Drought

In just a slight departure from our normal discourse, we start this week's correspondence with a quote from the U.S. Forest Service: "Drought affects forest and rangeland systems both directly and indirectly. In regions where seasonal droughts are common, forest and rangeland ecosystems respond through various physiological and morphological adaptations. In regions where drought is less common, responses can be substantial because ecosystems are not well adapted to drought conditions."[1]

Dead ponderosa pine trees are scattered across Bear Valley Springs, CA in July 2017 (Google Images)

Similarly, financial markets adapt to the prevailing economic and policy environments. In the decade-plus following the 2008 Global Financial Crisis, ample liquidity and stimulative policy contributed to a benign regime for risk assets. Access to cheap capital coupled with a constructive economic backdrop and low rates meant rising valuations, solid returns and the formation of many business models predicated on distant cash flows. However, the lack of any meaningful economic or financial headwinds (aside from the period immediately following the onset of the Covid pandemic), has left markets and the broader economy more susceptible to the consequences of a liquidity drought. To complete the analogy, the forest that is financial markets is not hardened against the changing economic environment.

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The below chart of the yield on 10-Year Treasuries and the Federal Reserve's policy rate illustrates the abrupt shift in financial market conditions. For myriad reasons (inflation, fiscal policy, Fed policy, geopolitics), we have exited an extended period that was beneficial for risk assets and have likely entered a new one that may pose challenges to firms and investors dependent upon low interest rates. Companies and financial market participants will need to adapt with the changing ecosystem to thrive.

10-Year US Treasury Yield (White) and Federal Funds Target Rate (Blue)

Our advice for portfolios remains consistent with our usual mantra: own high-quality companies whose products/services and management provide some discernable competitive edge, and to make new purchases at reasonable valuations. Most importantly, we think the focus right now – in an environment where access to capital is more constrained – has to be on asset resilience.

What is resilience? Simply put, a resilient business is one that provides critical products or services, for which demand is close to inelastic, whose balance sheet management and cash flow generation provides both flexibility and a buffer to any cyclicality, and one that has operating leverage built into the business – meaning that costs of operations do not scale 1:1 with sales.

The types of firms that may weather the effects of a liquidity drought better than average include conventional energy, health care, consumer staples and some of the leading technology firms.

Conventional energy (oil, gas and midstream) makes sense in particular right now, as global demand continues to exceed analyst estimates, investment in new production is insufficient to meet future demand and

