrastructure bill, more money might be on its way. Fed Chairman Jerome Powell has made it clear it is the committee's goal to have inflation run higher than what we have seen over the last two decades and wants to boost the average to 2%. It will be a matter of them being able to control it and keep it within this range, something they have not had success doing in the past.

If inflation persists, the best hedge in your portfolio is your stock exposure. In the short-term the markets may fall but inflation will actually benefit some companies, hurt others and be indifferent to the rest. An increase in inflation is typically followed by higher interest rates which can negatively impact company profits, but in the long-term, stocks in general are the highest returning asset class and are your best option to combat increases in goods and services. This is also why you hold Inflation-Protected Securities (TIPS).

In the end, no one knows what will happen. Which means we need to protect against the probabilities of numerous eventualities. And this is what your portfolio does. We like this analogy:

> "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 knowing that, while the speedboats may outrace us for some time, they are bound to eventually hit an iceberg and sink." -- Vitaliy Katsenelson, Contrarian Edge

Is inflation that iceberg? Deflation? We don't know. We believe in icebreakers over speedboats, they are far better designed to achieve our primary task to avoid permanent loss of capital and maintain purchasing power in both inflationary and deflationary environments.

With all the talk of inflation out there, much has been said about Bitcoin (and crypto assets in general) as an inflationary hedge and "store of value." We will be commenting more about crypto in future letters but wanted to touch on it now since it is being marketed as an inflation hedge. Bitcoin has only been available in a low inflationary market since it was invented merely ten years ago so there is not much evidence supporting this. Some compare Bitcoin to gold. Gold has been viewed as an inflation hedge, but historical data shows this has not always been the case.

Crypto currencies offer some intriguing characteristics but at their core they have no intrinsic value, much like gold. With stocks and bonds, you receive interest and dividends from simply holding them even if the price of the security does not go up. Cryptocurrencies on the other hand do not provide an expected stream of future cash flow, they are based simply on speculation. Additionally, there is uncertainty about potential future government regulation and taxation. Couple all this with extreme volatility and the risk parameters of Bitcoin are extremely high, more like a speedboat.

In our last quarterly letter, we mentioned Dimensional Fund Advisors (DFA) were converting some of their tax-advantaged mutual funds to Exchange Traded Funds (ETFs). They converted the tax-managed funds that invest in the US in June. In September they will convert the tax-managed funds that invest internationally. They have also announced they will be swapping their US Tax Managed Marketwide Fund for another sister fund which has an 35% lower expense ratio (0.24% versus 0.37%) which will continue to improve your returns. We will send out an email to clients impacted by these changes when we get closer to the conversion dates.

Jim, John, Richard, Mary, and Ryan

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