Clothier Springs
Capital Management

Premium Points

Timeless Truths | New Perspectives | Endless Evolution

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From the CIO’s Desk

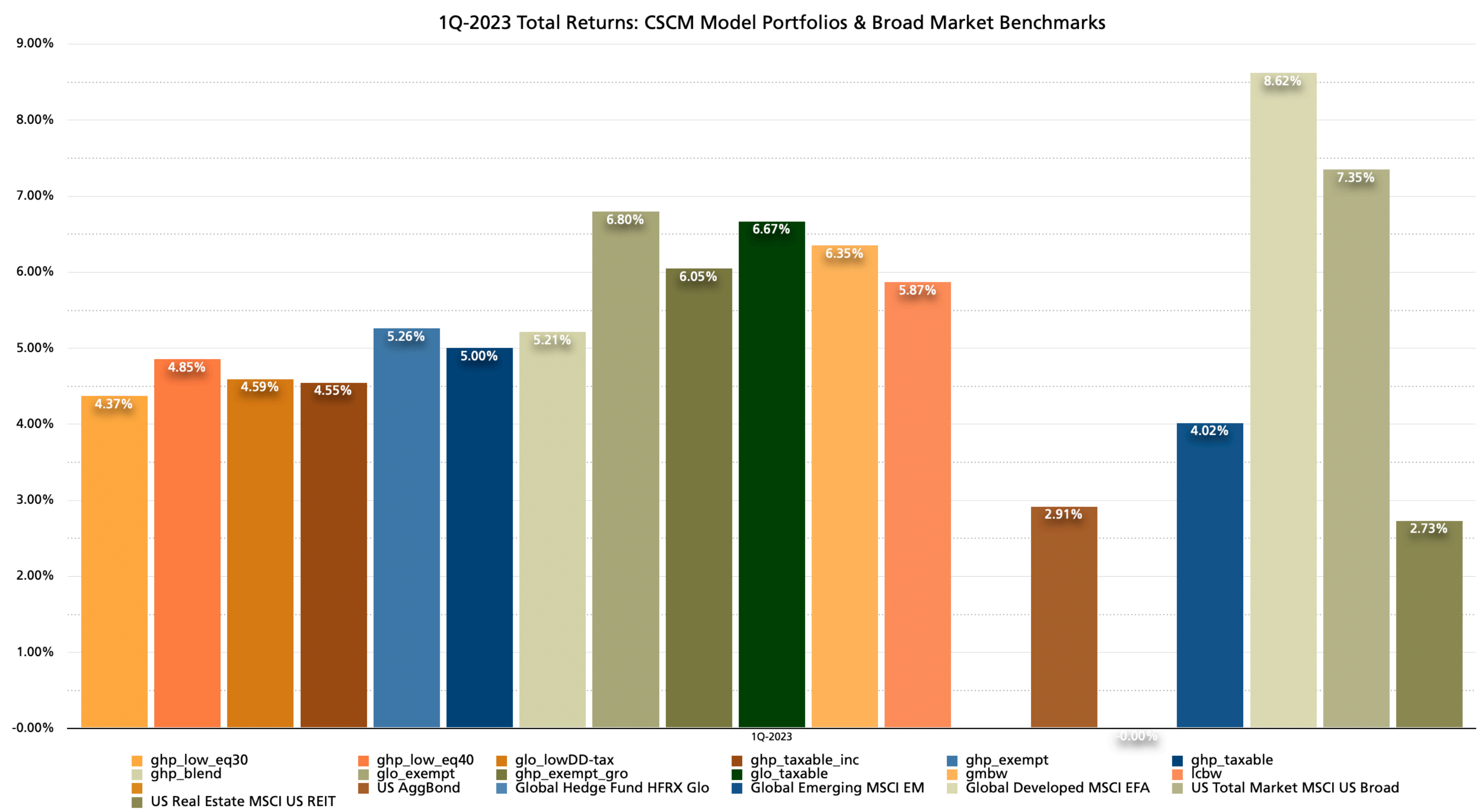
Normally, I struggle to come up with content for this quarterly newsletter. The challenge is to come up with material that is relevant, timely and absorb-able. It also needs to be content other than regurgitated pabulum from the endless sources of financial punditry.

