April 11th, 2024

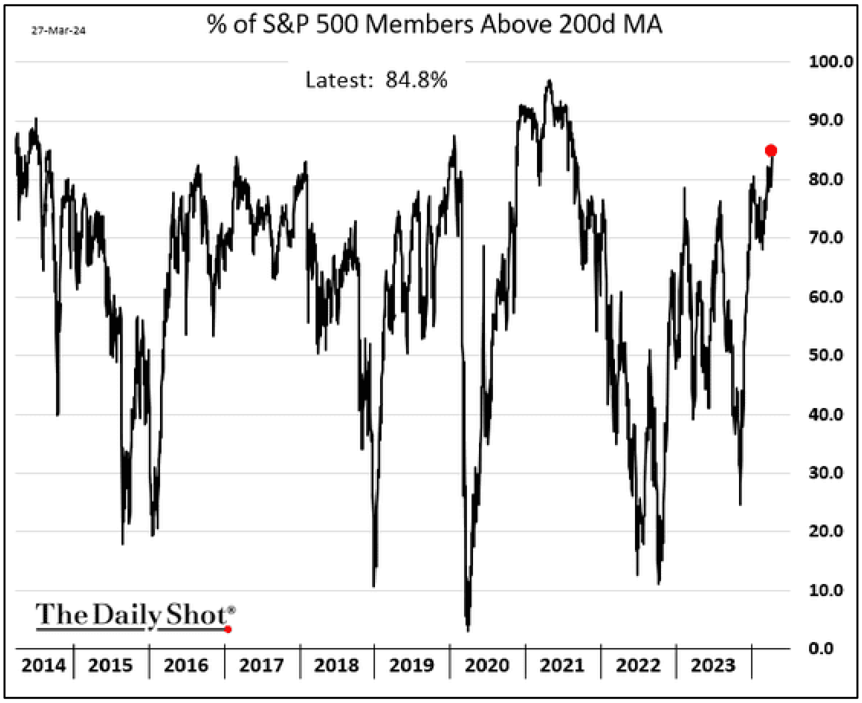
Spring Quarterly Commentary

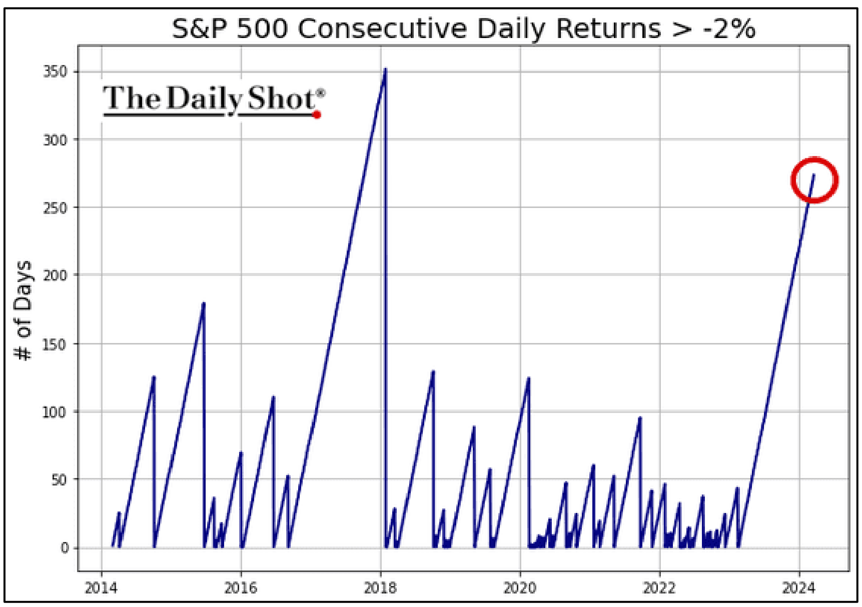
"Let's start with the soul – that's the immaterial part of us, our essence, the dearest part of ourselves. The game is whatever creative endeavor we are deeply involved in, be it running a company, creating art, writing, investing, or making sushi – any creative pursuit that you believe is worthy of your effort and time. When you have soul in the game, this pursuit has all of you, every ounce of your attention and strength and love."

