Pavlic Investment Advisors

Client Review & Outlook

3rd Quarter, 2022

Dear Client,

Despite a bumpy ride, the third quarter was largely flat for equity markets and our portfolios when compared to the prior quarter. Our core equity strategy continues to perform well relative to the broader indices as high quality companies with sustainable cash flows, strong management teams, and stable balance sheets that are in secular growth sectors continued to outshine the broader market. The clear issue with the economy has been, and continues to be, inflation. The word "transitory" has now been replaced with "persistent" as the last three monthly Consumer Price Index (CPI) readings registered +9.1%, +8.5%, and +8.3%, respectively. While the direction of the year-over-year decline is encouraging, the pace of decline is not what the market had been hoping for—particularly the August reading, a decline of only 0.2%. "Persistent" inflation, along with a stubbornly strong labor market, has given the Federal Reserve continued ammunition to continue to increase interest rates to over 4.0% by year end. This will keep a lid on equity returns in the near term, until the Fed begins to pivot to a less hawkish stance.

25%+ Drops in S&P500 and Subsequent Returns

Peak	Trough	% Decline	+1 Year	+3 Year	+5 Year	+10 Year
12/12/1961	6/26/1962	-28.0%	31.2%	69.2%	94.8%	171.1%
11/29/1968	5/26/1970	-36.1%	32.2%	44.3%	27.9%	97.5%
1/11/1973	10/3/1974	-48.2%	1.4%	23.8%	42.0%	188.4%
11/28/1980	8/12/1982	-27.1%	43.9%	81.2%	238.6%	403.9%
8/25/1987	12/4/1974	-33.5%	14.7%	34.1%	96.8%	387.1%
3/24/2000	10/9/2002	-49.1%	0.2%	1.9%	21.5%	38.3%
10/9/2007	3/9/2009	-56.8%	-6.9%	3.7%	61.2%	209.6%
2/19/2020	3/23/2020	-33.9%	56.4%	**???**	**???**	**???**
1/4/2022	**???**	-25.2%	**???**	**???**	**???**	**???**
Averages:		**-37.5%**	**21.6%**	**36.9%**	**83.3%**	**213.7%**

Source: Ycharts, A Wealth of Common Sense

The top-down macroeconomic picture, admittedly, looks bleak today. However, we are avid believers that it is darkest just before the dawn. Throughout our firm's history, the largest amount of wealth created for our clients has not been made while investing in a bull market, but, rather, while investing in a bear market. We, personally, continue to invest for the long term in our core equity, US REIT, and bond strategies, and we continue to encourage our clients to do the same.

Clients who have been with us for a long time, know that we invest based on bottom-up fundamentals—meaning we comb through company earnings reports and call transcripts looking for companies that we want to own at least over the next 3 to 5 years. We have owned several companies, like Apple and Microsoft, for 10+ years and they remain some of the largest positions in our portfolios today. We continue to see the biggest opportunities in technology, robotics, chip manufacturing, and health care. While inflation has knocked down share prices across the board, inflation will not change the structural tailwinds that benefit these industries. Purchases that we have made this year include medical device company Stryker (SYK), e-commerce asset intelligence provider Zebra Technologies (ZBRA), and equipment and software provider for the semiconductor industry Applied Materials (AMAT). We believe that the cash flow generation at these companies (and the prices we are paying for this positive cash flow generation) will be strong tailwinds to portfolio performance. We remain steadfast on seeing the forest through the trees, and remain optimistic about the future of the companies in which we are invested.

Stock Market Review

This quarter, we focus our stock market review on share buybacks, a strong dollar, and inflation expectations.

Net Buyback yields impact on our expected returns. We have previously discussed, as a key characteristic in our analysis, companies that generate strong positive cash flow. These cash flows have to be deployed in some way. Managements of these companies pay shareholder dividends and corporate taxes. The question for the management team then becomes what to do with the excess cash (a good problem to have). Companies have three options:

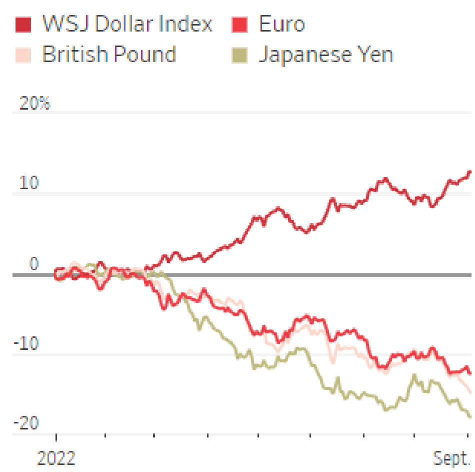
1. Increase the dividend paid to shareholders.
2. Buy back a company's own shares, thereby reducing the number of shares outstanding.
3. Increase investment in Research & Development (R&D) projects; AKA investing back into the business.