Now we have another source of content to contend with: robots. If the growing frenzy about AI generated market and financial commentary is any indication, we might as well pack it in and sail off into the sunset. I’m not so sure. I’m not much for biblical references but my name is Thomas after all. My own hunch is that machine learning will absorb millions of other data pieces then spit out an intelligent sounding pure average of all the data it ingested. That will be true for content and other kinds of output. There will be no “thinking outside the box” to use a tired metaphor.

We’ll see.

For this edition of our newsletter, there is a wealth of material for us to draw on: from the private equity plunderers moving down market to lure retail investors, to the rise of “buffered” ETFs, to the fallibility of veteran investment professionals, to the 2022 results of the largest sovereign fund in the world--the Norway Fund.

Thomas F. McKeon, CFA
April 30, 2023



Review & Outlook 1Q-2023

The markets delivered a second consecutive strong quarter, perhaps looking forward to the end of rate hikes by the Federal Reserve. The upside to higher rates is that fixed income investments across the board now have attractive yields. A one-year Treasury now has a yield of 4.7%, up from as low as 1.8% less than one year ago, and as low as 0.6% less than two years ago.

Just yesterday (5/3/2023) the Federal Reserve raised rates yet again (1/4%) and rates are now above 5.0% for the fist time since 2008, a full fifteen years. The Fed did indicate that they may be finished with the rate raises for the time being, as they let the previous raises work their way into the economy and perhaps have the effect on inflation they are aiming for.

Inflation & Corporate Gouging

There is mounting evidence however that inflation is not simply the result of wage growth pressure. Corporations are taking advantage of the current situation.

From the Wall Street Journal: 5/2/2023

"Why Is Inflation So Sticky?

Inflation has proved more stubborn than central banks bargained for when prices started surging two years ago. Now some economists think they know why: ***Businesses are using a rare opportunity to boost their profit margins.***

Figures released Tuesday by the European Union's statistics agency showed consumer prices in the eurozone were 7.0% higher than a year earlier in April, a pickup from March and more than three times the European Central Bank's target. However, the core rate of inflation—which excludes food and energy prices—edged down to 5.6% in April from a record high of 5.7% in March.

Inflation rates also remain uncomfortably high in the U.S. and many other parts of the world despite interest-rate rises that have gone further and been delivered more quickly than at any time since the 1980s.

There have been good reasons for businesses to raise their prices in recent months. The supply-chain disruptions caused by the Covid-19 pandemic and the energy, food and raw-material bottlenecks that followed Russia's invasion of Ukraine have pushed costs higher. But there are signs that companies are doing more than covering their costs.

According to economists at the ECB, businesses have been padding their profits. That, they said, was a bigger factor in fueling inflation during the second half of last year than rising wages were.

Jan Philipp Jenisch, chief executive of construction-materials maker Holcim, said on a recent earnings call: "We are in that inflationary environment already for almost two years now…We have done the pricing in a very proactive way, so that our results aren't suffering. On the contrary, they are improving the margins."

Consumers have also been unusually willing to accept higher prices lately. Paul Donovan, chief economist at UBS Global Wealth Management, said businesses are betting that consumers will go along because they know about supply bottlenecks and higher energy prices.

"They are confident that they can convince consumers that it isn't their fault, and it won't damage their brand," Mr. Donovan said.

Our interpretation of that comment is that corporations are using the very successful marketing of inflation to gouge their customers and expect that they will not be blamed….as though inflation was some natural phenomenon like gravity.

And if this is in fact the case, rising interest rates will have little impact on inflation. So one has to wonder what the Federal Reserve is actually doing.

Looking Forward

The consensus about capital market returns is that equity returns in the US will be somewhat more modest than historical averages. We agree and as such, we continue to maintain an equity bias toward high dividend holdings. Historically, dividends have provided half the total return of stocks and we may be in that type of environment again. Bonds now offer healthy yield as well and once inflation settles down, market returns should be more than adequate. Collecting income while we wait is A-OK.