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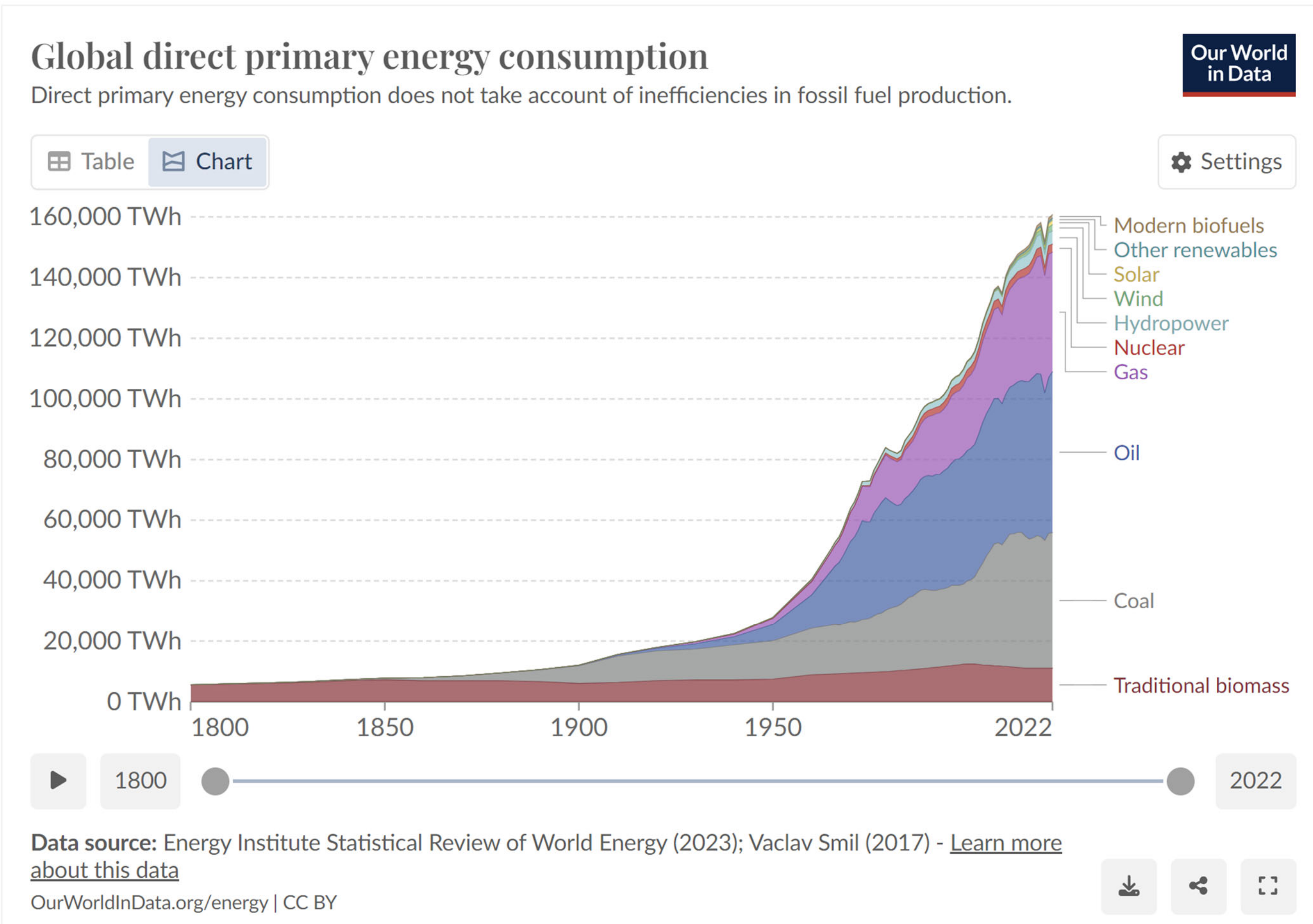
heightened potential for geopolitical disruptions to supply. Further, renewables (an industry we still like) have not scaled fast enough to make a meaningful dent in global energy consumption. The reality is people need energy – especially those in developing market economies where access to energy is low – and that energy has to come from somewhere. If not renewables or nuclear, it will be conventional carbon-based energy (see below charts).[2]

We appreciate many have an environmental bias against owning carbon-emitting firms. Remember though, that all economic activity is derived from the conversion of energy into something productive. The reality is that activities we engage in over the course of our day have a far greater impact on carbon output than owning a conventional energy firm in your portfolio. While we think energy is a great way to diversify portfolios – especially for those with significant technology and growth exposure – we understand that one's investments must align with one's values, and we respect that.



