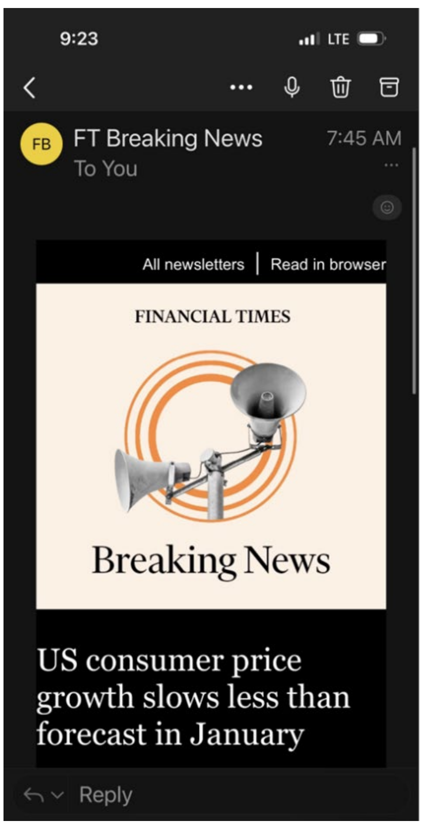
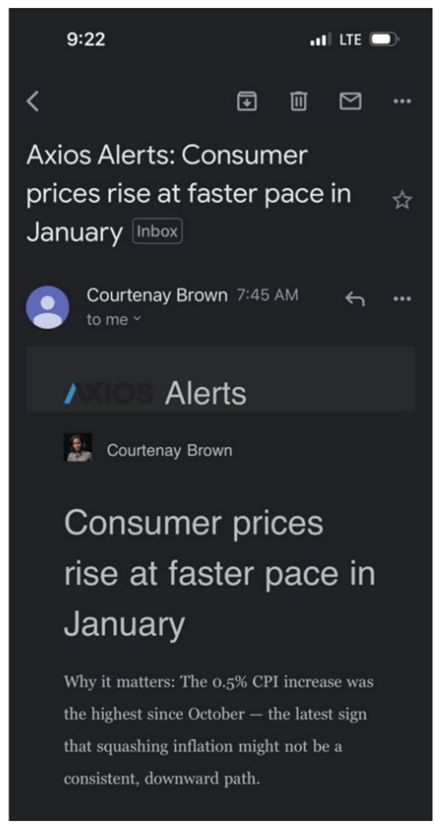
Binary and Non-Binary Outcomes

The thing we like to avoid most in investing is binary outcomes, or situations where there are only two possible outcomes. In these situations, investing boils down to more of a coin flip than a careful measurement of risk and potential reward. Investing in a binary stock or broader market is more a game of luck than skill. Where your outcomes signify fortune (or a lack thereof) more so than foresight. Unfortunately, a binary market is essentially the environment we find ourselves in today.

On the one hand, if inflation continues to moderate and economic data holds up along with company earnings, then stocks should perform well. If, on the other hand, inflation data proves stickier or more volatile, the Federal Reserve hikes interest rates higher and for longer than expected and company earnings begin to deteriorate, then stocks will probably remain range-bound until the outlook improves.

The key outcome determinants have proven almost impossible to handicap for even the most esteemed economists and investors the past several years. Nor do market reporters agree on how to frame data. For instance, see the below headlines this morning from both the Financial Times and Axios regarding today's higher than consensus inflation report for January.[1] Is inflation "slowing" at a more moderate pace, or did prices "rise at a faster pace"?





Again, binary outcomes make for a challenging investment environment. We are more comfortable seeking opportunities where even if things don't work out as hoped, valuations provide support to the price (known as a "margin of safety"). There are certainly individual stocks where that's the case (where low valuations have largely discounted a high degree of negative news that is unlikely to materialize in full). But, for most part, the narrative the first month of the year was that moderating inflation would lead to moderating monetary policy, that the economy was doing fine, and stocks would mount a comeback – a "soft-landing" for the economy and markets.

Over the last week, though, it seems as if this narrative is being reconsidered in light of new economic data. For the most part, bonds and stocks have digested the news without too much damage, but changing expectations could prove to be a short-term to intermediate-term headwind.

Fortunately, there's a good alternative to stocks if one wants to deploy capital: U.S. Treasuries. Right now, there is something akin to a margin of safety in government bonds and bills. Where high rates of interest – particularly for securities maturing in the next two years – compensate for continued upside inflation risk.

Receiving a nearly 5% coupon (tax-preferred) for a year to "wait and see" how major market themes evolve might have an opportunity cost relative to stocks, but at least the outcome isn't binary. Short of a catastrophic default (which despite the Debt Ceiling gamesmanship, we don't expect), holders of U.S. Treasuries will get paid back.

Treasury Yields

NAME	COUPON	PRICE	YIELD	1 MONTH	1 YEAR	TIME (EST)
GB3:GOV **3 Month**	0.00	4.63	4.75%	+17	+439	11:00 AM
GB6:GOV **6 Month**	0.00	4.75	5.01%	+24	+428	11:00 AM
GB12:GOV **12 Month**	0.00	4.71	4.94%	+27	+387	11:00 AM
GT2:GOV **2 Year**	4.13	99.10	4.61%	+38	+304	11:01 AM
GT5:GOV **5 Year**	3.50	97.78	4.00%	+38	+208	11:00 AM
GT10:GOV **10 Year**	3.50	97.86	3.76%	+25	+177	11:00 AM
GT30:GOV **30 Year**	3.63	96.89	3.80%	+19	+152	11:00 AM

Advocating for an allocation to fixed income – specifically U.S. Treasuries – with excess cash is not a call to sell out of core equity positions. We continue to believe portfolios should remain invested for the long-term and do recommend taking advantage of any market and valuation dislocations in single stocks or industries where prices have departed from fundamentals (we are happy to discuss such opportunities). Rather, we just want to point out that perhaps the greatest risk/reward opportunity right now is not in stocks for a change.

Over a year's time horizon and in consideration of all the potential for continued volatility due to the path of economic data, monetary policy and geopolitical developments, we think it's hard to beat a 5% reward with close to 0% risk. This is more of a non-binary outcome. The type of which the reward is asymmetric with the risk.

February 14, 2023

As always, please reach out if you would like to discuss your portfolio and any of the ideas in this month's letter. We hope you and your families are all well.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[1] Financial Times and Axios (Feb. 14, 2023). All data herein sourced from Bloomberg unless otherwise cited.