Pavlic Investment Advisors

Client Review & Outlook

4th Quarter, 2021

Dear Client,

2021 was a terrific year for both our clients and for Pavlic Investment Advisors. We look forward to continued accomplishments together in 2022. The monumental task of changing custodians to Charles Schwab is largely complete and will lower total fees by about 20%. Also, Schwab's technological capabilities are far superior to what was previously available. This will be a win-win for both our clients and PIA. We now have access to even better technology which will enhance our ability to focus on investment performance and at the same time provide our clients with a better service experience. Thank you again for your help through this transition.

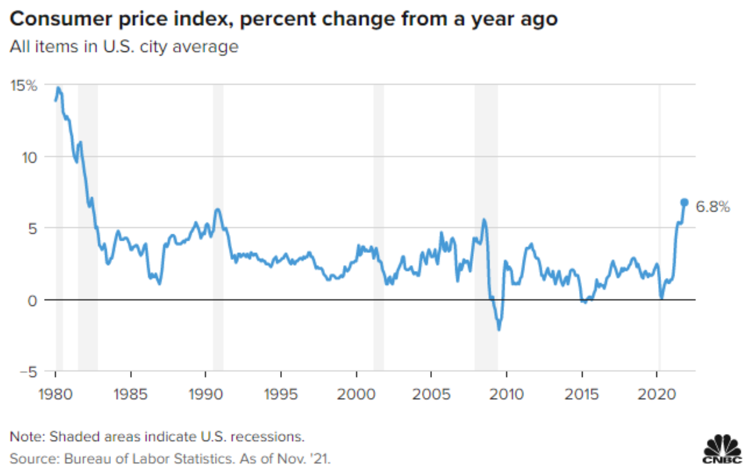
While the custodian transition was a time-consuming exercise, we did not lose sight of investment performance. **Our core equity portfolio returned +10.1% in 4Q21 and +25.0% for the year**, significantly outperforming the NASDAQ (+20.8%), Dow Jones (+20.2%) and the Russel 2000 (15.0%) for the year and in line with the S&P500 (+26.9%). Our portfolios, on average, hold cash positions in the mid-single digits to take advantage of opportunities when the market dips, however stock markets go up over the long term which keeps us close to fully invested. Risk is always present, and always will be. However, if you have an investment time horizon of 5 years or more, you will come out on top by being near fully invested which was proven yet again in 2021.

PIA & Stock Index Performance		
	4Q 2021	**Full year 2021**
PIA Core Equity	**+10.1%**	**+25.0%**
S&P 500 Index	+9.3%	+26.9%
NASDAQ Index	+9.1%	+20.8%
Dow Jones Index	+6.4%	+20.2%
Russell 2000 Index	+2.1%	+15.0%
S&P 500 Value	+7.3%	+25.5%
S&P 500 Growth	+10.6%	+25.1%

Despite many reasons to be cautious throughout 2021, the market gave us very few pullbacks with the largest peak to trough intraday move for the year of just 5%. For clients with excess cash or new cash to invest, we used these 5% pullbacks as buying opportunities and this proved to be a very prudent investment strategy. Holding ourselves accountable to what we wrote in our fourth quarter, 2020 Review and Outlook, we were correct to remain bullish on stocks for this year. But, we did expect more volatility than what actually transpired throughout the year. With the largest peak to trough move in the broader equity market of about 5% (once in September and once in late November) volatility was subdued in 2021. Normally, the markets to correct 5-10% every year. Looking to 2022, we again think markets will finish the year higher than they are today. However, with the Federal Reserve tightening monetary supply, continued uncertainty around new variants of COVID, and as supply chain issues work themselves out around the world, we believe there will be more volatility and thus more buying opportunities in 2022.

Stock Market Review

Inflation. There is no doubt the most talked about topic in 2021 was Inflation. For most of the year, Federal Reserve Chair Jerome Powell used the word "transitory" to define inflation, however in November he admitted defeat in saying that "transitory" isn't the best word to describe the inflationary pressures that we are seeing right now. We think most Americans would agree. In November, the Consumer Price Index (CPI) rose +6.8% vs. November, 2020-the highest reading in over 30 years. We believe that inflation will remain high in 2022 compared to the prior decade, but that it will not skyrocket toward double-digits. Instead, we believe +3.0-4.0% is a reasonable estimate for year-end 2022. Although this is a cooling from 2021, it is important to note this is still above the historical 10-year average, which is closer to 2.0%. The reason we believe inflation will cool is because there is a component that is transitory related to energy and supply chain distributions from policies related to COVID that we see subsiding.



