August 2022

Price, Value and the Cost of Relative Valuation

"S&P 500 Posts Worst First Half of Year Since 1970"
Wall Street Journal front page headline, June 30, 2022

"S&P 500 on Track for Best Month Since 2020"
Wall Steet Journal front page headline exactly one month later

Dear Friends and Fellow Investors,

These headlines confirm that Ben Graham had it right when he characterized markets as manic-depressive. They tell us everything about price and nothing about value, but underneath lurks an important question, perhaps *the question*: What is an investment worth?

The answer is simple and timeless: *Any* investment is worth the sum of its future cash flows, *appropriately* discounted to the present. The key is the appropriate discount rate, or rate of compounding, which is the subject of this letter.

An investor would not pay $1 today expecting to get $1 in 5 years, or a rate of 0% and a return of $0.00, with purchasing power further eroded by inflation. Rather, one would only pay less than a dollar, which raises a second important question: how much less? The answer is crucial because it implies an investment's discounted, or compounded, rate of return.

For many investors, and most of Wall Street, the answer is "It depends". What it depends upon mostly is the *current* level of interest rates and the returns available from competing investments *right now*. As we shall see, this form of short-termism may lead to a permanent loss of capital.

U.S. stocks have returned 9-10% compounded annually for a century. Because stocks are risky, long-term investments, it is axiomatic that they must provide a better return than the "risk-free" asset of comparable duration, which for us is the 10-year United States Treasury Note. Backed by the full faith and credit of the United States, U.S. Treasuries are the safest assets in the world in terms of the likelihood of timely payment of interest and principal. Any other investment is perceived to be riskier and must compensate with a better return. The 10-year is an investor's North Star, the reference point around which returns from all other investments are compared.

The last 13 years, however, have witnessed an unprecedented distortion of this North Star relationship. Beginning with the Global Financial Crisis in 2008, and culminating with the pandemic, central bankers around the world drove short-term interest rates lower, nearly to zero, to avert recession. (In fact, over $18 trillion dollars' worth of bonds globally had *negative* yields in the spring of 2020.) While cash returns from bonds were collapsing, corporate earnings, which fell dramatically in the early months of the pandemic, recovered sharply in the latter half of

2020. By the end of 2021, S&P 500 earnings were *30.76% higher* than they were in pre-pandemic 2019.

When risk-free rates are near zero, *any* rate of return, no matter how minuscule, compares favorably, particularly if they are rising. For example, in a 1% interest rate environment, an investor could pay a ludicrous 75 times earnings, equal to an earnings yield of 1.33%, for a no-growth, mature industrial business and *still* beat the risk-free rate by a wide margin. It never got quite that crazy, but with *any* cash flow looking better than *no* cash flow investors bid up many stock prices to silly levels that left them little chance of compounding at the market's historical rate of return. This is relative investing at its worst and it even earned an acronym that may haunt investors for a long time: "TINA", or "there is no alternative".

For a while, it worked. With the risk-free rate generally below 1.5%, and earnings skyrocketing, enormous sums poured into stocks. The S&P 500 rose 18% in 2020 and 23% in 2022, more than double the average of the past 100 years. With money so cheap, and returns on safer investments so low, many investors could not resist the temptation of rapidly growing but profitless technology enterprises that held out the speculative potential of significant cash flows years down the road. But to quote the famous University of Virginia economist, the late Herb Stein (Ben's father), "If something cannot go on forever, it will stop".

And stop it did. A decade-plus of money-printing, the spike in commodity prices stemming from Russia's invasion of Ukraine, persistent supply chain bottlenecks and rising labor costs has kindled the worst inflation in four decades, which reached an annual rate of 9.06% in June. The Fed, whose mission includes ensuring price stability, quickly reversed the easy money policy it had pursued since 2008. The goal of this reversal is the taming of inflation by withdrawing a portion of the money the Fed has printed or imagined into existence, which theory says should cool the economy and take some pressure off prices. It raised the key federal funds rate from near zero to a target as high as 2.5%. The 10-year treasury rate rose from 1.5% to 3.4%. Higher inflation and higher borrowing costs cut into corporate earnings just as rising bond yields became more enticing, delivering a brutal and rapid shock to the stock market as valuations adjusted to a higher risk-free rate that was closer to the long-term average, but still historically low. The S&P 500 shed almost 20% in the first six months of 2022. The harshest punishment was received by those whose reach for return was driven by the perceived lack of alternatives and the sheer need to do *something.*

We do not invest on a relative basis. Avenir holds itself to an *absolute* standard, which is a rate of return consistent with, or which improves on our past Equity Composite performance, which exceeds 12.7% compounded since 1989. This standard is intentionally synchronous with one of our core investment beliefs, which is that the managers of our investees should be able to reinvest in their businesses at their own historical high rates of return. This high *absolute* reinvestment rate criterion is the key to the success of our long-term super-compounders.

Admittedly, this is harder to do in a low interest rate environment when essentially free money has driven up the cost of both assets and talent, but it is critical that these managers have a consciousness of how their growth initiatives impact both capital and per-share returns. It is an exceedingly poor choice to accept low rates of return simply because alternatives are worse. Sitting on one's hands and waiting for Mr. Market to provide juicy opportunities, as he inevitably will, is a far better approach.

It is a high standard, and a difficult one to achieve, which means both we and our investees are certain to fall short from time-to-time, but it is one you should expect of us.

We hope the summer is treating you and your family well, and that you have had time to relax and avoid the headlines for at least a couple of weeks. We are here at our posts and would love to hear from you.

Best regards,

Peter C. Keefe James H. Rooney

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