Vitaliy N. Katsenelson
Author and Investor

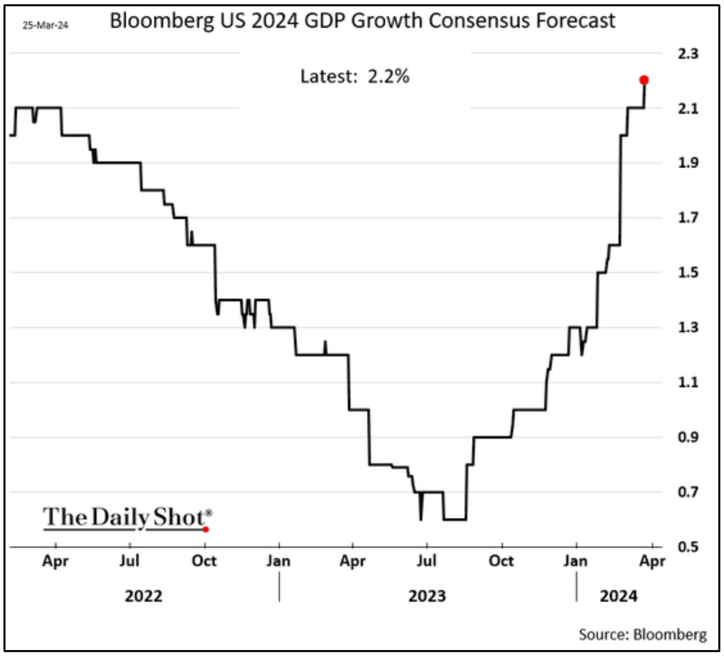
In our last quarterly letter, we preached that investors can expect the stock market to deliver strong returns over the long term. It appears the market didn't want to make anybody wait very long. Equity markets again delivered very strong performance in the recent quarter with the benchmark S&P 500 Index returning 10.6%.

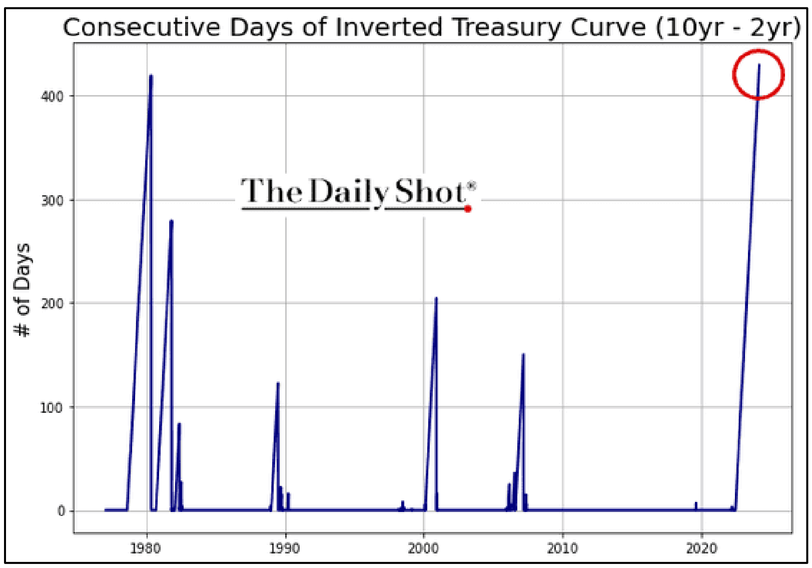
Not only did the headline index deliver a strong return, but most rank-and-file constituents participated in the updraft as well. The chart atop the following page shows the percentage of S&P 500 stocks above their 200-day moving average. This measure of participation is called market "breadth" and is usually a sign of a healthy market.