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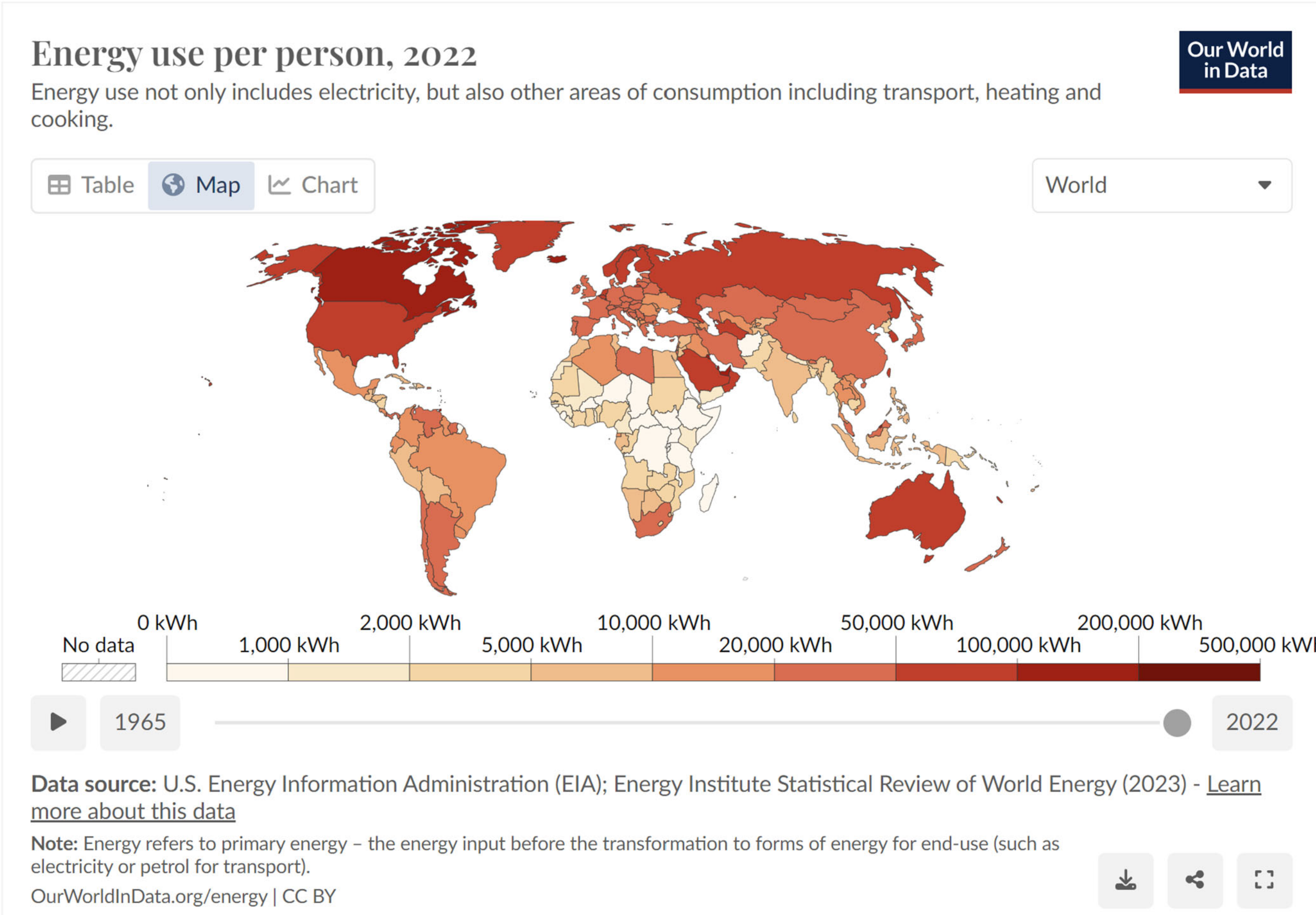

The below chart of year-to-date returns segmented by market capitalization shows that small companies are struggling in the current environment.[3] To go back to our forest analogy: in periods of drought, a seedling or sapling is more likely to perish, but if it survives, it will have less competition in its immediate area of forest (or for markets, its business niche). Right now, investors are ascribing a higher likelihood to risk of non-survival for small companies. Selling has been indiscriminate in many cases, which typically leads to valuations misaligned from fundamentals – so there may be opportunities for those willing to assume a higher degree of risk and volatility, But we recognize that owning small cap firms at the moment could remain challenging.

