TEMPLETON & PHILLIPS
CAPITAL MANAGEMENT, LLC
A BETTER VALUE

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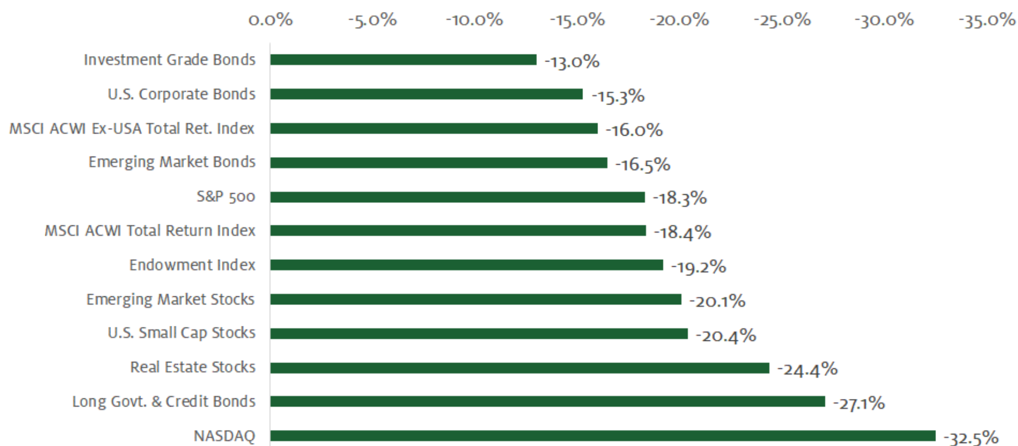
2022 Annual Letter

Pandemic, war, inflation, natural disasters, speculative crashes, financial frauds, and the prospect of an economic slowdown. Perhaps we are all ready to live in less "interesting times." On the other hand, looking at history suggests that these times may be less interesting than we assume. Our curiosity led us to pull together a modern summary of pandemics, wars, and inflation dating back to the early twentieth century. Our findings show that 77% of all annual periods contained some instance or a mix of above-average inflation, pandemics, and wars. Additionally, the other 23% of the entire period included the nine years of the Great Depression (marked by *deflation*). Taking the Depression into account, 85% of all annual periods faced challenging circumstances of some variety. Upon reflection, the decade of ultra-low inflation and interest rates preceding 2020 was abnormal, and the inflated asset prices it produced were proven unsustainable in 2022. The silver lining, in our opinion, is that interesting times like those today provide a fertile landscape for future investment returns.

The 2022 financial markets brought abrupt change for many complacent investors. Rising inflation was the main culprit, but the pandemic and the Russian invasion of Ukraine proved ready accomplices. Global stocks and bonds suffered, some even historically, across the board. In fact, 2022 was the first year since 1926 that both large-cap stocks and investment-grade bonds posted simultaneous double-digit losses.



Source: Bloomberg

Taking a contextual look at our portfolio in 2022, we began preparing the portfolio for this environment several years ago in 2019. No—we in no way, shape, or form predicted a pandemic or even the magnitude of its disruption when it arrived. Instead, our preparations were focused on constructing a portfolio durable enough to weather what we believed would be the inevitable reversal of a decade defined by reckless monetary policy through zero-bound interest rates and quantitative easing. More specifically, the unusual decade between 2009-2019 we referenced in our beginning comments looked unsustainable, even at the time.

As we have discussed many times in the past several years, our preparations (purchases) included owning firms with quality balance sheets showing the ability to fund their operations and reinvestment plans through internal cash flows (versus borrowings) across a business cycle. This focus was owed to our perception that ten years of zero-bound interest rate policies from the Federal Reserve led to excessive risk-taking and capital misallocation, mostly among corporate borrowers and firms (both old and new) who were unable to stand on their own two feet. When the Fed presumably withdrew these unusual levels of policy support, we envisioned owning a portfolio of companies that could continue operating and growing in the absence of ultra-cheap external funding. Moreover, we sought to own firms that could continue deploying their resources in a weakened environment, whether through reinvestment and market share gains, share repurchases, dividend increases, or acquisitions. In sum, we sought firms with strong demonstrated capital allocation practices. The only problem was that as value investors with a strict focus on buying firms for less than their intrinsic value, these quality firms rarely go on sale. Thankfully, help arrived in March 2020. As the market panicked over COVID-19, lockdowns, and an inevitable recession, all stocks, everywhere, instantly went on sale. Trouble is opportunity, and we systematically turned over approximately two-thirds of our portfolios during a few weeks in March.

