Pavlic Investment Advisors

Client Review & Outlook

4th Quarter, 2022

Dear Client,

Three years ago (in the fourth quarter of 2019), a cluster of patients in the city of Wuhan began to experience pneumonia-like symptoms, however they weren't responding well to the standard treatments of care. What started off as what most thought would be yet another outbreak limited to just a select portion of the global population turned into 650 million positive cases and over 6.6 million deaths across the world within three years. Although the health impacts of COVID have largely run their course, the economic impacts of shutting down our economy, then reopening it with massive amounts of both fiscal and monetary stimulus are still being felt today—most notably in 2022 with inflationary pressures we haven't seen since the late 1970s and early 1980s. There is a saying that although history never repeats, it often rhymes. The closest comparison to the COVID outbreak of 2019 is the Spanish Flu outbreak of 1918-1920, which also caused massive destruction and division. What came after the Spanish Flu, as it relates to the economy and the stock market, was a period known as the "Roaring 20's"- a period of wide-spread prosperity, particularly for America. Will the "Roaring 20's" play out in the 2020's like they did in the 1920's? We believe we still have to undergo more consolidation of economic growth in 2023 and we have positioned the portfolio as such, but we are not giving up on the potential for the Roaring 2020's scenario to repeat itself in this decade.

Annual Major Indicies Performance

Peak	2020	2021	2022
Dow Jones	7.3%	18.8%	-8.8%
S&P 500	16.3%	26.9%	-19.4%
NASDAQ	43.6%	21.4%	-33.1%
Russell 2000	20.0%	14.8%	-20.4%
US Agg. Bond	7.5%	-1.5%	-13.0%
Gold	24.9%	-3.4%	0.1%
Oil	-20.5%	55.0%	6.7%
Bitcoin	304.0%	59.9%	-64.2%

Source: Ycharts, Pavlic Investment Advisors

Our average stock portfolio was up mid-single digits on a percentage basis in the fourth quarter of 2022. While 2021 was a year of very strong growth for our stock portfolios with no material pullbacks to speak of, 2022 had lower highs and lower lows. **We are proud to report that our average equity composite portfolio outperformed the S&P 500, the NASDAQ, and the Russell 2000 on both a gross of fees and net of fees basis in 2022.** This is in addition to not owning any mutual funds in our equity composite portfolios which saves clients an additional customary 1.0% in mutual fund expense ratio fee. We were able to drive our outperformance by keeping our portfolios "boring"—we often say investing with us is like watching paint dry. Anchors in our portfolio, such as Walmart (WMT), Dollar General (DG), McDonalds (MCD), not only outperformed, but were actually *positive* in 2022. During down markets, we remind our investors to remain focused on the long term, to see the big picture, and to know we are investing your capital into companies that have withstood much darker times then these. Inflation, a rising dollar, slower economic growth all too shall pass, setting up the next bull market. Often the darkest and most challenging economic times are followed by the most prosperous.

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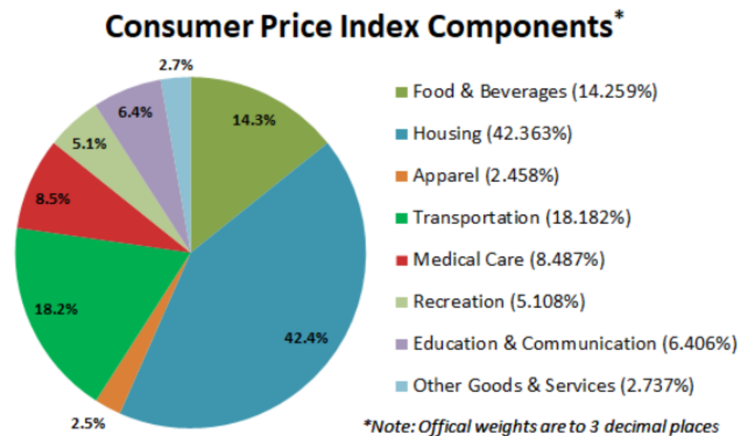
Stock Market Review

This quarter, we focus our stock market review on inflation, what the actions of the Fed mean for economic growth, and our biggest accomplishments and biggest regrets of the year.

Inflation remains elevated, but continues to cool. We continue to focus, first and foremost, on inflation, and what it means for the companies we own in our portfolio. Although inflation is ruthless for the consumer--particularly those with lower disposable income—inflation can be a positive for our companies provided they can pass on price increases at or above the inflation rate and control their cost structures, thereby maintaining their profit margins. Companies that cannot maintain their profit margins, often because of higher labor costs, have been punished hard by the market, e.g. FedEx. Balancing price increases and expenses is an incredibly difficult task for company management teams. This is why "experienced management teams" remains a key factor for us in choosing our investments. Companies such as Dollar General (DG), Walmart (WMT) and McDonalds (MCD), all mentioned earlier, have all been able to accomplish pushing higher prices on to consumers in 2022. This led to ***appreciation*** of these stock prices in comparison to significant ***depreciation*** for the broader stock market indices for the year.