Lessons From the Oracle of Omaha

Like many other investment professionals, we pay attention to what the Oracle of Omaha has to say in his annual report to shareholders. Arguably one of the most successful investors of all time, Warren Buffet has been compounding the value of his flagship company Berkshire Hathaway since the 1960's. He does not take a salary, does not pay himself with stock options. He comes to work and seeks to identify and invest in companies that he believes will grow and which he can hold in near perpetuity. Below is an excerpt from the 2022 Berkshire Hathaway annual report that give some insight as to why his investments work so well.

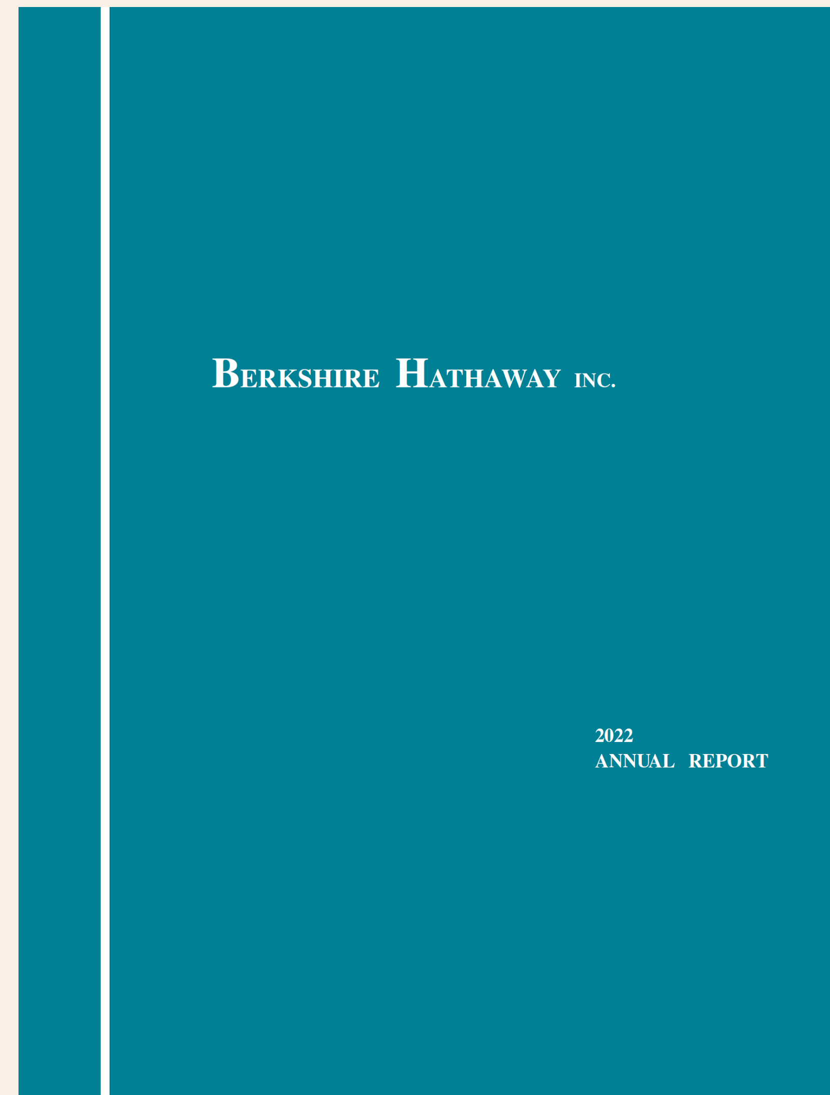
The Secret Sauce

In August 1994 – yes, 1994 – Berkshire completed its seven-year purchase of the 400 million shares of Coca-Cola we now own. The total cost was $1.3 billion – then a very meaningful sum at Berkshire.

The cash dividend we received from Coke in 1994 was $75 million. By 2022, the dividend had increased to $704 million. Growth occurred every year, just as certain as birthdays. All Charlie and I were required to do was cash Coke's quarterly dividend checks. We expect that those checks are highly likely to grow.

American Express is much the same story. Berkshire's purchases of Amex were essentially completed in 1995 and, coincidentally, also cost $1.3 billion. Annual dividends received from this investment have grown from $41 million to $302 million. Those checks, too, seem highly likely to increase.