Despite our careful planning and execution, however, the immediate year offered fresh policy surprises. Namely, the misallocation of capital resources that we guarded against (aggressive issuance of risky debt: high-yield, covenant light, second lien, and PIK Bonds) took a backseat as the markets received a new installment of central bankers gone wild. So, while the Federal Reserve had been well into a rate-hike cycle just before COVID, as the lockdowns commenced, it suddenly reversed course and flooded the capital markets with fresh liquidity. The Fed unloaded at least $4.8 trillion in liquidity (doubling its balance sheet between Feb. 2020-April 2022). This was quickly accompanied by Congress sending $931 billion worth of checks in the mail (April 2020-December 2021) to qualifying individuals and families. In sum, a combined record amount of monetary and fiscal stimulus entered the economy over the next year and a half.

To be fair, there were people in need during COVID, and it is not unreasonable for governments to send relief. However, as the need for essential relief was met and the Fed maintained its aggressive stimulus levels, its impact on inflation and speculative asset prices created a new financial misadventure. The Federal Reserve's surplus of liquidity found its way into various forms of speculations, including real estate, profitless tech stocks, crypto-assets, NFTs, and meme-stocks. The latter speculations drew public interest in tech-related bubbles to levels not seen since the late 1990s. For investors who witnessed the late 1990s, there were signs everywhere. In the January 2000 Super Bowl, we were amused by advertisements from soon-to-be failed dotcom firms. Almost right on cue, in February 2022, a barrage of Super Bowl advertisements sought to distract football fans from their guacamole dip to buy cryptocurrencies instead. As the actor on the FTX commercial told us, "It's a safe and easy way to get into crypto" just before closing with an all-caps message, "DON'T MISS OUT." Slightly less than nine months later, FTX filed for bankruptcy. Today, FTX's co-founder and the CEO of Alameda Research have both pleaded guilty to fraud and are cooperating with SEC prosecutors in its case against FTX co-founder and CEO Sam Bankman-Fried. Thankfully, by December 2021, the Federal Reserve had

acknowledged that inflation was too high and not as transitory as it once asserted. The Fed postured and embarked on a new round of interest rate increases, thereby pulling the rug out from under speculators. One of the most prominent casualties in the speculative bust was the ARK Innovation Fund, which lost approximately 81.1% from its high in 2021 through December 28, 2022.

Despite the steep declines among speculations in tech and crypto, it remains unclear whether the excesses have been completely wrung out of the markets. Our experience from observing the dotcom mania early in our careers is that it may take years for the speculative corners of the market to bottom and recover. For illustration, we often cite the dotcom era case of Microsoft, the remarkable technology firm that has maintained a dominant market position dating back to its beginning in the mid-1980s. Even today, Microsoft Windows holds a market share of 76%. Despite its ongoing success and lucrative developments in video games and cloud computing along the way, the firm's shares struggled mightily for the better half of a generation. During the original dotcom mania, Microsoft shares touched a high valuation of 21.9x sales and 61.0x EPS in 1998. From that valuation as a starting point, it required 17 years for Microsoft shareholders to generate a positive return on their holdings. At the beginning of 2021, we counted no less than 718 stocks in the U.S., trading at or above 20x sales. We still repeat the same question from our January 2021 commentary, how many of those companies will prove as successful as Microsoft? Despite tough lessons for speculators, the dotcom era news was not all bad—far from it.