Last quarter we focused on monthly CPI inflation reports for June, July, and August: +9.1%, +8.5%, +8.3%. We now have three new monthly data points for September, October and November: +8.2%, +7.8%, +7.1%. As you can see, the trend continues to be downward, particularly the latest one that shows an acceleration to the downside. The make-up of what constitutes the heavily watched CPI readings is in the nearby pie chart. Housing is the largest component (42%), followed by Transportation (18%), and Food and Beverage (14%). We are seeing more and more leading indicators of energy prices falling (the Delafield Mobil across from our office now has gas at $2.89/ga. vs. $5.09/ga. this summer), housing prices and rents are stalling due to a lack of housing transactions, and food and beverage prices are leveling off. We believe inflation will continue to come down in 2023 and will end the year in the 3-4% range.

Let's revisit the most important question, "What does the inflation trend mean for the stock portfolio we own?" The market often cares most about the second derivative of change—in other words, the pace of the rate of change. The last six monthly CPI readings have been +9.1%, +8.5%, +8.3%, +8.2%, +7.8%, +7.1%. The rate of change for the November reading was viewed very favorably and stocks ripped higher by almost 3.0% on the day they were announced. However, the Federal Reserve shot down any hope for a "Santa Claus Rally" by continuing to reiterate their plan to increase interest rates and keep them higher for longer. Usually, the faster inflation falls, the more likely the Federal Reserve is to halt interest rate increases, and the more likely a floor will be put under stock prices.

The Federal Reserve's Impact to Economic Growth. After letting investors drink from a very potent punch bowl in response to COVID-19, 2022 was marked by a Federal Reserve's clear message indicating it's "closing time" at the party. In fact, the Fed has embarked on the fastest rate of interest rate increases that we have seen in modern times as shown in the next chart:

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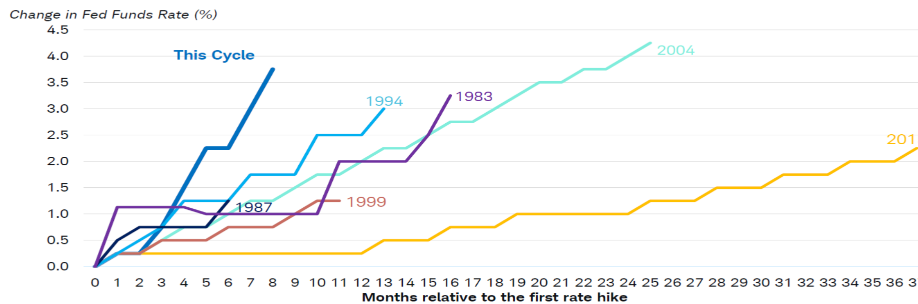

The outcome of these increases has been what we are already beginning to see—a decline in inflation. The second outcome, which is a necessary byproduct of slowing inflation, is slower economic growth, which we expect to continue into 2023. We are firm believers that the Fed should heed to their own messaging, i.e., that their monetary policies of quantitative tightening and increases to the Federal Funds rate impact the economy with a lag. This means that the economy is just now feeling the .75% increases they implemented earlier this summer. We see the Fed taking a "wait and see" approach after increasing the Federal Funds rate to roughly 5.0%, which they will achieve sometime in the next 2-5 months. The Fed can't raise interest rates into infinity, and they will pause or even reverse course in later 2023 in response to the slower economic growth we anticipate. We will likely get a 0.50% rate increase at the January, 2023 meeting followed by a 0.25% increase after the March, 2023 meeting. This will increase the Federal Funds Rate to 5.00-5.25% from the current level of 4.25-4.50%. In summary, we expect inflation to continue to slow and economic growth to weaken, which should give the Federal Reserve reason to pause their rate increases in 2023.

Biggest Accomplishment and Biggest Regret of 2022. Investing is a humbling business. If your investments beat the market 60% of the time, that will make us one of the most successful money managers in the world. And even if we do, we recognize that this also means we will be wrong 40% of the time. We don't plan or expect to knock every ball out of the part, but by sticking to our strategy of investing in companies that earn substantial cash flows relative to their valuations keeps us poised to continue to outperform over the long term. Companies that didn't earn consistent and growing cash flows were punished harshly in 2022, e.g., Carvana down 99%, Peloton down 95%, Coinbase down 92%, and yes, even TESLA down 72% on the year—all of which we don't own. We are most proud of sticking to our disciplined investment process which generated our outperformance for our investors.

