April 21, 2023

Fellow Investors:

Market Update

The first quarter of 2023 was volatile in both equity and bond markets, with the S&P 500TR Index ultimately returning 7.9%. Headlines were dominated by the collapse of Silicon Valley Bank and other banking troubles. Fortunately, these isolated events have not led to systemic problems. Inflation continued to decline. Labor markets remained surprisingly strong. International tensions persist. Less talked about in general—but interesting for investors—is the ongoing divergence between the Federal Reserve and the bond market regarding the future course of interest rates. The Fed insists rates will remain high until inflation is down. However, the bond market's implied expectations indicate the Fed will start reducing rates as soon as this summer. Prominent investor voices have come out in support of both arguments. We will know in time which side was right. My own views generally favor the Fed but are not firm enough to warrant significant action. Like Howard Marks of Oaktree Capital (whose excellent memos are highly recommended reading for all[1]), I do not find much use for macroeconomic forecasts as they are nearly always unprofitable. Instead, the best approach is to focus on business fundamentals and remain diversified. This will always be what I do for your portfolios.

Expectations Revisited

Not infrequently, I am asked some version of the question: "The economy is bad and getting worse; shouldn't we sell all our stocks and wait for things to improve?" I've addressed this question before but feel the need to revisit it for those who still wonder. In summary, the markets do not trade directly on what *is happening* in the economy. Rather, the markets trade on expectations for what *will happen* in the future. This includes not only general macro events but also company-specific events like earnings. To some, the difference may seem

[1] https://www.oaktreecapital.com/insights

subtle, or perhaps unimportant, but it is crucial to understanding why markets move the way they do.

To illustrate, if it is widely expected that the economy will decline, then the decline will already be reflected in stock prices. Meaning if the economy does in fact worsen in line with those expectations, there will be no significant change in stock prices at the time the economic news is released because it will have already been traded on at the time the expectations were formed, which happens well in advance of the actual events. Of course, if the decline is worse than expected, then this would require a change in expectations and would result in movement in the market.

I've included two charts at the end of this letter that help further demonstrate these ideas. The first is a history of the S&P 500 Index since 1927, with recessions shaded in grey. You'll notice that, despite many recessions over nearly 100 years, stocks have continued their steady climb (about 6.5% annually in this chart, which excludes dividends). The second chart shows the correlation of changes in the S&P 500 Index and changes in GDP. You'll notice that there is basically no correlation; in other words, changes in these two data series are independent of each other.

All of this is to say that you should only trade on economic data if you feel the expected decline is not well known or not accurately priced into the market. Merely believing that a downturn will occur is not enough. Please excuse me for belaboring this point so frequently, but it remains one of the most common questions I receive. Thus, it seemed to warrant additional attention.

Goals and Motivations

This letter marks the two-year anniversary of when I started writing. In my first few letters, I laid out my reasons for writing and for starting this business, why I chose to be an investor in the first place, and what I hope to accomplish. After two years of insights and experience, I want to use the remainder of this letter to revisit those goals and elaborate on future potential.

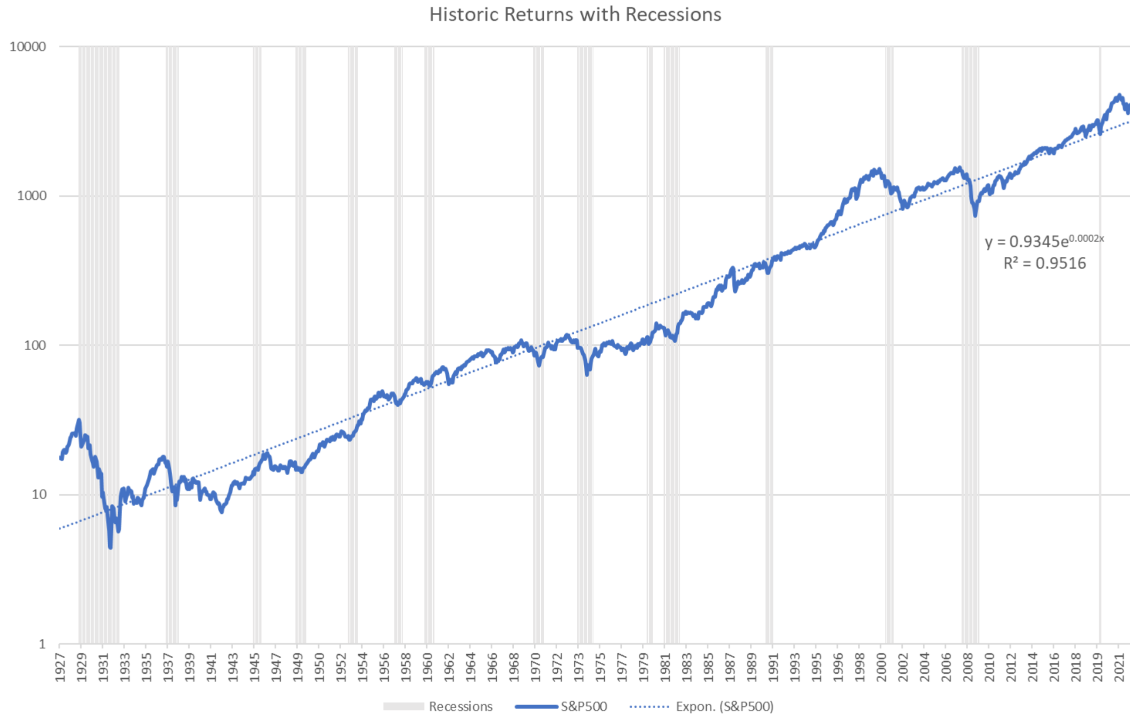
As always, I continue to be fascinated with the markets. As the intersection of finance, business, psychology, economics, and many other fields, I find the markets endlessly intriguing. I study them constantly. This small firm was created to employ my learning for the benefit of my friends and family, who constitute the entirety of the client base. Realistically, this will probably always be a very small friends and family shop. However, if I allow my dreams to carry me away, sometimes I do imagine a larger role for this little firm. Please indulge me as I explain.