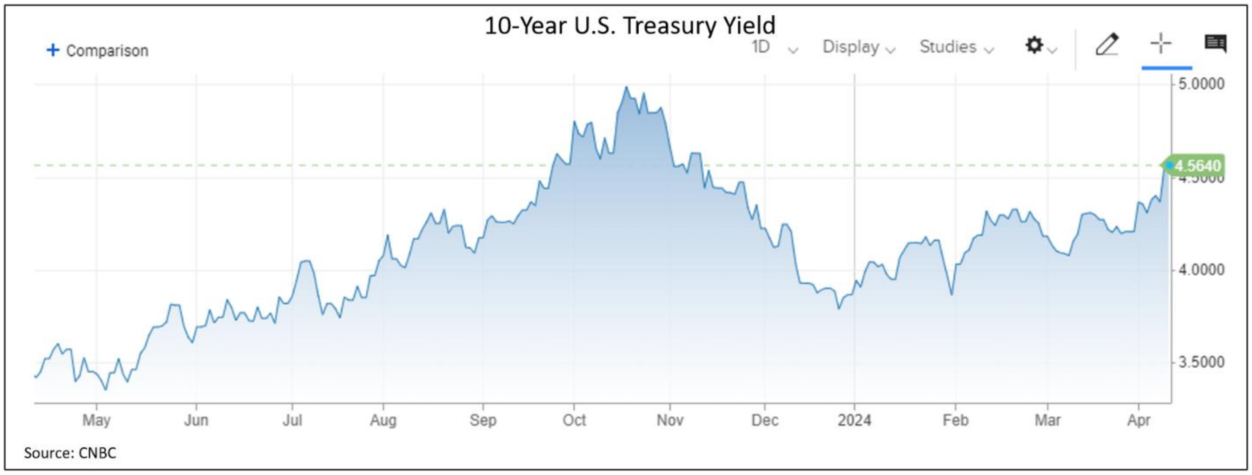
The recession that so many, including ourselves, had anticipated once the yield curve inverted, has yet to materialize. The market has risen as an increasing number of investors conclude that the recession has not just been delayed, but cancelled. (As a reminder, an inverted yield curve is when short-term interest rates are higher than long-term interest rates, and it is supposed to be among the most reliable indicators of a coming recession.)



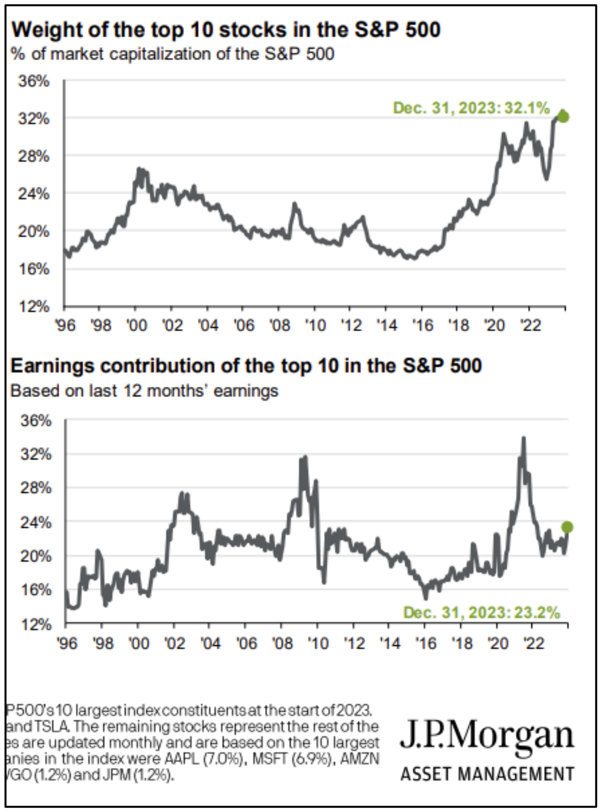


The stock market's recent upward trajectory partially stems from anticipation that Federal Reserve rate cuts will come as inflation continues to recede. These lower short-term rates would likely un-invert the yield curve and break the record-long inversion streak shown above.