Our view is that stocks (and real estate) are the best ways to hedge against inflation, provided the companies we invest in can push price increases on to their customers AND are not being squeezed from a labor cost perspective. Although wages are going up for all workers, they are going up the most on a percentage basis for the lowest wage class so companies with a large low-skill labor force are those we want to avoid.

M&A Hits Pavlic Core Equity Portfolio—TWICE in 4Q21. For companies that we own in our core equity portfolio, you've probably heard us say several times that we look for "Quality". "Quality" is a word that is used by many investors, yet it can mean several different things to different people. We define "Quality" in three ways: companies with sustainable competitive advantages with a strong runway for growth, companies with experienced management teams, and finally, companies with a healthy balance sheet. These characteristics are good for not only long-term investments, but also there is occasionally an additional bonus—private equity or another large company makes an offer to purchase all of the outstanding shares of said quality company that we own, often at a sizeable premium to recent trading levels.

This occurred twice in our portfolio in the fourth quarter: KKR purchased CyrusOne and Oracle made an offer to purchase all of the outstanding shares of Cerner. CyrusOne (CONE) is our sole real estate holding in our core equity portfolios. The average client has made over +25% on this position within less than 6 months. We are grateful for the execution of one of the pillars of our investment theses, but also cognizant that this doesn't happen often. Oracle also announced a deal to buy Cerner for an all cash offer in the fourth quarter, for which it called Cerner the "anchor asset" of its future healthcare ambitions. We are glad we invested in Cerner long before Oracle made this deal, as our average client is up +52% since we purchased the stock in 2017. Our investment thesis was predicated on the datapoint that for every one-hour physicians spend treating patients, they spend one-two hours on patient record keeping activities. U.S. healthcare spending accounts for nearly 20% of the country's gross domestic product, however it has often been slow to adopt to the latest digital tools. There is a massive opportunity for health technology in digitizing health records and Oracle capitalized on this opportunity.

For both CyrusOne, and Cerner, the deals are set to close in 2022. While the 20%+ premiums paid for these companies are big wins for our clients, they will force capital gains realization (and therefore taxes) in 2022. We are holding shares in both companies past the end of 2021 to defer these capital gains tax payments until April 2023.

Bifurcation between "Big tech" vs. "High-flying tech". Higher quality names have held up much better than lower quality (and, more expensive) tech stocks in 2021. One of the most blaring examples is Peloton-it declined over 78% in the past year. Several of these high-flying tech stocks that trade at high valuations and have negative cash flows, we watch and (sometimes) admire, but will never purchase in a client portfolio. A company can make a terrific product, but before we become investors, we want to see cash flow generation, because as shareholders, we are owed our respective share of the future profits of the business. Facebook (now Meta Platforms), Apple, Alphabet (Google) and Microsoft all fall within the "quality mega tech companies" that trade at much more reasonable valuations while also growing faster than the average company. With the recent volatility that we saw at the end of the year, our portfolio of quality technology stocks, including Apple, Microsoft, Facebook and Google, performed very well compared to higher valuation growth technology stocks and the broader market in general.

Earnings growth much better than expected in 2021. In 2021, there was every reason to be bearish and get more defensive: inflation at 30-year highs, supply chain disruptions, and continued COVID variants. However, one of the oldest adages in investing is to watch earnings. And even more importantly, to watch actual earnings vs. analyst's forecasted earnings. In all four quarters of 2021, companies substantially beat earnings estimates in totality. In fact, earnings in 2021 were **up 45.1%** vs. 2020, according to FactSet (for comparison, the average since 1926 is 7-10%). The price/earnings multiple actually came *down* over the year because the growth in the S&P 500 index price was less than the growth in earnings. Looking forward, while we still remain in the higher end of the historical valuation averages (a reason to be cautious), we also see 8-10% earnings growth (which should propel stocks higher in 2022).

Sometimes the Sells are more important than the Buys. Although several of our buy and hold positions performed well over the year, our performance was also boosted from the timing of our sells, when the investment thesis had changed. Two of our most impactful sales during the year were Southwest Airlines (LUV) and AT&T (T). We sold LUV at $55/share vs. current trading price at $44/share. The new variants pressured travel and entertainment stocks in 4Q21 and we wanted to avoid the coming flu and COVID season. Further, higher oil prices quickly crimp already small margins for airlines. Although Southwest Airlines is the strongest of the airlines in our opinion, a good company doesn't always mean a good stock. AT&T also announced a deal with Warner Media. In a joint press conference with the two CEOs, John Stankey CEO of AT&T said they were going to "right size" the dividend. As we wrote in a previous *Review & Outlook*, we have been in this business long enough to know "right size" means "cut" and, as such, investors would flee to the exits knowing many owned this stock primarily for 7% dividend. We sold at an average price of $31.50/share vs. the end of the year price of $24.70/share.

