NIEMANN
INVESTMENTS

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Fellow Investors:

Market Update

Interest rates continued to draw my attention in Q3. While the Federal Reserve hiked short-term rates only once during the quarter, long-term rates increased sharply. The 10-year treasury bond yield rose from a June month-end yield of 3.84% to a September month-end yield of 4.57%, and it has climbed even higher in the first part of October as I write this (see the chart at end of this letter).

Equity markets were also surprisingly resilient. Inflation is no longer the concern it previously was, currently hovering around 3.5%, which remains above the Fed's target of 2%. In other words we should not expect rate cuts from the Fed for some while longer. Interest rate futures markets are coming around to this view slowly. As I've said for some time now, barring any external shock, the labor market needs to weaken before we see much stress in other parts of the economy. This is what the Federal Reserve is waiting for before they can consider reducing short term interest rates.

I also believe we may have increased volatility through the year's end as expectations change and investors adapt to the new economic reality of higher interest rates. Early October has already shown an uptick in volatility. Of course, I position the portfolios to do well through any economic environment, but the future remains impossible to predict.

Grant's Conference

In my last letter, I wrote about the Berkshire Hathaway annual meeting that I was fortunate to attend in May. In early October, I made a trip to yet another investor gathering. The bimonthly publication *Grant's Interest Rate Observer* is currently celebrating its 40th year. I've long been a reader of Grant's. The content is both insightful and delightful to read –a rare combination in financial literature. Each fall, Grant's holds a conference in New York City at The Plaza Hotel. Compared to the Berkshire Hathaway meeting, which is enormous, the

Grant's gathering is a relatively intimate group of perhaps 100 or so dedicated investment professionals. I very much enjoyed meeting Mr. James Grant himself and his colleagues as well as hearing the thoughts and ideas of other Grant's readers. The group naturally has a bearish bent. Grant's is known for being overly conservative, even pessimistic at times, and attracts many dour-minded readers. Major take-aways included:

- Convexity: This is a somewhat esoteric topic in investing, defined mathematically as the second derivative of the price function of an asset. In more general terms, it represents the idea that there are times when asset prices move dramatically. Astute investors seek to build portfolios that have positive convexity; they go up a lot when conditions are favorable, but only go down a little when they are not. This is obviously desirable. However, the markets are often counterintuitive, and actually building such a portfolio may require the investor to do things that are not obvious, such as accepting small losses for a time in order to reap a larger reward later. Or holding unusually high cash reserves, and thus trailing a benchmark, while waiting for better opportunities to invest. If it were easy, everyone would be doing it. I consider myself fortunate to be able to implement these strategies and do so whenever I find opportunity.
- Risk: Warren Buffett has said that rule #1 of investing is never lose money, and rule #2 is never forget rule #1. As mentioned above, many of the attendees were rather pessimistic about the outlook for the market. Yet at the same time, they offered some useful ideas that should do well despite a poor economy. They first focus on the downside to make sure it's covered, and then consider the upside with some skepticism. Today's equity markets, with stubbornly high valuation levels, confirm this is a contrary approach today.
- Cash Flow: While this last point wasn't explicitly mentioned at the conference by any speaker, it was still very much on my mind and seemed to be implicitly reinforced that companies with high levels of cash flow and reasonable prices will do well over the long term. These are the sorts of companies I focus on finding.

This is definitely a conference I would like to attend again next year. Perhaps I will see you there!

Conclusion

A brief reminder: please do not text me with questions. I understand the inconvenience of this for all of us today, but unfortunately the communication regulations are such that I cannot respond with information via text messages. Of course, I welcome the chance to chat on the phone with any of you anytime.

As always, thank you for allowing me to manage a portion of your wealth.

Kind regards,
Todd Niemann, CFA