TJIM QUARTERLY INSIGHT

Fourth Quarter 2020

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2020 was the most tumultuous investing year since 2008. It began with 30% declines across equity indices in February and March, nearly 15% unemployment in April, then markets ceaselessly rallied to close the year at all-time highs on news of multiple effective vaccines, with COVID cases surging. The market appears ready to move to 2021 and beyond, but there will be multiple long-term consequences of the COVID-19 pandemic.

Despite an incredible amount of stimulus and Federal Reserve intervention, unemployment levels remain elevated, GDP experienced a significant yearly decline, and for many the workplace may never be the same. The earnings of the S&P 500 companies likely will not recover to 2019 levels until late 2021 or 2022. Yet the S&P 500 is valued nearly 50% higher for those earnings today than they were in January 2019. This appreciation is not entirely unjustified. The value of any security should be the value of future cash flows discounted back to the present at the appropriate discount rate. Interest rates are near all-time lows in the US, so the discount rate is much lower than it was two years ago. This should lead to a corresponding increase in the value of all financial assets, but especially those that would be considered longer duration assets. For example, high growth stocks whose earnings growth extends to the distant future, rather than established industries with slower growing earnings. Put simply, when growth is scarce, it makes sense to pay a premium for it; when growth is widespread, the premium for growth should shrink. It would follow that as interest rates and inflation increase, we should see a similar decline in multiples that investors are willing to pay for distant future earnings, and greater emphasis placed on immediate future earnings.

Regardless, it is vital to remember two key lessons for investing:

1. The further off into the future we must venture to recoup our initial investment, the riskier the investments become.
2. The more we pay for an asset now, the lower our future returns will be.

We continue to believe that investing in well-run companies with solid balance sheets will be a winning long-term investment strategy, but the price we pay for these companies remains important. Essentially, we believe in investing in stocks with attractive valuations relative to growth, rather than growth at any price.

With multiple stimulus packages passed by Congress totaling nearly $3 trillion in 2020, and additional stimulus possibly on the way, it is logical to wonder what inflation will look like going forward. During the last twelve months, the money supply increased by 23%, as defined by M2. Since 2008, it has increased by early 157%. Somewhat surprisingly, this has not led to an increase in inflation, at least not yet. The ten-year breakeven inflation rates are only marginally higher than they were this time last year. Nevertheless, this unprecedented level of intervention has created much speculation and anxiety about the future value of the US dollar. Consequently, we have seen surges in many asset classes like precious metals, residential real estate, and equities.

During the Dutch Golden Age, tulips became quite popular. Exceptionally beautiful bulbs would fetch extraordinary prices. It is said that some single tulip bulbs sold for more than 10 times the annual income of a skilled worker. In the 18th century, the South Sea bubble destroyed the wealth of Isaac Newton, one of the smartest men to ever live. Thirty years ago, we saw the rise and fall of the Japanese real estate bubble, where it was believed that the value of the land under the Imperial Palace was worth more than all the real estate in California. More recently, we experienced the popping of our own housing bubble. It is difficult to determine exactly when a market reaches bubble territory, but bubbles are not new phenomena, and there are a few indicators from the past we can look to. Rapid price movements become normal. Feelings of euphoria become abundant. Investors will invent new valuation measures to justify price, and everyone you know begins to talk about the market.

America's favorite digital tulip bulb, Bitcoin, returned an astounding 176% during the fourth quarter. This movement likely started as a response to anxiety about the US dollar or the debasement of various other fiat currencies. Indeed, with a long enough time horizon, the value of any currency will approach zero. Despite this, we cannot help but wonder when the fear of the dollar devolved into the fear of missing out. We remain skeptical that a currency that trades like a penny stock will become the cornerstone of the future global monetary system. Personal biases aside, one of the primary goals we face as investors is to ensure that we do not outlive our money and that our purchasing power keeps pace with inflation. The only proven long-term way to achieve this is by investing in productive assets. We believe that companies with essential and defensive business models, that offer necessary goods and services, will be able to maintain and grow earnings and dividend streams. These companies can pass on additional costs of inflation to their customers and invest capital to increase future production of goods and services. As a society, we all become beneficiaries of this increased production output. This wealth is measured in the actual quantity of goods and services we collectively possess. It is safe to assume the future earnings power of bitcoin and the like will remain consistently low.

Outside of the crypto craze, we can see other speculative bubbles. Despite controlling approximately 1% of global auto market, Tesla is worth more than all other car makers combined. Tesla trades at greater than 25x sales, while arguably the world's best run car company, Toyota, trades at a mere 1x sales. Chipotle's stock has more than doubled since 2015, despite having lower earnings today than five years ago. Carvana has a market cap greater than the next seven publicly traded car dealerships combined, despite being unprofitable and having sales worth only 3% of the latter group. Last summer, Hertz investors eagerly lined up to buy $500 million in new equity issuance from the bankrupt company before being blocked by the SEC. The market's appetite for risk appears to be insatiable, and there is little doubt that hopes and dreams are being priced into certain stocks for earnings far off into the future. In response, we continue to believe that the best way to navigate volatile markets, inflation, and achieve long-term capital appreciation is through a diversified portfolio of high-quality equities and fixed income.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With very low long-term rates and elevated equity valuations, TJIM will continue to selectively add positions in attractively valued stocks, treasuries, and corporate bonds. Our overall equity positioning will remain focused on high-quality companies we believe to be resilient to, or benefit from, changes in these various economic forces. Similarly, we will maintain a lower duration than the index in our fixed income portfolios, with a concentration in high quality corporate bonds and Treasuries.

As always, TJIM appreciates the trust you place in us, and we will continue to be prudent stewards of your capital by building diversified portfolios of high-quality securities that we believe will provide attractive risk adjusted performance going forward.

Sincerely
TJIM Investment Team

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