These dividend gains, though pleasing, are far from spectacular. But they bring with them important gains in stock prices. At yearend, our Coke investment was valued at $25 billion while Amex was recorded at $22 billion. Each holding now accounts for roughly 5% of Berkshire's net worth, akin to its weighting long ago.



Assume, for a moment, I had made a similarly-sized investment mistake in the 1990s, one that flat-lined and simply retained its $1.3 billion value in 2022. (An example would be a high-grade 30-year bond.) That disappointing investment would now represent an insignificant 0.3% of Berkshire's net worth and would be delivering to us an unchanged $80 million or so of annual income.

The lesson for investors: The weeds wither away in significance as the flowers bloom. Over time, it takes just a few winners to work wonders. And, yes, it helps to start early and live into your 90s as well.

A simple yet insightful observation from someone who is regarded as one of the best investors. Several things related to prudent long-term investing here: dividends, time, compounding, intrinsic value.

Coke (KO) and American Express (AXP) are real businesses with assets, liabilities, shareholder equity, products and services, ongoing operations, revenues, profits, retained capital, valuable brands, etc. They share a portion of their profits with their owners the shareholders in the form of dividends.

Interesting that over the 30 year period examined by Buffett, the value of their KO holding had grown twenty-fold while the value of their AXP holding had grown seventeen-fold. These valuations significantly out paced the growth of their annual dividends received which both grew under ten-fold. While not a dollar for dollar link, the shares of these companies are worth much more than when purchased and some of that can be explained by the growth of their dividend payout. Certainly other metrics figure into that calculation as well: revenues, profits, shares outstanding, book value, etc. But the value-dividend link is integral.

Digital Nothing Burgers

Compare that to one of my current hobbyhorse's: crypto currencies. Not backed by a government, not backed by a business with any of the aforementioned drivers of market value (products, services, revenues, profits, brands, dividends) crypto's are digital nothing-burgers. They have zero value and no earthly rational reason why they should appreciate.

Moreover, they do not address a valid business purpose. Merchants who accept crypto's as payment now are exposed to the additional risk of price fluctuations and the task of converting them back into good old greenbacks. They exist on an ocean of hype and hope. Consider yourself warned.

Private Equity Plunderers

The private equity plunderers are coming for your money. They have been enriching themselves at institutional pensioners expense for years. Now that many boards and trustees are wising up to the private equity value proposition of mediocre returns and high costs, the plunderers need to look elsewhere for sheep to shear.

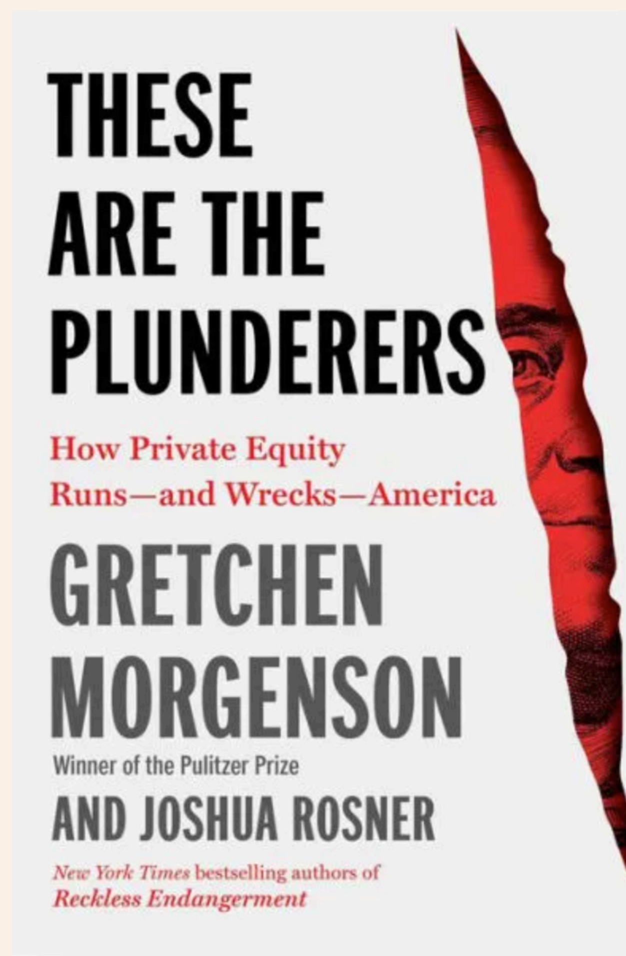
We have long been skeptics of the self-serving private equity business model. We were pleased to see institutional investors like the PA Public School Employees Pension raise some serious concerns about poor performance and high fees and fire some of the plunderers and reinvest in—lo and behold—low cost index funds.