From our standpoint, the good news from the recent speculative bust is manifold. First, given the Federal Reserve's clear role in seeding the recent inflation, it should be more hesitant to recreate inflationary or speculative conditions again in the near term—but it lacks credibility, so only time will tell. Second, near-term T-bill rates exceeding 4.6%, although still negative in real terms, represent an enticing upgrade for savers. Moreover, the much higher T-bill rates from a year ago combined with the current positive real return on the 10-Year Treasury Bond (based on TIPS breakeven) may effectively close the door on near-term potential misallocations back towards speculative assets (again, only time will tell). That would be a healthy development for the financial markets if true. Third, a meaningful cross-section of equity markets, particularly small-cap and international equities, carry historically low valuations that imply better-than-average future returns. Fourth, and as an addendum to the third, segments of the market that had been neglected and carried low valuations during the speculative phase of the late 1990s performed much better coming out of the dotcom bust, even while tech stocks languished for years on end. Fifth, the reopening of China could potentially help offset the anticipated slowdown in the U.S. (on the back of restrictive monetary policy) in terms of global GDP and provide ballast to the argument for discounted international equities. From a cyclical perspective, the current policies of the U.S. and China look like ships passing in the night.

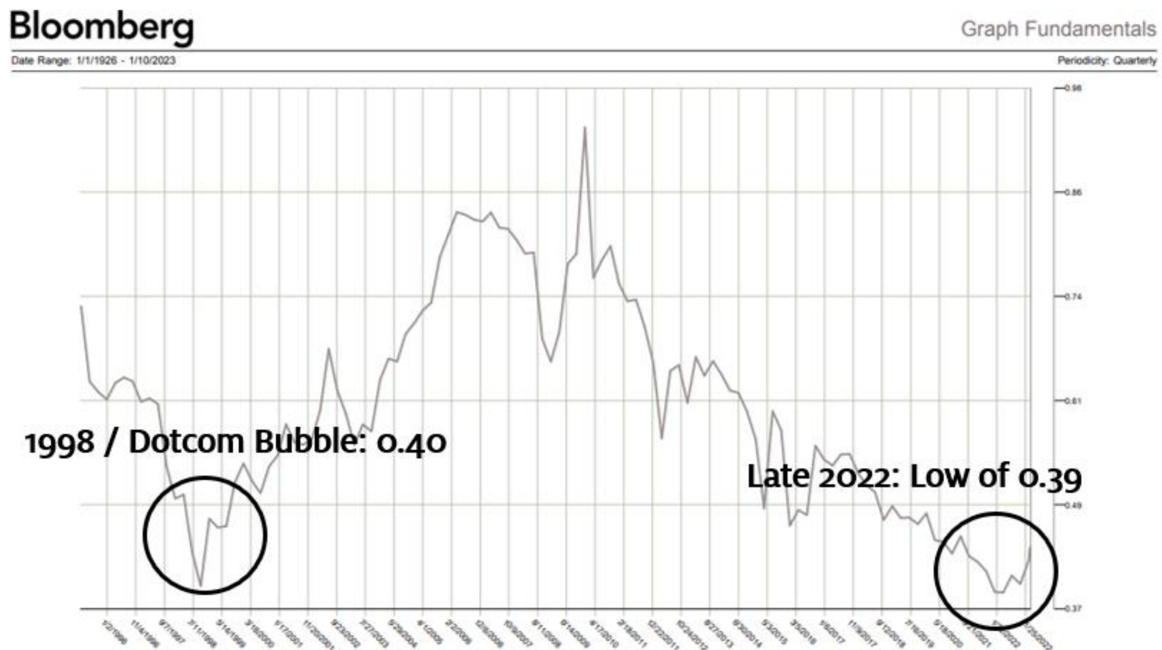
At this point in the discussion, we have now caught up to the present day. Regarding our portfolios today, we remain heavily concentrated in the higher quality balance sheet firms with strong capital allocation records that we purchased in March 2020. On balance, we believe the firms in our portfolio performed well in the business climate of 2022, as their collective resources of pricing power largely insulated their profits against rising costs, to date. It has also helped that dating back to the March 2020 investments, we have favored firms mainly with relatively defensive goods and services. While firms focused on increasing their dividends on a year-over-year basis were wildly out of favor in late 2020 and 2021, they

have become more popular in the current environment, given concerns over Fed rate increases and a potential slowdown. With that said, most of our energy today is spent combing through the markets in a bottom-up fashion to identify the investments that may hopefully propel returns on the more distant horizon. As we mentioned at the beginning of the letter, the fallout in the markets during 2022 was broad and, as alluded to in the preceding paragraph, provides a wider spectrum of potential bargains.

