January 31, 2022

Fellow Investors:

After many months, piles of paperwork, and sundry exchanges with the State of Utah Securities Division, I am now officially open for business.

Thank you for your support getting this far. And especially thank you for the recent referrals. As I've stated in the past, your willingness to mention my work to others is greatly appreciated.

There are a few documents that need to be completed as part of the new firm opening. I've contacted some of you about this already and will contact the remainder soon. I will also be sending a risk questionnaire that needs to be completed. Please watch out for the emails.

Portfolio Update

As some of you have no doubt noticed, at year end many of your portfolios had larger than typical allocations to cash. Current market valuation levels and future expected returns, as well as various risks on the horizon, made it difficult to identify attractive investment opportunities.

At times like this, cash tends to increase as I wait for opportunities to arise. I continue to monitor the markets daily and will invest when I deem it prudent. However, it may be some time until that happens. Better to be in cash than to have losses. There is an old saying among investors that "markets can remain irrational longer than you can remain solvent." It's typically used to describe short selling where investors can lose large amounts of money if they are wrong. While your portfolios do not hold any such short positions, the idea that the markets can remain irrational for extended periods of time is relevant.

The financial markets are always evolving, and I have no doubt that soon enough there will be attractive opportunities again. I intend to be patient and wait for them.

Investment Risk

The focus of this letter is risk. I feel investment risk in equity portfolios is often misunderstood by many investors. I also have a somewhat unorthodox view of it. So, I wanted to use this letter to explain how I view and manage risk in equity investing.

The simplest definition of *investment risk* is the probability of losing money. Higher risk investments have a higher probability of losing money, and vice versa for lower risk investments. Appropriately, the higher risk investments should also have higher expected returns. This is how most normal, clear-headed people think about investment risk.

Over the years, many analysts, and especially academics, have grappled with the idea of risk and with the challenge of quantifying it. Today the most common metric is *volatility*, or *beta*, which many consider to be a key investment risk measure. The idea of volatility risk is that some stock prices tend to move up and down more than others, and therefore must be riskier.

However, this definition of investment risk seems to have arisen more out of mathematical convenience than out of any real substance of risk. Volatility is not a fundamental company attribute, nor is it constant through time (as the valuation models assume), nor is it even measurable in any reliable fashion over future time periods (which are the only time periods that should be relevant to investors). The best investors I know largely ignore volatility in their definition of risk and analysis of investments. Market fluctuations are a part of market behavior but should not be considered a significant risk to the long-term investor. Most investors would clearly prefer a stock that rises on a volatile path over one that declines on smooth path.

So how can we better measure investment risk? Properly framed, investment risk is a qualitative concept. Therefore, I believe a qualitative approach to risk is both more rigorous and more accurate than any quantitative measure, despite some arguments to the contrary.

(Remember that "not everything that counts can be counted and not everything that can be counted counts.")

Here are a few of the primary qualitative components of risk that I use in my investing process:

Business risk: This is a broad concept intended to capture the competitiveness of the company's products and/or services, the competency of the management team, general trends in the industry, and similar concepts. No one can be an expert in every business, but investors should at least know the basics of the businesses they are investing in.

Financial risk: This is the risk that the company is in good financial health. Is the debt load reasonable? Is the firm profitable or expected to be profitable soon? Is cash flow strong?

Valuation risk: This is simply the pricing of a stock in the market. Even the best business can be a bad investment at a high enough price. And conversely, even a poor business can be a good investment at a low enough price. Typically, and rightly so, a quality business has a high price, and a poor business has a low price. However, this is not always the case: Where there is a disconnect, there is opportunity. While investors cannot precisely know the correct value of a stock, getting close is sufficient. Benjamin Graham famously quipped that you don't need to know a man's weight to know that he's fat.

Compliance risk: There is always some risk that a company has misreported its earnings, that a lawsuit may arise, or that a regulatory penalty will come. These risks can never be fully eliminated, but investors can focus on businesses where the risk is lower or perhaps already priced in.

It is never possible to fully eliminate the risk of an investment. And there really is no risk-free investment. Therefore, an investor must evaluate each of these risks individually and all risks collectively when making any investment. Even the best investors will miss the mark in their assessments of risk and company prospects a good portion of the time. Usually, the consequences of being wrong are mild. Occasionally they are severe. I try to avoid these latter scenarios.

There are several additional items related to portfolio construction that can also be used to reduce risk. Diversification effectively reduces the risk of any one investment; however, it can be taken too far. If you have high confidence, it's better to have a concentrated portfolio. Second, keeping a healthy amount of cash can greatly reduce risk in a portfolio and provide opportunity to act quickly when the timing is right. I keep these ideas in mind when building your portfolios.

Lastly, there is another risk worth mentioning that is not related to the markets or any specific investment but rather to the investors in that market. Perhaps we could call this *emotional risk* and define it as "an investor's response to both good and bad market developments." If you have a temperament that is inclined to panic sell when stocks are falling, or conversely to impulsively buy when stocks are rising, then you are a risk to your own investment process. Emotional investing almost always ends badly. Since you have delegated the investment decision making to me, you are far less likely to suffer from this risk. However, you do still control when funds come into and out of your account. I only invest the funds that are currently there. The takeaway then is that when the markets are down, and you're feeling hesitant, it's probably a good time to add to your account. And when things appear rosy and bright, it might be a good time to take some money off the table.

Being cognizant of all these risks is only the first step. Managing them is more difficult. This is why you have hired me. In some respects, risk management is the most important job of an investment manager. While I cannot guarantee I will always make good investments and correctly evaluate risk, I can offer you my continual best efforts along with the assurance that I invest my own funds in nearly every stock that I buy for your portfolios. So we are exposed to much of the same risks. This alignment of interests is important to me.

Career Update

In my last letter I informed you that I had resigned my full-time employment in order to focus on this investing business. Recently, and unexpectedly, I was offered a new job opportunity that was simply too good for me to refuse. I will therefore soon be employed again. However, I assure you that no matter my employment status, I will continue to run this investing business as I have for many years. As I've stated in the past, investing is never far from my mind. I think about the markets constantly and am always analyzing potential opportunities to invest. None of this will change.

Conclusion

As always, I am available to discuss anything in this letter or anything related to your portfolios. Please reach out if you have questions. Best wishes to you and yours in the new year.

Kind regards,
Todd Niemann, CFA