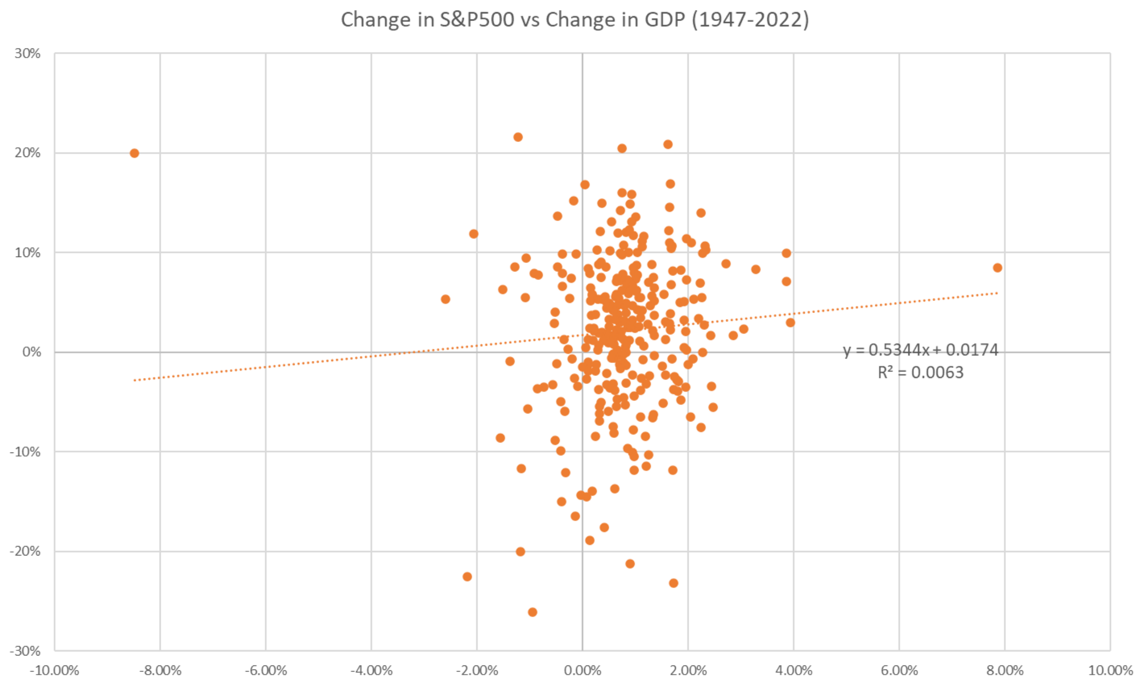
I've spent a substantial portion of my adult life studying financial analysis and market valuation, even developing my own approaches and methodologies. At times, I imagine that this little firm could grow to be a substantial market participant. At scale, it would help stabilize markets by reducing volatility and also by improving the accuracy of asset pricing, which then would improve the allocation of capital in society. Of course, in fulfilling this role, the firm would also generate substantial profits for the investors. This is a ludicrously grandiose vision for such a tiny firm, but it is nevertheless a dream and distant goal. The firms assets under management would need to increase by several orders of magnitude beyond their current levels to accomplish this. To this end, your referrals are greatly appreciated.

Conclusion

This year I will be attending the Berkshire Hathaway annual meeting in Omaha, Nebraska, on May 6, 2023. I've long been an admirer of Warren Buffett and Charlie Munger, whose track record and wisdom have inspired generations of investors, but I have never before attended their annual meeting. I'm elated to do so this year. If you are also attending or in the area, please let me know and we can connect.

Kind regards,
Todd Niemann, CFA


Historic Returns with Recessions
10000
1000
100
10
1
y = 0.9345e^0.0002x
R² = 0.9516
Recessions
S&P500
Expon. (S&P500)


Change in S&P500 vs Change in GDP (1947-2022)
30%
20%
10%
0%
-10%
-20%
-30%
-10.00%
-8.00%
-6.00%
-4.00%
-2.00%
0.00%
2.00%
4.00%
6.00%
8.00%
10.00%
y = 0.5344x + 0.0174
R² = 0.0063