Pavlic Investment Advisors

Client Review & Outlook

2nd Quarter, 2022

Dear Client,

The last quarter was a particularly bearish one for both stocks and bonds as rising interest rates, unabated inflation, and lingering supply chain issues caused havoc on global markets. As noted in our 1Q Review & Outlook, we have been very focused on inflation, the Fed's interest rate path trajectory, and the impact that substantially higher mortgage rates will continue to have on housing affordability. We began making adjustments towards more defensive stocks in our client's stock portfolios. Additionally, we maintained higher cash positions. These adjustments helped us protect clients' portfolios compared to the broader market.

Year to date, our stock portfolios are down about 18.6%, while the S&P 500 (our benchmark for the broader U.S. stock market) is down 20.6%, the small company index (Russell 2000) is down 23.9%, and the technology heavy index (NASDAQ) is down 29.5%. Our strategy of owning high quality, durable businesses that generate substantial free cash flow was the main driver of our relative performance. Although, on an absolute basis, lower stock prices are tough to stomach, our priority is to protect client assets in these types of down markets, while also keep pace during up markets by owning the best companies with the most durable business models. Given the roughly 20% stock correction we've seen so far this year, we believe now is a good buying opportunity and are encouraging clients that own balanced portfolios to buy stocks when bonds mature. And for clients that own all stock portfolios, to keep his or her eye on the long term. So, what defines, "long term?" Let's look at the data:

PIA & Stock Index Performance

	Full year 2021	YTD 2022
PIA US Equity Strategy	**+25.0%**	**-18.6%**
Dow Jones Index	+20.2%	-14.4%
S&P 500 Index	+26.9%	-20.6%
Russell 2000 Index	+15.0%	-23.9%
NASDAQ Index	+20.8%	-29.5%
S&P 500 Value	+25.5%	-11.1%
S&P 500 Growth	+25.1%	-27.3%
PIA US REIT Strategy	**n/a**	**-19.2%**
US REIT Index	n/a	-20.1%

Note: Past performance is not indicative of future results.

During bear markets, prices fall on average 32% from their most recent highs. This figure includes the Great Depression of the 1930's and the Great Financial Crisis of 2008-2009. If we exclude these two extreme financial events, the average bear market is just over a 20% drop. Today, the stock market indices, as noted above, have fallen 20% to 30% from their respective peaks. Using history as a guide, this implies we are closer to the end, versus the beginning, of the correction in stock prices.

Another question worth asking is, how long does it take to recoup losses from a bear market? In each of the 26 bear markets since 1929, the U.S. stock market has recovered significant gains in the months immediately after the market bottom. On average, it takes just under a year for the market to fully recover losses from the previous bear market. The first half of this year may feel worse since we are coming off a record year in 2021 in which our stock portfolios returned +25%. However, history tells us that these pullbacks are buying opportunities that we should use to purchase high quality companies at lower prices. So we are encouraging our clients to maintain their investment strategies, remember that we diversify for these types of market environments, and we will look to make adjustments to portfolios if great opportunities present themselves. Generally, stocks are now on sale—and when high quality companies go on sale, we will buy them.

Stock Market Review

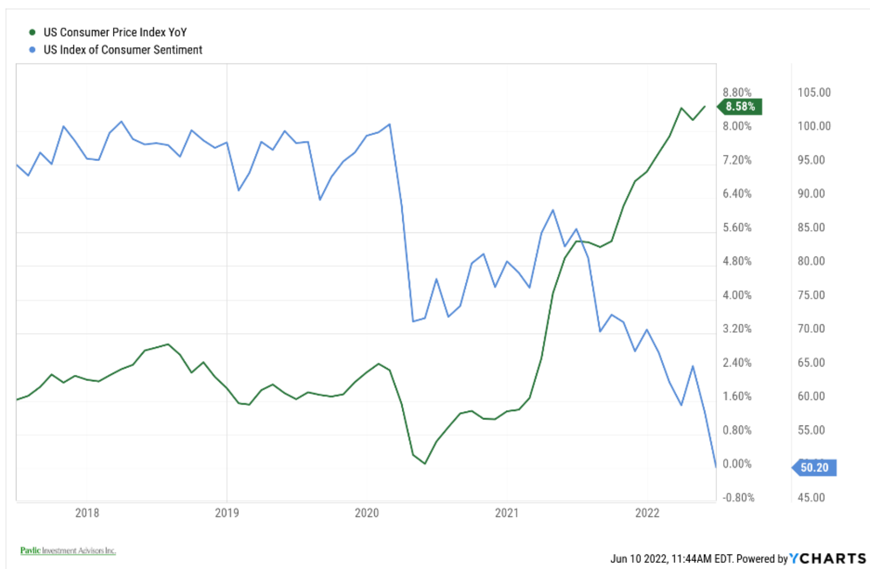
Looking out over the next six months, we are focused on 3 major topics: **Inflation**, **Corporate earnings/market valuations**, and the **Federal Reserve's interest rate path trajectory**.

Inflation. The traditional definition of inflation, that we learned a long time ago in our first macroeconomics class, is "too many dollars chasing too few goods" or stated another way, "too much demand per a given level of supply."