If you want to really understand how damaging private equity has been to the country and the economy, pick up a copy of "These Are the Plunderers" by Gretchen Mortensen and Joshua Rosner. Just published by Simon & Schuster these veteran financial journalists document and quantify the damages inflicted on everyday citizens by the rapacious "money spinners."

From the publisher:

Pulitzer Prize–winning and New York Times bestselling financial journalist Gretchen Morgenson and financial policy analyst Joshua Rosner investigate the insidious world of private equity, revealing how it leeches profits from everyday Americans, tanks the companies it acquires, and puts our entire economic system at risk.

Much has been written about the widening gulf between rich and poor, the pernicious effects our deepening income inequality has on the US's well-being, and how our style of capitalism has failed to provide a living wage for so many Americans. But nothing has fully detailed the crucial role a small cohort of elite financiers has played in this dispiriting outcome over the past thirty years. Pulitzer Prize–winning journalist and bestselling author Gretchen Morgenson, with coauthor Joshua Rosner, unmask the small group of celebrated Wall Street financiers, and their government enablers, who use excessive debt and dubious practices to undermine our nation's economy for their own enrichment: private equity.



These Are The Plunderers lucidly and maddeningly traces the thirty-year history of corporate takeovers in America and private equity's increasing dominance. Morgenson and Rosner investigate some of the biggest names in private equity, exposing how they buy companies, load them with debt, and then bleed them of assets and profits. All while prosecutors and regulators stand idle.

Morgenson and Rosner show how companies absorbed by private equity have worse outcomes for everyone but the financiers: employees are more likely to lose their jobs or their benefits; companies are more likely to go bankrupt; patients are more likely to have higher healthcare costs; residents of nursing homes are more likely to die; towns struggle when private equity buys the main businesses, crippling the local economy; and school teachers, firefighters, medical technicians, and other public workers are more likely to have lower returns on their pensions because of the fees private equity extracts from their investments. In other words: we are all worse off because of private equity.

These are the Plunderers exposes the greed and pillaging in private equity, revealing the many ways these billionaires have bled our economy, and, in turn, us.

Warren Buffet's partner Charlie Munger also had this to say recently about the investment industry:

Munger also took aim at his own industry, hitting out at a "glut of investment managers that's bad for the country". Many of them are little more than "fortune tellers or astrologers who are dragging money out of their clients' accounts, which [is] not being earned by any useful service". He had harsh words for buyout groups as well. "There's too much private equity, too many buyers of all kinds.. it's making it a very tough game for everybody." "The people getting the fees are still doing well," he said of private equity fund managers. But he warned: "People that aren't being served very well by paying all those fees may eventually be unwilling to pay them."

And what I see everyday from my seat inside this business is that the plunderers are moving down market: through advisors and planners and brokers. They want your IRA, they want your 401(k), they want your joint account…all untapped sources for them. Pitches, promotions and invitations to lunch from the plunderers are now landing in my inbox daily. Not on my watch.

A second book on the damage being wrought by the private equity bandits has just been published. "Plunder: Private Equity's Plan to Pillage America" by Brendan Ballou.

From the publisher:

In his new book, "Plunder: Private Equity's Plan To Pillage America," Brendan Ballou, a federal prosecutor who served as Special Counsel for Private Equity in the Justice Department's Antitrust Division, outlines the dangers of a trillion-dollar industry that hardly anyone understands. He explains how Americans can fight their harmful practices.

While many laud these plunderers as financial wizards and savants, they are anything but. And to those who invest in private equity I say you are financing a transfer of wealth from pensioners and other owners to the modern "masters of the universe" enriching themselves at your great expense.