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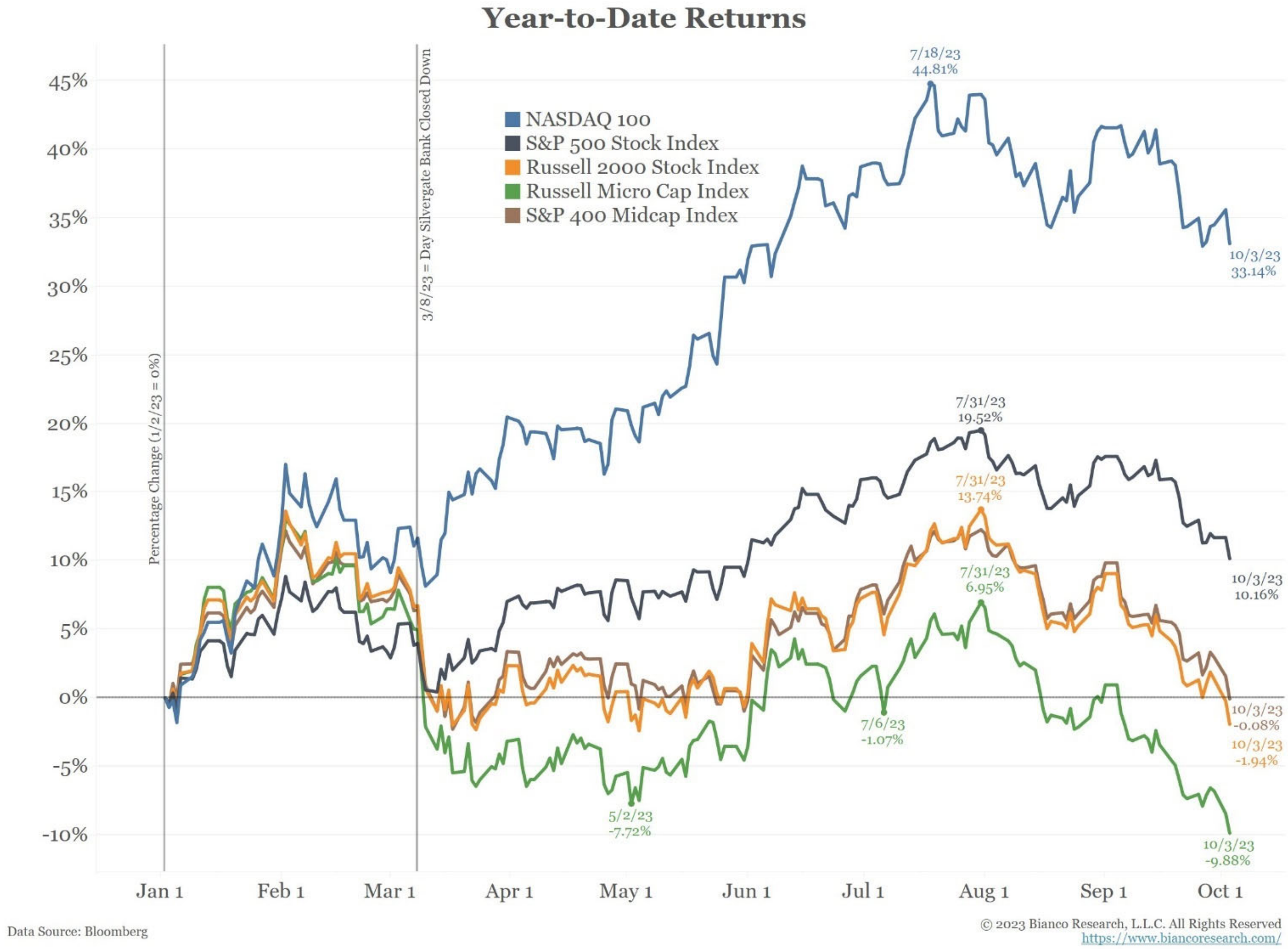

One last point about droughts and forests. The longer there are periods of overgrowth, the riskier droughts become for forests – specifically for forest fires. U.S. markets haven't had any burn that contributes to the process of "creative destruction" in some time (though we would argue small caps are in an inferno right now). While no one wants the destruction that comes with forest fires, in many cases they are ultimately nature's way of regeneration - contributing to a healthier ecosystem in the long-term, allowing for the heartiest of trees to thrive and new ones to grow. Similar to how we started this letter, we will end with a quote from the California Department of Fish and Wildlife:[4]

> Fire can act as a catalyst for promoting biological diversity and healthy ecosystems, reducing buildup of organic debris, releasing nutrients into the soil, and triggering changes in vegetation community composition... Both high and low-severity fire areas provide important benefits for different wildlife and plant species.

In the process of shifting into a potentially more challenging economic and market regime, perhaps we are sowing the seeds for an ultimately healthier investment ecosystem.

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Forest Regrowth after Fire Near Dunraven Pass in Yellowstone (Mike Centioli)

We hope you and your families are well. As always, please reach out with any questions. We are here to ensure that your portfolios are positioned to withstand any changes in the broader economic and markets regime.

Sincerely,

Peter Karmin	Stuart Loren	Alissa Hirsh
Managing Member	Director	Director

Citations and Disclosures

[1] U.S. Forest Service, *Effects of Drought on Forests and Rangelands* (https://www.fs.usda.gov/ccrc/topics/effects-drought-forests-and-rangelands).
[2] Our World in Data.
[3] Bianco Research (10.4.23).
[4] California Department of Fish and Wildlife, *Wildfire Impacts* (https://wildlife.ca.gov/Science-Institute/Wildfire-Impacts).

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