Diving into the demand side of the equation, the federal government fueled demand through several programs: Federal unemployment benefits were provided at the annualized amount of $31,200/year, or $15.00/hour assuming a 40-hour work week. This was in addition to the unemployment benefits paid by each state (states are normally responsible for paying all unemployment benefits, i.e., usually there is no federal unemployment benefit). There was also federal rent assistance and, at the same time, a freeze on evictions. This allowed a certain percentage of renters to collect the assistance and not pay their rent knowing they couldn't be evicted from their rental units. Student loan deferrals were put in place and are still in place today. Recently, there has even been student loan forgiveness. All of these factors left the American consumer doing what they do best as pandemic restrictions eased—spend and consume their recently granted "stimulus."

On the supply side, energy production and transportation received new regulations and had old regulations, which were previously shelved, reimposed. Pipeline leases and energy projects in the Gulf of Mexico and Alaska were cancelled. Monthly oil production in the US is still 39 million barrels (as of March 2022, the most current data available from the U.S. EIA) below the level of December 2019-two and a half years ago, despite materially higher prices. Under normal circumstances, these higher prices would cause oil and gas companies to expand drilling. The cherry on top has been the war in Ukraine which has severely disrupted the approximately 10% of the world oil supply that Russia produces.

As a result, elevated demand combined with limited supply has led to three successive monthly 8%+ inflation reports (green line). And, as a result of rising inflation, consumer sentiment has reached an all-time low (blue line). The Fed is now combatting demand by raising interest rates to bring inflation down. A second tool, to rein in inflation, would be for the Federal government to incentivize energy and food investment to increase supply. Very little has been discussed in this regard, but we are carefully monitoring the supply side of the equation as well as demand.

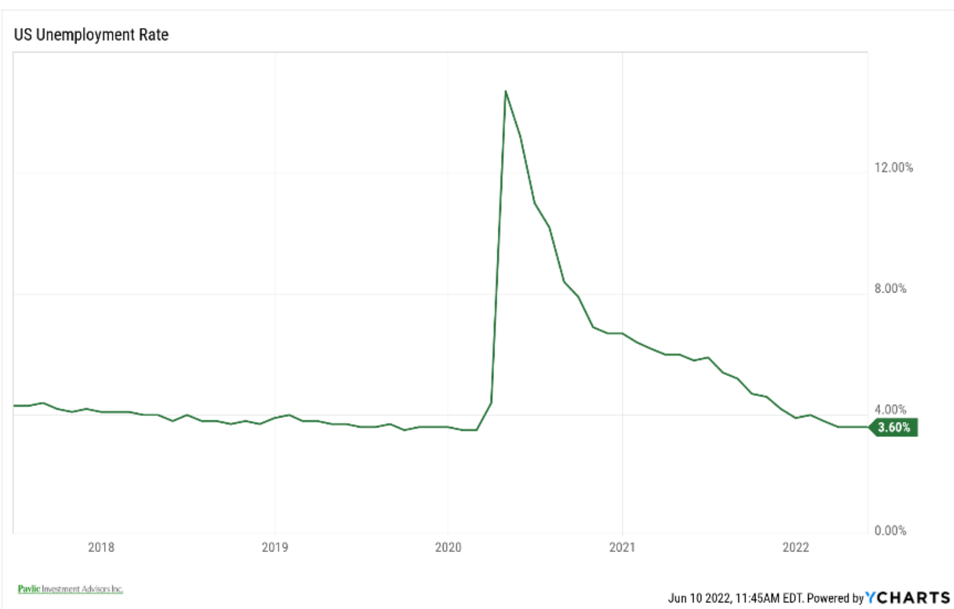


So, where do we go from here? We believe we are already starting to see "demand destruction" from the Federal Reserve's actions and consumers' responses to elevated prices. Due to the lag from when an investment is approved to the start of production (resulting in increased supply), we don't think that we will get much inflation help from the supply side for at least 12 months. However, we expect inflation to peak around about 8.5% in the next few months, and then move toward 6.5% by year-end as commodity prices peak and begin to fall (this process may already have started). Although 6.5% is better than 8.0%, it is still not the 2.0% we have experienced over the past many years. Consumers have noticed and sentiment will remain low at least for the balance of the year.

Corporate Earnings and Market Valuations. When stock prices fall, analysts scramble to determine how low stock prices can go. We believe the most important thing we can do as investors is understand the price we are paying for what we are buying. We only invest in companies with reasonable Price-to-Free Cash Flow (P/FCF) and Price-to-Earnings (P/E) ratios. These metrics help to answer the question, "If I buy a stock at this price, what return should I expect as a shareholder (owner)?" As many of our long-time clients know, we never invest in stocks that either trade at extreme price multiples, or even worse, don't make money at all. Companies like Carvana (CVNA), Peloton (PTON), Roku (ROKU) and DraftKings (DKNG) were darlings of the pandemic, but they all have one major problem—they continue to lose money and do not generate any cash flow. As a result, as interest rates have risen, these stocks have fallen about 90% from their highs. Sometimes what you don't own in your portfolio is more important than what you do own.