With that perspective in mind, we will shift our discussion toward the future and potential opportunities. History is far from a perfect guide, but it can be helpful in matters of human nature—including behavior in the financial markets. Thankfully, even in today's world of increasingly artificial intelligence, the combined folly (boom and bust) of 2021 and 2022 convince us that humans remain in charge. With that preface, let us discuss two valuation anomalies we see carrying historical precedent. Coincidentally or not, these anomalies were last seen in the late 1990s. The anomalies we are referencing include the deep discounts currently available in both international stocks and U.S. small-cap stocks.

Beginning with international stocks, we start with an illustration of a relative price to book value versus the S&P 500 dating back over the past quarter century. What we find today is the largest discount on record for international stocks.

International Equities at Largest Discount to U.S. Since 1998



Sources: Bloomberg, Templeton and Phillips Capital Management

To be sure, the international markets have their fair share of problems. COVID has hindered international economic performance for years, ranging from zero-COVID policies in China to the related supply chain disruptions that have reverberated across the globe. In early 2022, the Russian Invasion of Ukraine has been, first and foremost, a human tragedy, but it has also further disrupted supply chains, commodity prices, and global commerce. Russia's tandem assault on Europe through its natural gas supply monopoly

stoked legitimate fears of a continent struggling to keep itself from freezing this winter. Finally, a shared urgency among international central banks to address inflation has led to monetary tightening across many economies despite already present recessionary pressures.

So, without question, the widest discount to U.S. stocks in a generation reflects genuinely difficult circumstances. At the same time, value investors understand that once these levels of “maximum” pessimism are embedded in share prices, stocks can represent attractive bargains for long-term holders. The future is uncertain—for better or worse—but history has repeatedly demonstrated that companies are remarkably adaptive organisms. Share prices offer investors not much more than a set of expectations for the future, and when expectations become extremely dire, the only catalyst needed is for the future to be less bad than the markets fear. In late 2022, we believe the latter scenario was probable across the international markets. We found European stocks attractively priced and focused our purchases on shares in the U.K. and Europe trading well below their book values and at mid-to-low single-digit multiples on their earnings and cash flows. In recent weeks those markets breathed a sigh of relief due to an unusually warm winter.

Aside from severely depressed share prices in Europe, we believe the opportunity set for international equities extends east into Asia. We have written periodically over 2022 about the unsustainable nature of China’s zero-covid policy, and the only surprise of its reversal was how long it took, in our opinion. China’s drive to build a domestic economy over the past decade is impressive, but it remains a work in progress. Trade still represents an estimated 37% of GDP, and the inherent boom-bust-prone real estate sector represents another estimated 20-25%. With both engines idling due to government regulations (i.e., “Three Red Lines” and zero-COVID) coupled with a frustrated populace, the government had little choice but to restart its economic engines (through deregulation). It will be challenging to gauge the near-term effects of reopening as COVID infections spread rapidly and expose an ill-equipped healthcare system. Still, over the course of 2023, it appears likely that economic growth can rebound, perhaps significantly.