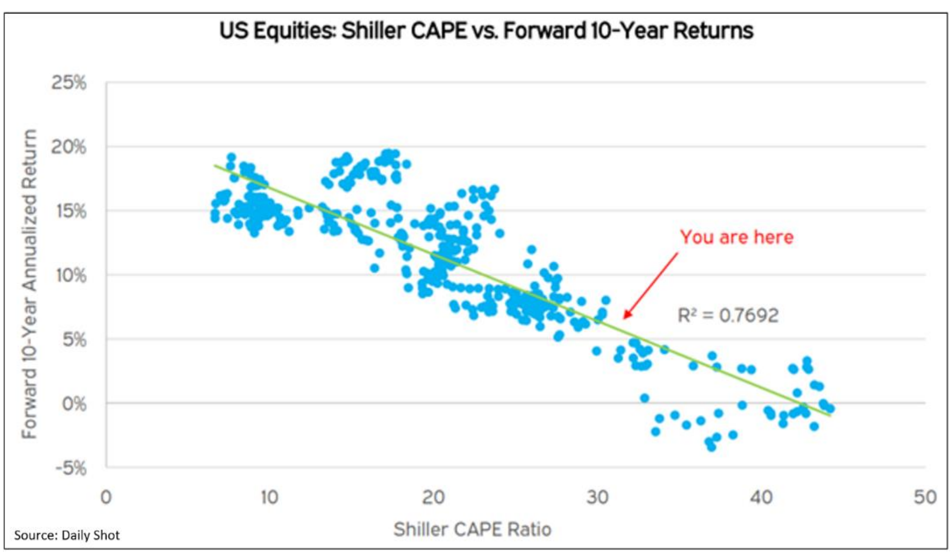
But perhaps the market is getting a bit ahead of itself here. Inflation, according to the official statistics, has stopped its downward march for the last few months and now appears stubbornly stuck around 3%. This represents good progress but is still meaningfully above the Federal Reserve's 2% target. This sticky inflation makes rate cuts less likely and has inspired a resurgent 10-year U.S. Treasury yield. Though it hasn't generated many headlines, we view this as a warning signal to financial asset partygoers.



There are some reasons to worry, starting with the fact that nearly everyone is bullish. Additionally, even though most stocks have been advancing (the breadth mentioned above), stock market concentration among the largest U.S. companies is at record highs and continues to increase. In the past, this has been a worrying signal of market fragility.

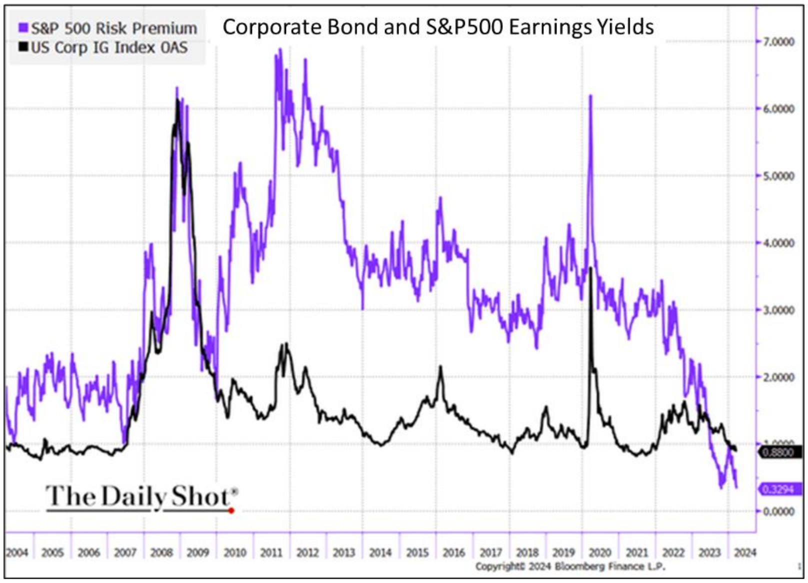


There are also valuation concerns. Though valuation is a terrible timing tool, it does have implications for longer run returns. The below chart, which we have run before, shows a scatter plot of the Cyclically Adjusted Price to Earnings (CAPE) ratio[1] vs forward ten-year returns. While hardly determinative, there is a clear, inverse relationship between the CAPE and forward returns. The graph indicates that, given our current valuation starting point, equity investors might expect subnormal, single-digit annual returns over the next ten years on average.



[1] The CAPE is a measure of how expensive stocks are compared to their 10-year earnings history.

While stocks have become more expensive, the rising interest rates we highlighted earlier mean that bonds have gotten cheaper[2]. This has resulted in the semi-unprecedented situation where corporate bonds now promise more in yield than the S&P 500 does in earnings[3].