When we look at our stock portfolio in aggregate, we strive to find companies that generate earnings and cash flow growth, but sell at a reasonable price. At the end of the quarter, average forward revenue growth for our stocks was in the high single digits with earnings growth in the low-double digits. The average Price/Earnings multiple was about 16.5x. What does this mean? The average earning yield (Earnings/Price) for stocks in your portfolio is about 6.0%. The earning yield can be used to compare the investment attractiveness of different asset classes, e.g., stocks vs. bonds. For comparison, the yield on the 10 year US Treasury bond (3.01%) is currently about half the earnings yield available on our stocks so stocks are more attractive. Our strategy helps to put a floor under just how far our stocks can drop in a recessionary environment. The second quarter provides a good example. Our aggregate basket of stocks was down less than the broader market indices because of this more defensive strategy.

All eyes remain on The Federal Reserve. Although things look very bleak today, the market has a few things going for it. Unemployment remains near an all-time low (3.6%). With the Federal Reserve tightening monetary policy and consumer and business sentiment low, unemployment should tick marginally higher over the coming quarters.



The good news is that, at 3.6%, we are nearly fully employed (green line in nearby chart), and thus there is room for the unemployment rate to tick up toward or a little above 4.0% and still be far from a more traditional recessionary unemployment level (>5%).

The expected rise in the unemployment will likely coincide with a fall in the inflation rate as higher interest rates already have caused demand to fall. Commodity prices have fallen in the last few weeks and that should take pressure off rising inflation. Rising unemployment and falling inflation will give the Federal Reserve two big data points to consider and possibly ease their pace of interest rate increases. **With the stock market always forward looking (6-12 months), we believe that this turn from "hawkishness" to "dovishness" on the part of the Fed, will mark the bottom of stock prices.** Markets bottom when the pace of economic data gets less bad—not when the coast is all clear (by this time, stocks will already be at all-time highs again). We are very focused on being positioned appropriately to capitalize when the tide turns.

Bond Market Review

Yields rise, pressuring prices, and new bond purchases at >5%. Our bond strategy continues to incorporate a 10-year laddered bond portfolio investing in only investment grade corporate bonds. Our strategy has performed better than many bond mutual funds and ETFs that have a much longer average length to maturity. In fact, with our 10-year laddered portfolio, our average maturity is about 5 years. The average bond mutual fund's average maturity is more than 10 years. This longer average maturity leads to substantial principal risk and volatility. These funds have experienced high volatility as yields have risen and bond prices have fallen so far this year. The prices of the bonds we hold, that are maturing in the next three years, have not strayed far from their principal value of $100/bond. This is because the market knows exactly what they will be worth at maturity--$100/bond. The bonds we own that are 7-10 years out from maturity are trading at paper losses. However, we reiterate that if held to maturity, the prices will recover (by definition) and we will get our $100/bond back while having collected interest payments along the way.

The good thing about rising interest rates is that bond buyers can redeploy capital at higher levels of interest. For our clients, with the proceeds from the bonds that mature in 2022 (if we aren't recommending buying stocks at cheaper valuations), we are able to buy high quality bonds, 10-years out from today, at >5.0% yields. For some clients, where a shorter to maturity makes more sense, we have been able to build a 3-year bond ladder with bonds paying about 4.0% on average. These yields are far higher than what we could have gotten just 6 months ago.

2022 Market Outlook and Commentary

Remain focused long term. The first six months of this year rank in the worst 3% of all 6 month returns since 1926. Said another way, 97% of the time, returns have been better than what we just lived through. We know why consumer sentiment is at an all-time low—surging inflation (the highest in four decades), rising interest rates (limiting the consumer's ability to finance the purchase of homes and cars), lingering supply chain issues, and geopolitical conflicts—all of which fills the news we watch, 24/7. A lot of people think that investors become wealthy in bull markets, but the opposite is true—the buyers of stocks in bear markets, and those with the patience to endure the volatility of stock prices, create material wealth over the long term. We have been through many bear markets since our founding in 1997 and we are executing the same playbook today as we always have and there are three reasons why we remain cautiously optimistic:

1. **Company earnings are still GROWING.** The consensus earnings estimate for the S&P 500 is currently $230, a growth rate of about +10% vs. 2021. Even if this is too bullish by half, a +5% growth rate is still very un-recession like. Inflation is bad for consumers, but high quality companies that can push through price hikes is good for company owners (shareholders). We continue to invest in companies that have this pricing power over their customers.
2. **Valuation multiples now at historical averages.** Assuming $230 of S&P 500 earnings on a price of $3,800 results in a 16.5x P/E multiple. On a valuation basis, this is the third cheapest the market has been over the last 8 years, third only to the Fed tightening of 2018 and COVID shock of 2020.
3. **We go against the grain.** "When others are greedy, we should be fearful. When others are fearful, we should be greedy." (This was advice offered by legendary investor Warren Buffet several years ago). There is no question fear is the much more prevalent feeling today and this creates opportunities. The rebounds from stock market sell-offs are often sharp and swift, and we intend to capture the inevitable rebound in stock prices.

"Owning stocks is risky in the short-term. Not owning stocks is risky in the long-term."