

SAYBROOK CAPITAL

INVESTMENT COUNSEL & MANAGEMENT

2022 Year-End Investment Review

The bear market of 2022 left few places for investors to hide, as stocks around the world were down significantly, along with nearly all other investments. Following positive returns of between 24% and 30% for each of the previous three years, our average equity account ended 2022 down 20%, only the fourth negative year in Saybrook's 46-year history. The table below illustrates how pervasive the damage was:

<u>2022 Price Changes in U.S. Dollars (not including dividends)</u>			
Dow Jones Industrial Average	-9%	GSCI Commodities Index	+26%
S&P 500	-19%	Nymex Crude Oil	+7%
NASDAQ Composite	-33%	3-Month U.S. T-Bill (current yield)	+4%
FTSE 100 (Great Britain)	-10%	Gold Spot \$/oz	+1%
DAX 30 (Germany)	-20%	S&P Municipal Bond Index	-8%
Nikkei 225 (Japan)	-21%	HFRI Equity Hedge Fund Index	-10%
MSCI Emerging Market	-22%	U.S. Aggregate Bond Index	-12%
Shenzhen A Shares (China)	-28%	Dow Jones REIT Index (real estate)	-29%

Much higher interest rates in 2022 negatively impacted investment returns, notably in the rate-sensitive real estate and tech sectors. Bonds, which usually serve as a low-correlated hedge against stock market drops, actually had substantial price declines as the yield on the benchmark 10-year U.S. Treasury rose abruptly from 1.5% to 3.9% over the last twelve months.

Strongest Ship on a Turbulent Sea

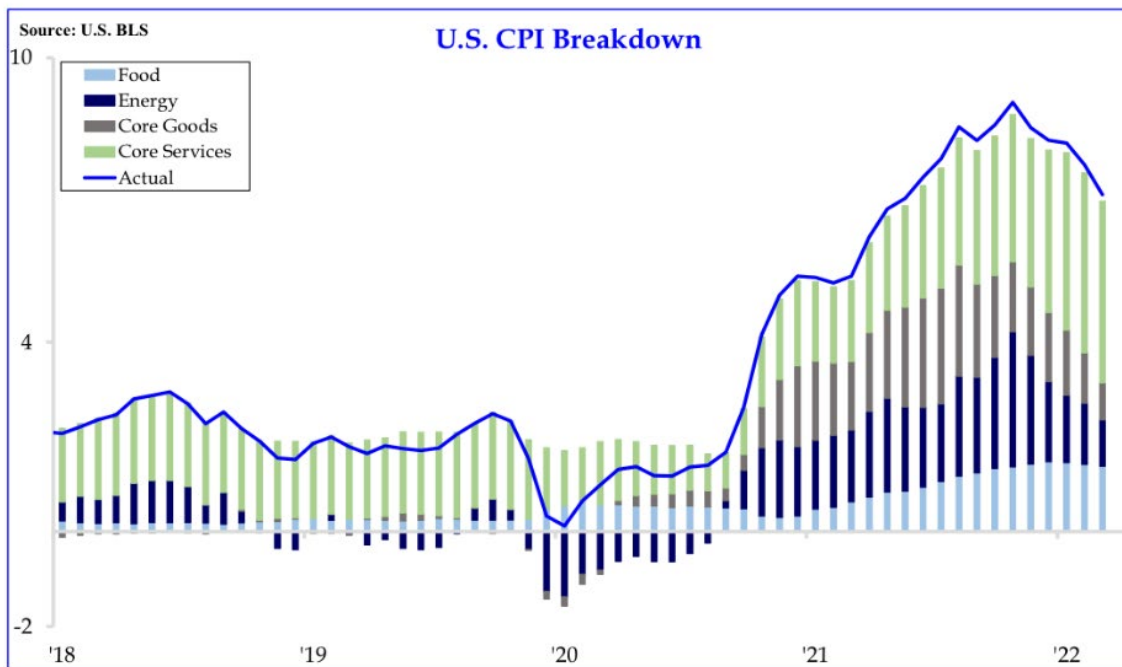
Amidst persistent worldwide inflationary pressures, monetary policies by global central banks have become more restrictive despite looming recession risk. As war in Europe approaches the one-year mark, consumer prices are up more than 10% in the euro zone, exacerbated by high energy and food costs. Many emerging market countries are hampered by heavy dollar-denominated debt, and it is unclear how China's economy will perform after the haphazard abandonment of its zero-Covid restrictions. Concurrently, Russia's invasion of Ukraine and China's increasing aggression towards Taiwan have caused a reorientation of Western trade and security policy that echoes the emergence of Cold War containment strategies of the late 1940s. In the fourth quarter, the U.S. implemented sweeping limits on semiconductor exports to China and sharply increased defense spending, both signs of the wide-ranging ramifications of this geopolitical upheaval.