We are also proud that we encouraged clients to use the market turmoil of 2022 to "buy the dip" knowing that we will likely be early. We pushed back against the natural human psychology that tells us down markets only have further to fall. We have a lot that keeps us up at night: 1) rising interest rates 2) high inflation 3) geopolitical conflict 4) slowing economic growth and now 5) declining earnings. It shouldn't come as a surprise that it doesn't feel great out there. There is a tendency for clients to want to throw in the towel and abandon their long-term financial plan. Market history is clear: periods like this, in the market, are opportunities to secure a long-term financial future, as long as investors can resist the urge for short-term protection at the expense of longer-term gains.

Looking back on 2022, our biggest regret in the portfolio was not owning an energy company. We benefited with Archer Daniels Midland (ADM), a chemical/food products company, on the rising cost of fertilizer and food products, but we missed on energy. In December, we used the pull back in energy share prices as an opportunity to add **Devon Energy (DVN)** to the portfolio. Devon is engaged in the exploration, development, and production of oil and natural gas—as the price of these items increases so too does the free cash flow Devon can award to its shareholders. Despite its run this year, we bought the stock with a price/earnings ratio under 7.0x and an EV/EBITDA multiple under 5.0x—a very cheap stock. The company is returning an ample amount of its profits to shareholders through a fixed and variable rate dividend of about 8.5% and, in addition, it is on pace to repurchase 5.0% of its outstanding shares this year. We believe the demand/supply dynamics will be in oil companies' favor for years to come, especially as China reopens its economy. We expect to hold Devon for many years to come and capitalize on this trend.

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Bond Market Review

Yields rise offering new bond purchases at ~6.0%/year. 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 most bond mutual funds and ETFs in 2022, which are down 15%-20% on the year. In fact, with our 10-year laddered portfolio, our average maturity is about 4.5 years compared to the average bond mutual fund's average maturity of 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 our bonds will be worth at maturity--$100/bond. The bonds that we own that are 7-10 years out from maturity are trading at large paper losses. However, it is 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 bonds mature in 2022, we are either recommending the purchase of stocks, now that prices are so much lower, or we can buy bonds maturing in 10 years at >6.5% annualized 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. Prime money market funds now offer over 4.0%/year. These yields are far higher than what we could have earned just six months ago and present a compelling alternative to stocks if market volatility is keeping you up at night.

2022 Market Outlook and Commentary

"Will there be a recession in 2023?" This has been the most common question we have heard from our client this last quarter, and quite frankly, over the last year. If we get an economic recession in 2023, it will be the most anticipated recession ever because it seems like 100% of the consensus view is that we will have one. Although we aren't forecasting that everything to be bright and rosy and extremely exuberant in 2023, we also recognize that when too many people forecast exactly the same thing, the market often is at a turning point and reverses course (this works both ways of course). Investor sentiment is very low, at levels last seen in 2008, which means a lot of bad news is already reflected in current stock prices. We experienced peak to trough price declines of 25-35% for the broader indices in 2022. This is, historically, the average for bear markets. Every bear market in the history of U.S. stocks has resolved to new all-time highs at some point in the subsequent bull market, with some taking longer than others. Losses feel worse than gains feel good, as just recently evidenced by the fact that the gains of 2021 were larger than the losses of 2022. Although markets don't always trough and peak at calendar year ends (although this most recent bull market ended January 4th, 2022), the fact is that a year of losses are followed by a second year of losses in only 9% of occurrences going back to 1928. This time-period includes the Great Depression, so if you can assume we won't suffer another great depression (we don't see this on the horizon), the likelihood of another down year in 2023 is <5%, historically speaking.

On the economic front, 2023 will see a Federal Reserve that ends its interest rate tightening. This, alone, makes us more bullish on the future. Lagging inflation data has already accelerated its pace lower which we believe will end 2023 near 3%--still above the Fed's 2% target but well below 2022's heightened levels. There can be no denying that with stocks down about 25%, a lot, if not all, of the economic slowdown that we are about to experience, has already been "priced in." Remember that stocks are always a leading indicator, often by 6 to 9 months. We believe we will have enhanced stock market volatility in the first half of 2023 just like we experienced during much of 2022. However, as inflation continues to fall and the Federal Reserve continues to slow its pace of interest rate hikes, we will see just how resilient the American consumer will be. We agree with Warren Buffet: "Never bet against America, and never bet against the American consumer."

"If you wait for the robins, Spring will be over." – Warren Buffett

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