A growing trend, that is encouraging to us, is that the companies in which we are invested are increasing option #2--buying back their shares. This is how Apple, one of our largest holdings, continues to generate substantial value for shareholders. Many investors only focus on the dividend yield—the cash dividend divided by the current share price. For Apple, the dividend is $0.92/share, or just 0.6% of its share price. However, the net buyback yield —the amount of cash value returned to shareholders by reducing the amount of shares outstanding, is $5.06/share, or 3.4%. In fact, in the last 4 quarters, Apple has bought back over $80 billion dollars of its own shares and continues to have an active buyback program. The management teams of these companies have faith in the fundamentals of their own companies, and that gives us confidence they will not only make it through this current storm but come out stronger than before. Apple doesn't know where the near-term bottom of its stock price will be (and neither do we), but the company strategically buying back its own stock is a sign they believe in themselves and see their share price at a substantial discount to its fundamental value (coincidentally, this is Warren Buffet's key investment selection metric.)

Looking at our core portfolio more broadly, 90% of the companies we own have a buyback program in place ranging from 0.5% to 7.5%/year. In fact, while the average dividend in our portfolio is 1.3%, net buy backs add an additional 2.9% of expected return of capital to shareholders bringing the total yield return to shareholders to over 4.0%/year. There are two other factors that are key to determining the expected returns of stocks—the level of earnings and the price we are paying for those earnings. The weighted average earnings growth rate of our companies is 14.3% and 12.6% over the next one and two years, respectively. While we are paying a slightly above market multiple to achieve these high growth rates, the higher multiple is negligible compared to the consensus earnings growth rates for the S&P 500 which currently stand at 8.1% for both 2022 and 2023.

A strong US Dollar—A good thing or a bad thing? The US Dollar has been on an absolute tear, up 15% year-to-date relative to other currencies around the world (and up substantially relative to cryptocurrencies). An index, which considers inflation when measuring the dollar's strength relative to currencies of major U.S. trading partners, in July, topped its previous peak (in 2002), showing just how much the dollar's surge has helped mitigate rising domestic inflation (right chart). However, this has the exact opposite effect for foreign countries that must convert their currencies into US dollars before buying our domestic goods.

Performance of select currencies in percentage terms



Sources: Dow Jones Market Data (indexes); Tullett Prebon (currencies)

A strong US dollar makes it cheaper for Americans to import goods while increasing the cost of US goods purchased by international consumers. For us, as Americans, we can buy our goods from overseas even cheaper which should help us to bring down inflation faster than the rest of the world. But, overseas importers of US goods are hit with a double whammy—both higher inflation of the underlying good and less purchasing power of their depreciating currency. We are glad to be investors in the US, and we are glad our clients make their money in the strong greenback.

From the company perspective however, when a multinational company makes money overseas in a foreign currency, it must translate that currency back to US dollars to report quarterly profits. Because the foreign dollars are worth less relative to the US dollar, overseas earnings are less valuable when translated back into US dollars. We are actively monitoring this situation, and we are pleased to see several of the large (and thus multi-national) companies, that we own, increase prices overseas to make up for the foreign currency headwinds they are experiencing. However, we are expecting foreign currency impacts to be a 3-4% headwind to top line revenues overall.

Inflation remains elevated, but cooling (slowly). In last quarter's newsletter, we devoted an entire page to the topic of inflation. Fast forward three additional monthly CPI inflation reports (+9.1%, +8.5%, +8.3%), and we see the inflation trend coming down, albeit, at a slower pace than investors would like to see. This in turn has given the Federal Reserve the proof it needs to continue to boost the Federal Funds Rate. As a result, we are starting to see "demand destruction" as the consumer reacts to the Federal Reserve's actions and elevated prices. Our last quarters' prediction that inflation will decline toward 6.5% by year-end may still look too low, but we are encouraged by the falling commodity prices we have seen in the last month. For example, lumber prices have now fallen to pre-pandemic levels and gasoline that has dropped 25% at the national level since its summer peak price. In September alone, the Bloomberg Commodity Index fell by 10%, a sign the Federal Reserve's actions are taking a material toll on demand. We expect that the Federal Reserve will "get the picture" in the next 3 to 6 months, and as such, will give some hints that it will move to a "wait and see" posture.

Let's revisit the most important question—what does the inflation trend mean for the stocks we own? The market often cares most about the second derivative of change—in other words, the pace of the rate of change. The inflation reports over the past three months were +9.1%, +8.5%, +8.3%. The rate of change of these figures, particularly for the August CPI reading, was much too slow and the market sold off as a result. However, the direction is right, and if we are correct that the Federal Reserve has and will continue to slow the demand side of the equation by raising interest rates, the pace of inflation slowing should increase in the coming months. Historically, this is great for stocks. In periods of falling inflation, stocks have returned well above the historical norm (see table below). In periods of rising inflation, like we have now, stocks have returned only 5.5%/year--which coincides with the lower returns we have seen since inflation really started to take off in the first quarter of 2021.