We will stop short of saying that corporate bonds will outperform stocks going forward. For starters, the corporate earnings which underpin stocks should grow, unlike bond interest which is fixed. However, it seems very clear that bonds are better positioned relative to stocks than they used to be.

If corporate earnings were not to grow, then we indeed would expect investors to do better in bonds while taking less risk. Is that likely? Probably not. However, we do worry about corporate earnings growth in the (unlikely) event that Congress gets serious about addressing the federal government deficit problem.

Corporate taxes as a percentage of U.S. government income have shrunk substantially in the past few decades. If Congress seeks sources of additional revenue, corporate income tax would be an obvious place to look. The stock market barely yawned when President Biden said he wanted to raise the corporate tax rate, but we think this is the number one risk to stocks that few people are currently talking about. With that said, we don't expect a lot of action on the deficit until politicians have their hand forced by some sort of crisis, which is not likely to happen in the very near future.

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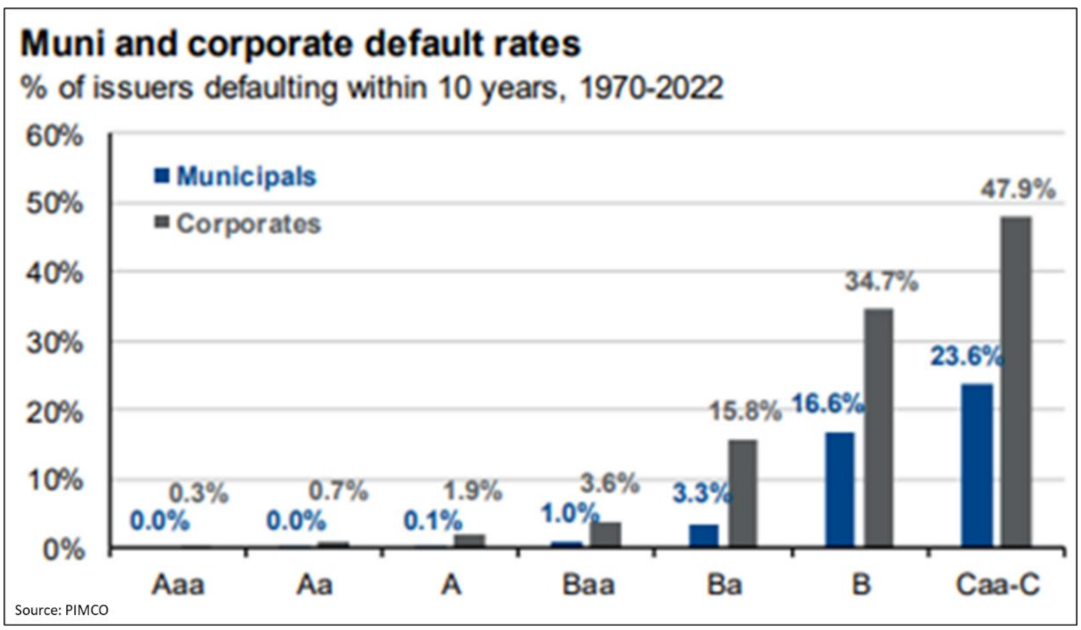
[2] Bond prices move in the opposite direction from interest rates.

[3] The accompanying chart expresses both S&P 500 earnings yield and corporate bond interest as a spread above Treasury yields.

With nothing too exciting going on in the world of macroeconomics, we'd like to go behind the scenes to share some of the work we do to provide extra return for a subset of clients.