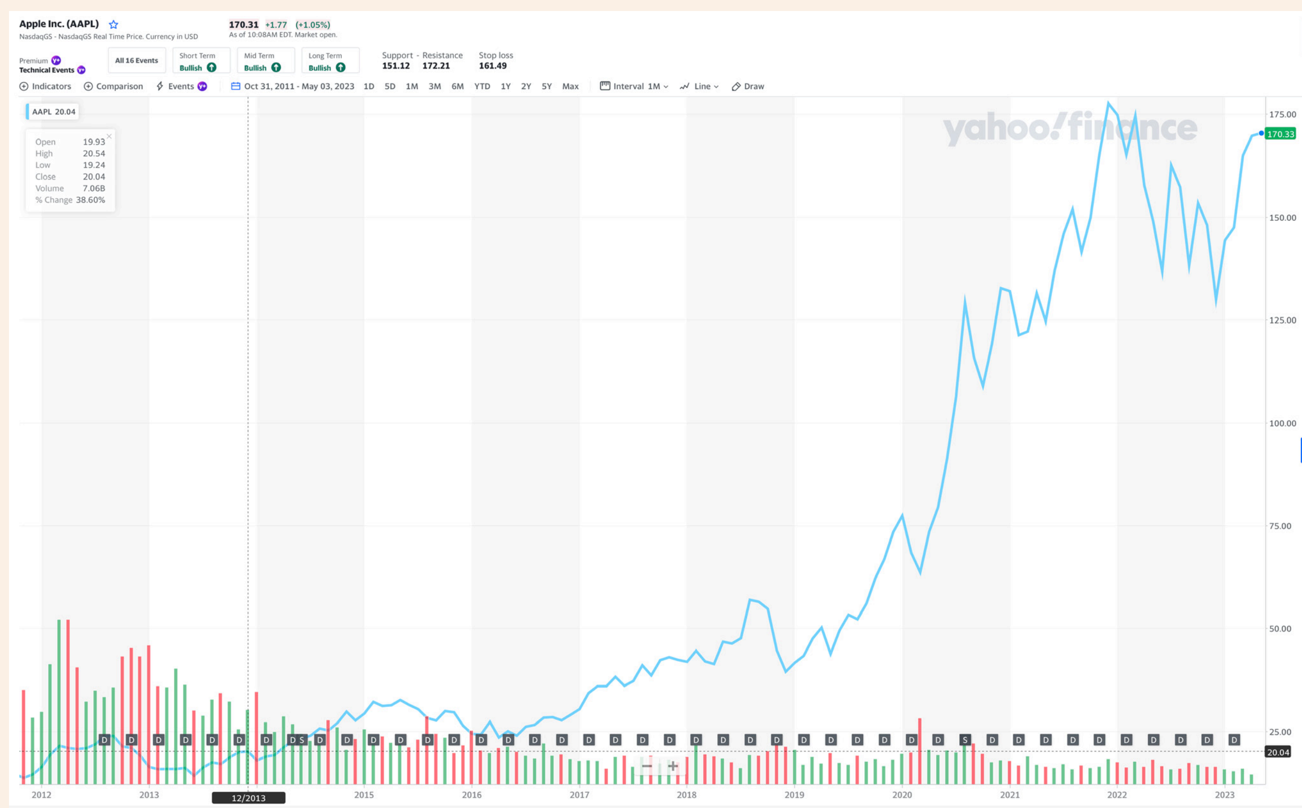
The Greatest "Short"? Not So Much

Early in the life of Clothier Springs Capital Management we had an informal advisory board of investment professionals we thought would be helpful. They were not but that's a story for another time. One of the board members was the retired Chief Investment Officer of a large bank-owned mutual fund complex. We will call him Chuck.

In November of 2011 when Steve Jobs of Apple (AAPL) died, Chuck sent us an email exclaiming: Apple stock is the greatest short of all time. For those who don't know "shorting" is opening a position by selling a stock without owning it in the hopes of buying it back at a lower price in the future.