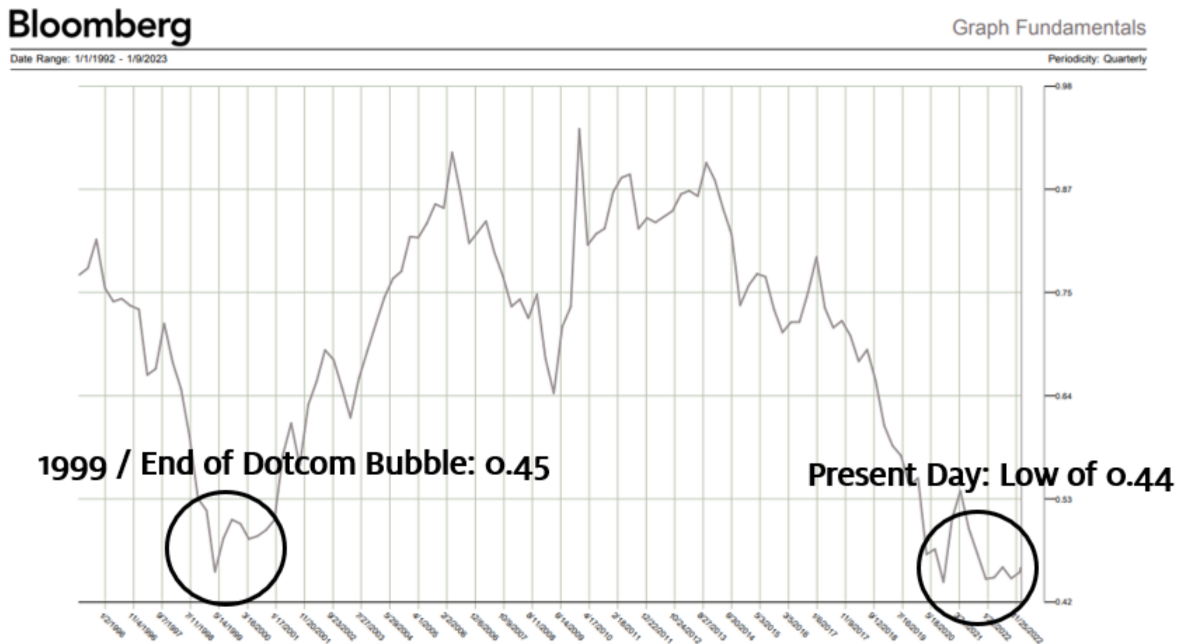
Our optimism surrounding Chinese economic activity stems from a rebound in consumption following three years of COVID lockdowns. To begin, like their western counterparts, Chinese consumers should have pent-up demand for various goods and services. Still, unlike western consumers, the Chinese have three years of accumulated savings (and cabin fever) at their disposal. Based on data from the People’s Bank of China, Chinese households have increased their savings by approximately 84% since 2019 (from RMB 9.7 trillion in 2019 to RMB 17.9 trillion in 2022). The consensus is that the Chinese consumer will emerge with a willingness to spend and the funds to do so, but it remains to be seen how much and for how long. In any event, we believe our multinational consumer product holdings stand to benefit after several years of weakened results in the Chinese market. From hot and cold beverages to personal care, apparel, and makeup, we anticipate renewed demand from Chinese consumers (and Asian neighbors) to help support business performance among several of our holdings.

While the international equity dynamics pique our interest, we have been equally enthusiastic to see the historic discount in U.S. small-cap stocks emerge within the past year. For many value investors, small caps are a favorite hunting ground where smaller trading volumes and low analyst coverage open the door to share price inefficiency and potential mispricing. While we believe the dynamics above are a critical

factor in small cap appeal, the other cause for interest has been the long drought for discounted opportunities in this space. During the preceding decade of zero-bound interest rates, we have found the space too expensive to meet our criteria, especially when combined with the additional risk that may accompany smaller firms and their frequently weaker capital structures and access to capital.

In the following illustration, we highlight the widest discount in U.S. small caps relative to the S&P 500, dating back to once again, the late 1990s.