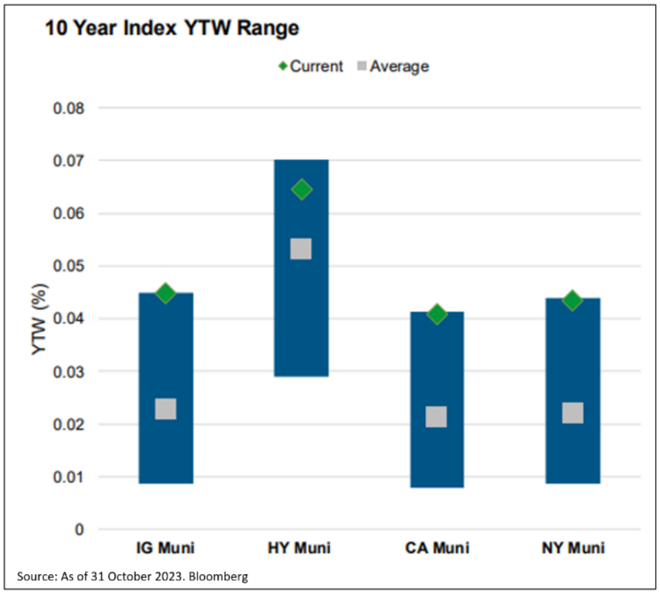
When putting together fixed income portfolios, we focus on after-tax returns, because that is what matters to your bottom line. For our clients in higher tax brackets, we buy a lot of municipal bonds because the interest on these bonds is typically free of both state and federal taxes[4].

For example, today a corporate bond might yield 5% while a municipal bond might yield only 3%. However, for the California investor in the highest tax bracket (who would pay a combined marginal 54.1% tax rate) that corporate bond yield of 5% is only 2.3% after taxes. The tax-free municipal bond income of 3% is not only higher, but also comes with less risk because municipal bonds almost never default. Another way to express this would be to say that the 3% municipal bond has a taxable equivalent yield of 6.5%. That is what the high-earning investor would have to earn on a taxable bond to get the same after-tax yield as the 3% municipal bond.

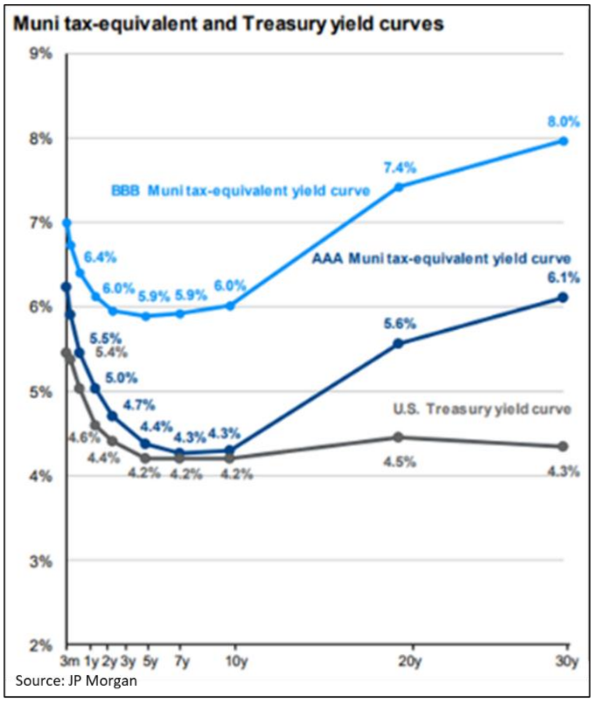


[4] When choosing municipal bonds, we take your state of residence into account as well. Thus, a California client will likely get California bonds because those avoid California state tax. For clients in Texas, where there is no state income tax, we look across a variety states for the best risk-adjusted yield. At times we buy bonds in other states for our California clients when they yield more even after paying California state tax.

This math almost always works out in favor of municipal bonds over corporate bonds for a high tax bracket investor. It is also worth remembering that we only report your pre-tax returns. Thus, despite the higher after-tax return of municipal bonds, the *reported* pre-tax returns will always be lower than that of corporate bonds. That's fine. We'd rather invest in something that is actually better for your pocketbook than in something that just looks better on your quarterly statement. It is our job to get the best return for you at the lowest risk, and that's what we seek to accomplish.



Source: As of 31 October 2023. Bloomberg



Source: JP Morgan

In any case, as with corporate and mortgage bonds[5], municipal bonds are looking more attractive than they have in the past because interest rates have risen. As you can see from the chart above, tax equivalent yields on BBB rated municipal bonds are quite attractive.

We endeavor to protect your principal by purchasing bonds with maturities shorter than 15 years, as unexpected inflation can emerge over longer periods. We also stick to good geographies with favorable demographics and essential municipal services. To enhance your returns, we buy individual bonds so you don't have to pay an additional management fee for a mutual or exchange traded fund (ETF).

