TJIM QUARTERLY INSIGHT

Fourth Quarter 2021

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2021 was another banner year for U.S. equities, and the third year in a row with double digit returns on the S&P 500. It seemed every equity style went up. Growth and Value stocks both did well. Small cap did well. Real estate had an excellent year. All of this occurred with a backdrop of the highest inflation prints in nearly 40 years, a pandemic that just won't quit, persistent supply chain woes, and some minor brinkmanship about defaulting on our national debt. Now, for the first time in years, the market is beginning to expect a hawkish Federal Reserve.

The Federal Reserve has begun their tapering of their balance sheet. In this case, tapering is being defined as *not buying more*. Up until November 2021, they were purchasing $120 billion in additional government backed bonds each month. Or as we like to phrase it, 15x the annual state budget of Oklahoma. They will finish their tapering by March 2022, and the market eagerly awaits their next move. With the highest inflation prints in decades, there is a lot of anxiety that the Fed has lost control of this situation. On the flipside, many of the current inflation issues we are experiencing do appear to be directly caused by the pandemic and are expected to be transitory. Furthermore, if inflation is caused by temporary supply-chain kinks, it is difficult to see how raising interest rates, which would increase borrowing costs needed for further investment in the supply chain, fixes the issue. All of this could be a moot point. Inflation looks bad, and the market wants the Fed to do something about it.

At TJIM, we have a few levers that we can pull during times like these. As a general rule, most of the time you can outperform in fixed income simply by taking on more risk. On the other side of the coin, bonds are asymmetric. For example, when purchasing a bond that yields two percent and holding until maturity, the highest expected return is two percent. The lowest possible return is losing everything. Considering these points, it is our philosophy to take risks only when carefully balancing the risk and return expectations. Though interest rates have rebounded from their 2020 lows, treasury yields remain below inflation expectations. Additionally, credit spreads on corporate bonds are near twenty-year lows. The current opportunity set favors conservatism, so we remain underweight both corporate bonds and duration. Our significant liquidity made possible by high weightings in treasuries will enable us to quickly reallocate whenever more attractive opportunities arise.

An ongoing trend of the last few years is that stock market performance has largely been driven by the success of the index mega-stocks such as Apple, Microsoft, Alphabet, Amazon, Facebook, and Tesla. During 2021, market performance was much more widespread. 2021 marked the first year since 2016 where the S&P Equal Weight index outperformed the top-heavy S&P 500. We expect this trend of market breadth to continue for a couple of reasons.

Large companies have become larger, and eventually the math will catch up with them. For example, Apple is now a 3 trillion-dollar company, and the larger a company becomes, the more difficult it is to grow. Since 1957, the stock market has returned an average of 10.5% annually. If future stock market returns will look anything like past returns, Apple will have to add the entire value of a company the size of Pfizer, Walt Disney, Mastercard, or Exxon Mobil to their market cap every year. Additionally, the larger the company grows, the more they become the target of competition and disruption. In fact, research from Research Affiliates has shown[1] that stocks tend to underperform after entering the top 10 largest stocks by market capitalization. It is typically only a matter of time before the stock holdings fall from grace. General Motors, IBM, and General Electric were all the largest company by market capitalization for years at a time. Their rankings have fallen to 98, 72, and 77 respectively. All these companies had dominant market positions. They were considered the best of the blue chips, and were surely

[1] Steidl, J. (2021, May). *The fall of the Titans! | research affiliates*. Retrieved January 10, 2022, from https://www.researchaffiliates.com/publications/articles/830-the-fall-of-the-titans

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valued as growth stocks, but their competitive position eroded over time. New players emerged and slowly chipped away at their business. We have a healthy respect for this history and believe that no advantage is insurmountable. As of year-end, TJIM only owns two of the S&P 500 top ten holdings.

A less accommodative Federal Reserve should also contribute to sustained market breadth. Various factors have contributed to the underperformance of value stocks over the last decade. Notably, lower GDP growth in the aftermath of the 2008 Global Financial Crisis led to the outperformance of secular growth stories over more economically sensitive companies. In addition, dovish low interest rates from the Federal Reserve have led to the outperformance of companies that have a long ramp towards profitability. Simplistically, if interest rates are high, investors are looking to recover their money more quickly. This favors companies with established business models and reliable cash flows. We refer to these as low-duration stocks. If interest rates are low, riskier companies and longer time horizons become more acceptable. This allows investors to buy companies in newly emerging industries, with low current earnings, but high expectations for future growth. These are longer duration stocks. Of course, this concept doesn't just apply to companies. Lower interest rates and excess liquidity favor investments in other highly speculative assets such as cryptocurrencies and NFTs (non-fungible tokens).

We believe that the factors that have contributed to this environment are beginning to unwind. GDP growth has been exceptional. The broader economy seems to be doing well. Inflation has picked up significantly, and interest rates now seem poised to rise. All these factors should lead to a healthier economy and more market breadth. That is a recipe for value to do well. Regardless, the pandemic created many winners in growth areas, and we continue to look for ways to participate in these trends. Future growth remains a key input when valuing companies, and we believe in accounting for future growth prudently with a healthy respect towards valuation and history. A few themes that we continue to believe in are e-commerce, streaming, and cloud computing. The growth towards e-commerce should continue. However, we remain somewhat agnostic on which retailers will win and lose. Instead, we benefit from owning International Paper, which makes cardboard boxes, along with owning FedEx and UPS. These logistic plays trade at reasonable valuations and should benefit regardless of which individual retailers do well. In a direct response to the pandemic, we own Pfizer, CVS, and Walgreens. In addition to their COVID-19 vaccine, Pfizer has also developed what appears to be a highly effective antiviral pill treatment that should become widely available by summer 2022. Walgreen and CVS both benefit from increased store traffic from administration of vaccines and sales of home tests. Another ongoing theme is the transition from linear TV towards streaming services. Instead of owning Netflix, we've owned Discovery, ViacomCBS, Comcast, and AT&T, which owns HBO Max. In the migration to cloud computing, we own Oracle, NetApp, Seagate, and Alphabet. All these companies should continue to benefit from cloud computing as the demand for storage and computing power increases.

Given the uncertainty facing the economy and markets, we believe conservative positioning remains prudent. With low interest rates and elevated equity valuations, TJIM will add positions in selective opportunities across attractively valued equities, treasuries, and corporate bonds. However, our overall equity portfolio positioning will likely remain consistent with a focus on high-quality companies that we feel will be resilient to, or benefit from, changes in these economic forces. Similarly, we will maintain a lower duration than the index in our fixed income portfolios, with lower allocation to corporates and higher allocation to treasuries.

As always, TJIM appreciates the trust you place in us, and we will continue to be 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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