While recognizing the seriousness of these global challenges, JPMorgan CEO Jamie Dimon recently highlighted the relative strength of U.S. consumers and American companies: "The United States

economy is the strongest economy in the world today, so we should celebrate that a little bit...and that's why capital is coming here, and businesses are coming here...that's the good news."

Impact of Fed Rate Hikes on the U.S. Economy?

The U.S. economy indeed remains resilient. But unfortunately, the Consumer Price Index (CPI) rose to 9% in mid-2022, forcing the Federal Reserve to aggressively increase the funds rate from essentially zero to above 4.25%, much higher than the 1% hike it had originally forecast a year ago. Headline inflation peaked in June, and commodities and goods prices are now falling. Yet costs for services, especially wages, remain high. This is shown in the chart below, where services account for over half of the CPI:



Job and wage growth were strong in 2022, with the U.S. unemployment rate near 50-year lows. In fact, there are still not enough workers to fill available jobs. Pandemic retirements and deaths, along with slower immigration, have contributed to the labor shortage. As a result, employers are reluctant to cut headcount. Reflecting these sentiments, Norfolk Southern's management admitted at their December analyst day that they cut the railroad's headcount too much at the onset of the pandemic: "[Given] how long it takes to train and hire an employee...we have to make sure we manage through downturns in such a way that we're in a good place to handle the upturns."

In his December press conference, Fed Chairman Jerome Powell warned that robust employment and high wages require the Fed to keep rates higher for longer. Continued restrictive monetary

policy, along with the lagging impact of past rate hikes, will have a negative effect on the economy in 2023. A weakening economy, combined with the margin effects of higher wage costs, will be a drag on corporate earnings. How much the economy and earnings slow in 2023 is the big question. Much of this slowdown is reflected in lower valuations following last year's stock market decline. To wit: the aggregate stock market valuation, at a high 21x price-to-earnings multiple a year ago, is now near its 25-year average of 16x. However, a further leg down for equities could ensue if corporate profits come in worse than expected in the quarters ahead.

"Swimming Naked"

Warren Buffett famously quipped: "You only find out who is swimming naked when the tide goes out." Speculative excess, greed, and even fraud are exposed and curtailed in times of economic stress and financial constraint. Bloomberg reported that "[the Fed's] monetary tightening campaign is having a major impact in deflating asset bubbles that swelled during the pandemic." This financial de-risking has been achieved (thus far) without causing undue strains on the stability of the financial system. The air has come out of many irrationally inflated speculative bets fueled during the zero-interest rate era, such as SPAC IPOs, the ARK Innovation fund, and Bitcoin, each of which lost two-thirds of its value in 2022.

Every period of market excess has its cast of high-profile swindlers, from Ivan Boesky, the infamous 1980s insider trader, to Bernie Madoff, whose Ponzi-scheme unraveled in 2008. The latest posterchild, Sam Bankman-Fried, is charged with defrauding the lenders and customers of his now-bankrupt cryptocurrency exchange FTX. "This is really old-fashioned embezzlement," said John Ray, bankruptcy expert and caretaker CEO of FTX (interestingly, Ray played the same forensic role overseeing Enron's fraudulent collapse in 2001). It was not just outright gamblers who chased phantom returns on the crypto exchange, but, astonishingly, sophisticated asset managers, venture capitalists, and hedge funds (e.g., Blackrock, Sequoia Capital, and Tiger Global) also rolled the dice on FTX.

Importance of Staying Invested

Our investment discipline kept us away from the speculative areas of the market – and the associated scoundrels – but we have learned from our own mistakes. For example, we extrapolated PayPal's dramatic pandemic-era growth to justify the stock's then high valuation. In hindsight, the fast rate of 2020-2021 digital consumption was unsustainable, as eCommerce growth has returned to its pre-Covid trendline (illustrated in the accompanying chart). PayPal was down 62%, certainly our worst 2022 performer, but we think negative sentiment on the stock has swung too far. The company's more than 400 million active consumers and merchants are enabling its PayPal and Venmo services to continue to expand at or above the rate of eCommerce growth. With the encouragement of