Chuck could not have been more wrong. In fact it was perhaps one of the greatest buying opportunities of all time. Even after a recent selloff, AAPL is up 1,240% since 10/31/2011. That does not include dividends which would make the return even higher.

This is but an anecdote but it does support the notion that trying to outguess the market is a low-potential endeavor, even for supposed experienced investment professionals. Even wrong bets on small positions can degrade returns significantly. Capturing market returns accurately at low cost is the way to maximize your outcome. And that's what we do. The chart below is the 12 year price of Apple, starting in the month after Apple CEO Steve Jobs died.



Norway Fund

From the (Norway) Government Pension Fund Global Annual Report 2022—the largest sovereign fund in the world. At year-end 2022 its value was 12,429 billion kroner (12.429 trillion).

The Board's Assessment of the Results

2022 saw substantial movements in global financial markets. Russia's invasion of Ukraine contributed to a sharp rise in energy prices in Europe. Together with strong demand and constraints on the supply side of the economy, this led to a marked increase in inflation globally. Interest rates rose, and both equity and bond markets gave negative returns in the first three quarters of the year before rallying slightly in the fourth quarter.

The return on the Government Pension Fund Global closely follows developments in global equity and bond markets. Weak markets during the year meant that the fund's investments returned -14.1 percent.

The bulk of the fund is managed under the strategy for market exposure. The main aim of this strategy is to achieve market exposure mirroring the benchmark index as cost-efficiently as possible. Transaction costs are minimized by avoiding mechanical replication of index changes. An excess return is also generated by pursuing various indexing strategies.

Norges Bank manages the fund with a view to achieving the highest possible long-term return within the constraints laid down in the mandate from the Ministry of Finance. Norges Bank manages the fund close to the benchmark index, but all investment processes have active components. This puts Norges Bank in a better position to generate the highest possible return and be a responsible investor.

The fund's return before management costs was -14.1 percent in terms of the fund's currency basket. Equities returned -15.4 percent, bonds -12.1 percent, unlisted real estate 0.1 percent and unlisted renewable energy infrastructure 5.1 percent. Management costs amounted to 0.04 percent of assets under management.

The management of the fund is to be cost-effective. Cost-effective management supports the objective of the highest possible return after costs. In the period from 2013 to 2022, annual management costs averaged 0.05 percent of assets under management. In 2022, management costs amounted to 5.2 billion kroner, or 0.04 percent of assets under management. The Executive Board is satisfied that management costs are low compared to other managers.

Does any of that sound familiar? The largest fund in the world is invested using ultra low-cost market index exposures and keeping their costs as low as possible lets the fund earn the best net returns. Simple math.

Their listed asset mix is: 69.8% equities, 27.5% fixed income, 2.7% unlisted real estate and 0.1% unlisted renewable energy infrastructure. Being invested largely in market based exposures necessarily means earning the returns of the markets. As you may know, the markets were down in 2022 across the board: stocks, bonds and real estate.

Accordingly, the Norway Government Pension was down 14.1% in 2022, or -1,637 billion kroner. An unpleasant result to be sure, but the largest investment fund in the world understands that the price for participating fully in up markets is participating fully and enduring down markets. It really is that simple.

The Active Management Delusion
We at CSCM long ago abandoned the notion that we could pick stocks and outperform the broad market averages. In fact our services are premised on exactly the opposite notion—that building broadly diversified, globally allocated, low-cost portfolios are the most direct path to better investment outcomes.

Still, the Active Management Delusion persists. The simplest answer as to why that is comes from the old saw "it is difficult to get a man to understand something if his salary depends on him not understanding."

Below are a few choice excerpts from a recent article in the CFA Institute's Enterprising Investor website, authored by Mark J. Higgins, CFA, CFP.

"My basic point here is that neither the Financial Analysts as a whole nor the investment funds as a whole can expect to 'beat the market,' because in a significant sense they (or you) are the market . . . the greater the overall influence of Financial Analysts on investment and speculative decisions the less becomes the mathematical possibility of the overall results being better than the market's." — Benjamin Graham

For more than 80 years, the fact that few active managers add value has been validated by numerous research papers published by government agencies, including the SEC, and such Nobel laureates as William Sharpe and Eugene Fama, as well as the experience of Warren Buffett, David Swensen, Charles Ellis, and other highly regarded practitioners. Despite a preponderance of evidence, many investors continue to reject the undeniable truth that very few are capable of consistently outperforming an inexpensive index fund. Outside a small and shrinking group of extraordinarily talented investors, active management is a waste of money and time.