In addition to these "standard" municipal bonds, we've recently been buying unrated land-backed municipal bonds. These bonds are a favored investment of some of those closest to the municipal bond market. They typically yield 0.5% to 1% more than our "standard" municipal bonds for

[5] For reasons we won't get into, mortgage bonds are looking particularly attractive when compared to vanilla corporate bonds. Over the last six months, we have been allocating more of our fixed income portfolio for lower tax bracket and tax-free accounts into mortgages, moving some money away from corporates.

probably even lower risk. We want to explain these bonds and why we like them so much, as you may see them on your statements[6].

Some of you might be familiar with Mello-Roos taxes that come with home ownership in certain neighborhoods. House hunters generally dislike these extra taxes which are assessed on top of regular property tax. Essentially our unrated land-backed bonds are Mello-Roos bonds[7]; they are backed by special taxes on residential developments.

When a developer buys land and prepares to sell houses, they can issue Mello Roos bonds to raise the funds to build out the necessary amenities and infrastructure for the housing development (i.e. roads, parks, schools, and fire stations). The county is then responsible for collecting taxes from whoever owns the land (at first the developer, then the homeowners) to pay off these bonds. If someone doesn't pay, then the county tax collector uses the mighty powers of the government to collect, up to and including seizing the property and auctioning it off to pay the past due taxes. In the event of a bankrupt homeowner and land seizure/auction, these taxes are first in line to be paid before any mortgage or bank debt. This is what makes these bonds so safe: the value of the property that stands behind them and the power of the government to collect that value.

The secret to buying these bonds well is to buy them after the developer has already sold most of the lots to homeowners. Typically, this means a drastic increase in the value of the bond collateral over the original raw land; the higher, built out property value means greater protection for bondholders. We typically purchase these bonds in communities that have been built out and stable for a long time. In these situations, the collateral can sometimes be 30 to 40 times the value of the bond. If you've made an investment in getting to know the right partners (as we have) you can determine the value of the land as well as the current property tax delinquency rate.

Land-backed bonds in established communities where the collateral greatly exceeds the bond value are obviously a very good credit risk (arguably better than even California general obligation bonds). But here's what makes them so special: many investors won't buy them because they don't have a credit rating. These bond issuances are so small that it doesn't make sense for the bond issuer to pay a flat fee to bring in a credit rating agency (like Moody's or Fitch) to rate the bonds. If rated, they would rate highly. These bonds are unrated not because they are risky, but because they are issued in small amounts.

The absence of a rating doesn't make these bonds riskier, but it does make them cheaper! Because so many investors won't consider buying an unrated bond, they are available at very attractive yields. As stated

[6] Again, only for clients who have communicated that they're in a high tax bracket and have a substantial fixed income allocation.

[7] Many of the bonds we purchase are technically not Mello-Roos but work exactly the same way and that is how we will refer to the topic.

earlier, they typically offer 0.5% to 1.0% more *tax-free* yield than our "standard" municipal bonds. Those high bracket investors sitting on cash earning 5% taxable, might instead consider contacting us about potentially earning north of 7% on a tax-equivalent basis.

The only potential drawback is liquidity. Because these bonds are typically issued in small amounts and are unrated, if you had to sell in a pinch, you might take a haircut of approximately 1% to 2%. We turn this illiquidity feature into an advantage by being ready to buy these bonds at a discount when someone else needs to sell. The potential for a quick sale haircut is why we don't invest more than 50% of municipal bond allocations in these unrated land-backed bonds. If you, our client, need some cash quickly, we will sell the more "standard" municipal bonds at full price. We hope you enjoyed this explanation of one of the things we do behind the scenes to increase your return.

This has been a great quarter for stock market investors. You shouldn't expect such positive performance to be repeated often. Bond investors are better positioned moving forward after another negative quarter for the index. Despite our best efforts, investment results will sometimes inevitably be in the negative direction over shorter periods. Whatever happens, we remain aligned with you by always investing our own money in the same strategies in which we deploy yours. We take seriously the trust you place in us and seek to earn that trust every day.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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