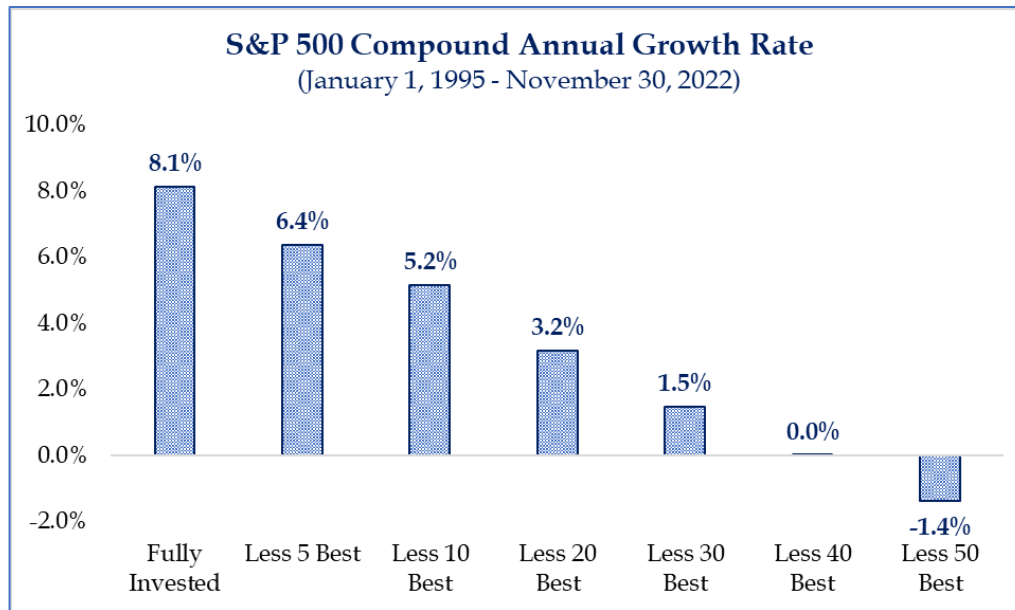
respected activist investment firm Elliott Management, a recent PayPal shareholder, the company is more focused on extending its dominant digital wallet capabilities, more efficiently investing for future growth, and using its strong free cash flow to buy back its now cheap shares.



Source: Federal Reserve Bank of St. Louis

In retrospect, we were wrong not to take some profits on PayPal at much higher prices. Yet our bias remains to give our companies time to win, even while recognizing there will be setbacks and that not all investments will prove successful. This approach has served us well with many of our portfolio companies, where holding on during selloffs was ultimately the right decision. In the decade that we have owned Apple, its shares have suffered and subsequently recovered from drawdowns of -45% (2013), -33% (2016), -39% (2018), and -28% (2020). A clever sale ahead of any of these drops, while feeling wise in the moment, might have resulted in never buying the stock back and missing much of the +650% appreciation from our original purchases through and including the -26% decline in 2022. With Apple currently enduring the wrenching technology sector selloff, we are once again tested in this discipline. Patiently giving great portfolio companies the opportunity to compound is an essential part of our investment philosophy.

Regarding overall client portfolios, we seek to maintain large equity allocations through thick and thin in order to capture upside performance. A trader who is out of the stock market, even for brief periods, would almost certainly have lower results in the long run. The chart below shows the perils of market timing. Missing the forty best days over the past quarter century reduces annualized equity returns to zero. While the investor who consistently held stocks, as represented by the S&P 500 index, earned over 8% on average per year, not including dividends.



Source: Strategas Research Partners

Getting out of stocks in negative or positive market environments increases the likelihood of missing unexpected price surges. Indeed, most upward moves are unexpected, both in terms of magnitude and duration. After the 20% stock market decline from mid-September to late December 2018, we could not have known we were at the onset of a remarkable three-year period from 2019 through 2021 when Saybrook's average stock portfolio would appreciate more than 100%.

We will stay the course, looking for new undervalued growth opportunities, while continuing to own high-quality companies and weed out weaker holdings. Our long-term winners share two distinguishing characteristics: significant pricing power – the best hedge against inflation – and management that understands the importance of reinvesting current profits for future growth. Amidst the current inflationary environment, our portfolio companies have kept pace by increasing pricing without sacrificing their market share. Many of our long-held companies have also made opportunistic acquisitions over the past year, including Berkshire Hathaway, Mondelez International, FactSet Research, and Sherwin-Williams.

We have successfully navigated through many severe bear markets in our investment careers, and we will steer through this one too. Financial markets are in the middle of a difficult adjustment away from an era of artificially low interest rates towards more normalized levels. While the passage is fraught, the destination will prove to be a healthier environment for long-term investors, one in which the cost-of-capital keeps markets more rational and stock valuations more reasonable, while also enabling decent income from cash reserves and bonds.