U.S. Small Cap Equities at Largest Discount to S&P 500 Since 1998



Sources: Bloomberg, Templeton and Phillips Capital Management

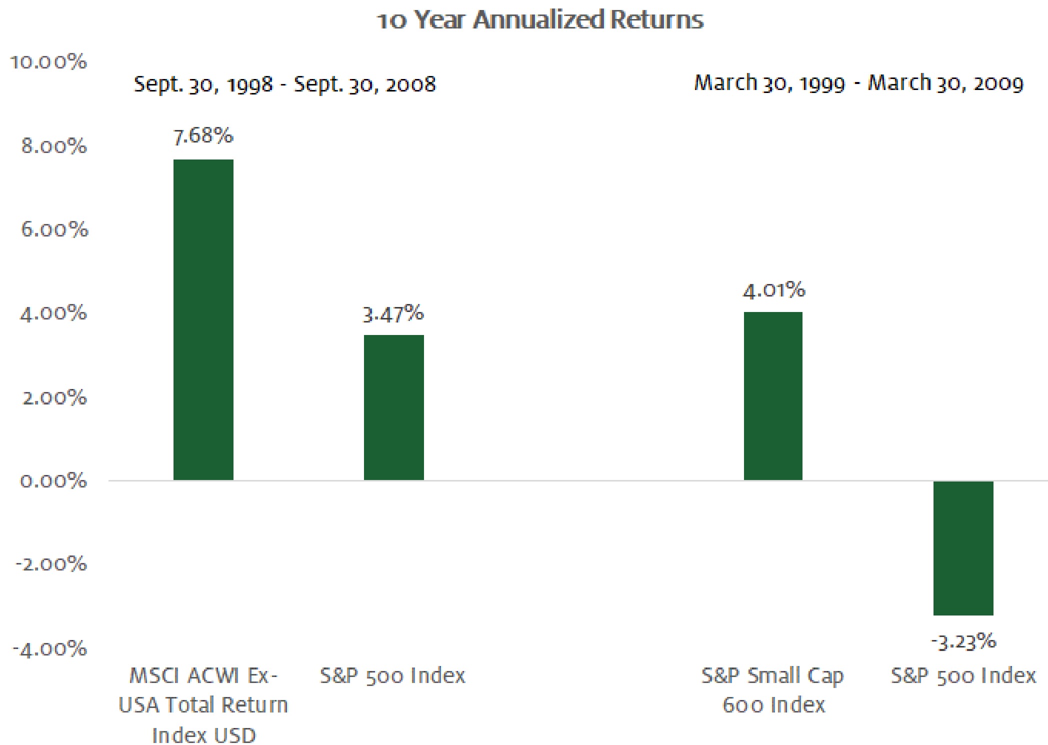
In keeping with our findings among international equities, we have been able to locate U.S. small-cap equities trading at significant discounts to book value and low-to-mid single-digit multiples on cash flows and earnings.

In the small-cap space, however, we have been more stringent around credit quality given these firms' traditionally lessened access to capital vis a vis large-cap firms serviced by a wider spectrum of banks and capital markets. Nevertheless, we have been able to find holdings in this space meeting our standards for credit quality, and for that matter, companies with shareholder-friendly capital allocation practices resembling those among our large-cap holdings: low agency risk, share repurchases, increasing dividends, and reinvestment into future growth—through minimal external borrowings.

As we mentioned earlier, history is not a perfect guide nor a guarantee of future performance, but we have found historical studies useful in valuation. With that said, let us examine the historical performance of

these two groups in the ten years following the last time they reached historically wide discounts versus the S&P 500.

In the illustrations below, we have presented the ten-year annualized returns of the MSCI ACWI Ex-USA Total Return Index versus the total returns of the S&P 500 Index from September 30, 1998, through September 30, 2008. We have repeated this same process for the total returns of the S&P Small Cap 600 Index compared with the total returns of the S&P 500 Index for the period of March 30, 1999, through March 30, 2009. In both cases, the historically wide valuation discounts signaled decisively better returns in the ten years that followed relative to the S&P 500. Notably, as an aside, the final year of the returns reported below dampened relative outperformance since 2008-2009 incorporate market turmoil associated with the Financial Crisis. During the crisis, international, small-cap, and emerging market stocks materially underperformed the S&P 500 as investors sought relative safety in U.S.-denominated assets. Despite any short-term underperformance near the conclusion of the ten-year horizon, both indices maintained a sizable spread over the S&P 500 well into the dark days of 2008-2009.



Sources: Bloomberg, Templeton and Phillips Capital Management

In sum, our discussion surrounding the current opportunities we see among international, and U.S. small-cap equities reflects our continual process of laying the groundwork for future portfolio returns. Considering the growing popularity of quality and dividend growth over the past twelve months populating our current portfolio (dating back to 2019), we are reminded of the necessity to part with the consensus over time in order to add value as managers and potentially generate excess returns. Put

differently; we have never forgotten the simple investment truth that "If you want to have better performance than the crowd, then you must behave differently from the crowd."

Thank you for following our commentaries, and please feel free to share any thoughts.

Sincerely,

Lauren C. Templeton
Principal

D. Scott Phillips, Jr.
Principal

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