U.S. Stock Market Average Returns: 1928-2021

Rising Inflation	Falling Inflation	Rising Rates	Falling Rates
5.5%	14.7%	9.7%	9.6%

Data: NYU (S&P 500, returns annualized)
Rates: 10 year treasuries

Over the long term (going back to 1928), stocks rise about 9.6% per year and rising or falling rates don't have an impact to total returns. This means on average, with the benefits of compound interest, a well-diversified stock portfolio has been able to double your money every 7.5 years. If only it were that easy—10%/year sounds nice, but the reality is +30%, -20%, +15%, 0%, -10%, +25%... Although it seems like the distant past, remember stocks were up +27% last year, up more than the amount we are down this year. In fact, if you consider all that we have been through over the past five years, a global pandemic that lasted two years and the inflation we are experiencing now, it is worth noting that the S&P 500 has appreciated over 7.5% on an annualized basis over that period.

Bond Market Review

Yields rise, pressuring prices, and new bond purchases at >5%. Our bond strategy continues to incorporate a 10-year ladder investing only in high quality investment grade corporate bonds. Our strategy has performed better than many bond mutual funds and ETFs that are down 15%-20% so far this year. In fact, with our 10-year laddered portfolio, our average maturity is about 5 years compared to the average bond mutual fund's average maturity of more than 10 years. Our shorter average maturity results in substantially less principal risk and pricing volatility. Because we only buy direct corporate bonds, 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 other bond investors know exactly what they will be worth at maturity--$100/bond. The bonds that we own that are 7-10 years out from maturity are trading at paper losses. However, it I worth noting that if we hold these bonds to maturity, the prices will recover, 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 now redeploy proceeds from maturities into new bonds with higher yields. For our clients that have had maturing bonds in 2022, we are either recommending buying stocks at cheaper valuations, or we can buy bonds with maturities 10-years out at >6.0% yields. For some clients where a shorter maturity makes more sense, we have been able to build a 3 or 5-year bond ladder with bonds paying over 5.0%/year on average. These yields are far higher than what we could have earned just 6 months ago and present a compelling alternative to stocks if market volatility persists.

2022 Market Outlook and Commentary

The Fed Pivot will mark the bottom—and it will come sooner than most think. As financial advisors, everything we do comes down to the evaluation of return and the degree of risk we are willing to take for that expected level of return. At present, we see one of the best risk/reward profiles that we have seen since the lows of the COVID crash in early 2020. The difference between now and the COVID crash (and the Great Financial Crisis for that matter) is that company earnings are still expected to be positive, in the high single-digits this year. We believe earnings estimates will come down largely due to a 3-4% headwind from a strong US dollar on translation adjustments. The macro-picture from the top down undoubtedly remains challenged, however we believe our high-quality companies, that are able to weather macro headwinds, will come out that much stronger.

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 generational wealth over the long term. We've endured 12 bear markets since WWII—the median drawdown is -30.8% and the average time is 302 days. We were already -25% (by S&P 500 Index) earlier this quarter and the last peak was 270 days ago—historically, we are already 75% of the median drawdown from peak to trough as well as 75% of the way there in average number of days. We believe that if a client can see just two years out, they will be greatly rewarded for staying the course. Although we believe we will likely have to endure more market volatility until the Federal Reserve stops tightening interest rates (likely by the end of this year), we believe this will be an incredible buying opportunity to look back on years down the road.

Peak to Trough S&P 500 since WWII

Peak	Trough	% Decline	# of Days
5/29/1946	10/9/1946	-26.6%	133
6/15/1948	6/13/1949	-20.6%	363
7/15/1957	10/22/1957	-20.7%	99
12/12/1961	6/26/1962	-28.0%	196
2/9/1966	10/7/1966	-22.2%	240
11/29/1968	5/26/1970	-36.1%	543
1/11/1973	10/3/1974	-48.2%	630
11/28/1980	8/12/1982	-27.1%	622
8/25/1987	12/4/1974	-33.5%	101
3/24/2000	10/9/2002	-49.1%	929
10/9/2007	3/9/2009	-56.8%	517
2/19/2020	3/23/2020	-33.9%	33
1/4/2022	**???**	**???**	**???**
Medians:		**-30.8%**	**302**

Please don't hesitate to reach out via call, email, or an in-person meeting. Bear markets are painful in the near term, but we believe we add the most value during these times helping our clients navigate through them.

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections, than has been lost in corrections themselves." - Peter Lynch