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INVESTMENT ALLOCATION TODAY: THOUGHTS FROM THE TRIPLE CROWN

This year I completed the triple crown of AGMs (as value investor Bob Robotti likes to refer to them): Fairfax Financial, Berkshire Hathaway, and Markel. Toronto, Omaha, and Richmond, VA. These meetings were a lot of fun and informative. For disclosure purposes, we own shares in all three companies. The team at Fairfax returned live from the COVID break with one of the best annual meetings in recent memory. Also this year, Scott and I took our children to the Berkshire Hathaway AGM, and I have written about the BRK experience with children here for those interested. At the Markel event, I was invited to join a panel discussion at Robotti Value Live – Markel 2022. In preparation for the event, we compiled some thoughts on the current market and how investors might find opportunities today. As Uncle John said, Trouble is Opportunity. I share a summary of my panel remarks below:

The markets are currently sorting through the implications of at least several if not ten years or more of capital misallocation into bonds, overpriced equities, cryptocurrencies, and NFTs. These misallocations have been highlighted by the large jump in inflation and the relatively sharp rise in interest rates from a low base. The implications in our minds are that capital allocation will need to focus once again on both the returns on and of invested capital. Traditional measures related to cash flows in their various forms: dividends, share repurchases, and returns on invested capital exceeding the weighted average cost of capital all matter again.

Historically, dividends and dividend growth strategies perform well during inflationary periods. Dating back to 1940, during periods when the CPI exceeds 5-6%, dividend growth historically outperformed equity price returns by approximately 16 percentage points, using studies based on Robert Shiller's data. Importantly, these dividend strategies outperformed from the 1970s and on, as the U.S. experienced crippling inflation and low economic growth. The good news is that in this current environment of panic and volatility, most stocks have been punished to some degree. This creates an opportunity to make allocations to managers and strategies that excel in these traditional measures of quality and value. We first wrote about the unusual bargains surrounding dividend strategies last year. In our April 2021 commentary *The Boring Path to Better Returns*, we illustrate the strategy. The letter was unpopular and led to an unusual number of unsubscribe requests having being written in the middle of a meme-tech-crypto-bubble frenzy. Unsubscribes are a wonderful contrarian indicator and it reminds me of the time I pitched the European-based steelmaker Arcelor-Mittal in 2013 at a value investing conference in Omaha. This was on the heels of the European debt crisis and the stock was trading at approximately 1/3 of its book value. At the time I was practically booed out of the room, but with some patience, it produced remarkable returns for the portfolios. In our most recent commentary *What Is Old Becomes New Again*, we highlight some recent ideas from the dividend growth field of value.

In addition to dividends and a deep focus on fundamentals and capital allocation at the corporate level; ignoring the valuation disparities between the U.S. and the international markets has become almost impossible. Based on our research and Bloomberg data, the MSCI ACWI Ex-USA Index now trades at the largest discount to the S&P 500 on record (dating back to the early 1990s) measured by P/Es. The MSCI Ex-USA P/E of 11x represents a 40% discount to the S&P 500. It is also interesting to note that these markets include economies in Continental Europe and Japan where inflation has not been as problematic as in the U.S. and U.K., to date.

Regarding fixed income, we have been concerned with the overall levels of corporate (for more see July 2021 *Self Reliance*) and government debt (Sept. 2020 *The Debt*). As bottom-up allocators, we remain concerned with the elevated levels (similar to 1Q20 as % GDP) of corporate credit in an environment of rising interest rates and declining market liquidity, even if balance sheet cash positions are supportive in the near term. The rising-rate environment seems likely to present eventual challenges to the weakest balance sheets, and in light of inflation, it appears that the Fed will be much more reluctant to step in and directly support corporate credit as they did in 2020. Therefore, it seems likely that peak credit conditions are behind us, defaults will eventually rise, and hopefully, distressed investment scenarios will appear again after a long hiatus.

Finally, and forever contrarian, it is important to remember that bargains can appear anywhere pessimism runs unchecked, and we are careful to point out that Amazon fell 93% to a low of $5.97 in September of 2000, a pretty shrewd bargain for those paying attention. So, it is also important that bargain hunters keep an eye on the current tech crash.

There may not be a need to find the next Amazon, when the old one will do just fine. We believe the firm's shares are now deeply discounted having not escaped the broader tech-related selling. For instance, Amazon currently trades at 11.0x its cash flow compared with 12.8x in December of 2008 (i.e., GFC). Similarly, we estimate that on a sum of the parts basis, equity investors are receiving Amazon's retail e-commerce business for free. We believe the company's fundamentals look poised for acceleration, following the recent completion of a significant capex cycle to meet pandemic demand, as well as easing comparisons from year-over-year pandemic stimulated demand that was well above normal. Clearly, the current environment is hostile towards any stock associated with technology. In the case of Amazon though, we see a dominant retailer whose capital needs are supplemented by an equally dominant cloud computing business, both of which remain in the early innings of their overall penetration rates across the U.S. and global economies. As the effects of rising inflation and interest rates eventually impact the credit-challenged retail industry (bricks and mortar retail), we believe Amazon can accelerate its growth through market share gains in the years to come.

Lastly, we are constantly reminded that good performance is usually dependent on your behavior in a bear market and not your behavior in a bull market. It is time to brush off your wish lists!

Happy Bargain Hunting,

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