After a time, Graham concluded that beating the market was no longer a viable goal for the vast majority of financial analysts. That did not mean that he had lost faith in their value; he just knew with mathematical certainty that outperformance was too tall an order for most. Despite his indisputable logic, his warning was largely ignored. By the 1960s, too many investment firms and investment professionals had staked their businesses and livelihoods on beating the market.

Why can't advisers and consultants accept the truth about outperformance? Because they fear it will lead to their obsolescence. It is a great irony, therefore, that the opposite is true. Once we let go of the outperformance obsession, we can add extraordinary value for our clients. Clients need us to hone their investment objectives, calibrate their risk tolerance, optimize the deployment of their capital, and maintain strategic continuity. By spending less time on unnecessary tweaks of portfolio allocations, the constant hiring and firing of managers, and unnecessary forays into esoteric asset classes, we can better serve our clients by focusing on what really matters.

The first step is to recognize and respect the wisdom of crowds. Only then can advisers and their clients join Benjamin Graham as elite investors.

Clothier Springs Capital Partners Update

We are currently in the process of seeking a new auditor for our annual audit. The audit is a regulatory requirement and we are hoping to save several thousand dollars from last year's audit fee.

With the dearth of capital events last year we are looking forward to having several of our investments re-appraised higher as a result of improved operating results. The auditor will ultimately sign off on whatever re-appraisals we agree on.

We made several investments recently: $150,000 with Penn Capital for their Creekside project in suburban Huntsville, Alabama and $75,000 with Mortar Group for their Newtown Flats project in Astoria, Queens in NYC. The source of capital for these investments came from a new member admitted at the end of March.

Both are equity deals with good preferred dividends and projected 20% or greater total annual returns upon exit.

Once interest rates stabilize, both buyers and sellers of multi-family properties will be better able to evaluate property valuations and transaction volume should pick up. That will let some of our mature deals exit and also bring new properties to the market.

Auditor Update
We are pleased to report that we executed an engagement letter on 5/5/2023 with Herbein & Company to perform our 2022 audit.

The process to identify and engage a new auditor was a little more protracted than we would have expected and we contacted more than half a dozen firms. Some never even responded. Some said they did not do this kind of work.

Interestingly, the pricing from the three prices we got varied from high to low by $18,500. Also, the low price came from the most responsive and communicative firm, Herbein. Needless to say their combination of competitive pricing and responsiveness carried the day for them. We look forward to sharing the results.

CLOTHIER SPRINGS
Capital Partners
Structure IS the Strategy

Coldplay - A Sky Full Of Stars (Live at River Plate)

1:51 / 4:48

Coldplay performing [“A Sky Full of Stars”](#) at a recent concert in Buenos Aires, Argentina. It is from a sold-out, ten-night run. Very few bands bring the energy and inspire as much joy as these guys do.

Closing Thoughts

The end of the fastest increase in rate hike history appears to be near, and with that the proximate cause of pressure on stocks will also end.

The rate hikes have put yield back in the markets and that is a welcome development. Many business activities are awakening from their Covid-induced torpor. We have begun attending local investment gatherings which had been halted for three years and there is anecdotal evidence that offices are opening up and companies really would like employees to be in the office again.

We receive endless pitches for investment product and it has become apparent that the private equity bandits are moving down market to exploit a whole new category of investors: private individuals. We have been skeptics of the private equity business model for some time and are very concerned that many advisors and private clients don't know enough to be highly circumspect about private equity pitches. Unfortunately, some or many of those sheep will be shorn before they learn the self-serving realities of private equity.

For now it's steady as she goes. Equity markets have posted two consecutive positive quarters. Bond prices have stabilized and one can now get paid to hold bonds and wait.

In our corner of the world the weather has turned to spring-like and after a winter with no snow, spring even seemed to arrive early. We'll take it.

Thomas F. McKeon, CFA | May 8, 2023