Best/Worst set ups for 2022. As in any year, not all stocks in the portfolio were outperformers. We believe you're not properly diversified unless there is something that is out of favor in your portfolio at any given time. Two of those names for the year included Visa (V) and Disney (DIS). Both lagged the broader market indices. When this happens, we reevaluate our investment theses to see if something material has changed and if we should add to the position, stay put, or exit. In both cases, we still believe in the long term growth trajectories and each company's competitive advantages. For Visa, we don't believe credit card spending will be replaced with bitcoin or cash. For Disney, we note that the Disney+ subscriber growth will be lumpy, and 2022 could be stronger after the slower pace of 2021. Disney+ has 118 million subscribers just two years after launch at $7/mo. We do not believe subscribers will cut their subscription if they raised prices by $1/mo or $2/mo and therefore we see both price ($/mo) growth and volume (subscribers adds) growth to be in Disney's favor in 2022. We also believe, as COVID works its way through the globe, entertainment parks will be a boost to cash flows as pent-up vacation demand is unleashed.

Bond Market Review

The U.S. 10-year treasury rate (which we view this as the "risk-free" rate of return) started the quarter at 1.48% and ended the quarter at 1.51%. In the first few trading days of 2022, it moved higher to 1.68%. This put pressure on tech stocks and bond prices. Although we do not base our investment strategy on forecasts of interest rates, we do believe that interest rates will march higher and end 2022 near 2.0-2.25%. This is a good thing for our bond strategy in two ways—first, we can redeploy the proceeds from the bonds that come due in 2022 in higher interest earning positions out 10-years on the next rung of our maturity ladder. Second, we hold several variable rate spread bonds and, as the outer years of the yield curve rise, these bonds pay higher rates of interest. Our bond strategy maximizes coupon interest while holding bonds until they mature and we then collect par value.

We have had questions from clients on why some bonds are trading at levels distant from par value—sometimes at a discount to par and sometimes at a premium. We, ourselves, have challenged Schwab on bond pricing, and because of the nature of the illiquidity of direct bonds and the variability in the interest rate variable bonds pay, Schwab (and other large custodians) have struggled to price these bonds in a way that reflects reality. We ask investors to focus on our plan to hold each bond to maturity or call date, upon which we will receive $100/bond held. If a bond is trading at $90 and originally was set to earn 4%, you can expect to now to earn 5% as the price moves back to $100 at maturity. If we can make at least 3-4% in yield by holding a bond until maturity, we consider this a strong alternative to holding excess cash in a money market or savings account earning approximately nothing.

2021 Review and 2022 Outlook

The S&P 500 notched 70 record closes in 2021, the second-highest annual tally behind 1995's 77 closing highs. As we mentioned earlier, we believe that the largest driver of stock prices over the long run is corporate earnings. Earnings in 2021 were tremendous, up +45% vs. suppressed 2020 levels due to COVID. The economy has come roaring back from its deep COVID freeze in large part due to the incredible amount of fiscal and monetary stimulus that has been injected into the economy. Looking forward, we see earnings continuing to grow in the high single-digits for 2022. This should support a floor for equity prices. However, the Federal Reserve will be tightening, not easing, and the excuse of COVID variants to keep injecting the economy with money has already become stale. We believe this will, in turn, create volatility in the stock market in 2022. And, although we don't see a looming recession on the horizon, we do see the potential for 10%-15% pull backs in 2022. These will be buying opportunities for us, as investors with long time horizons.

As for bonds, we continue to look for inflation indexed and variable spread rate bonds to maximize yield and minimize the risk of any default in our bond portfolios. We have never had a bond default, and by buying only investment grade bonds with shorter duration, we wouldn't expect to. Our goal remains focused on maximizing return while keeping our eye on bonds maturing at $100/bond. This strategy can offer yields in excess of 4%, and we believe we will see even higher yielding opportunities if rates continue to rise in 2022.

As always, if you would like to discuss your investments, please don't hesitate to call or email us so we can arrange either a phone, video, or in-person meeting.

**** "Plan Ahead. It wasn't raining when Noah built the Ark" – Howard Ruff ****