Warnke/Nichols Ltd. INVESTMENT MANAGEMENT
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LETTER OF VALUE

Ruminations for investors seeking to enhance their wealth using the principles of VALUE INVESTING

TO OUR BUSINESS PARTNERS:

There is a lot of discussion in the public forum about interest rates. It is quite a divisive topic. Market pundits fall into one of two camps. Either rates will gently slope down from here or there will be upward pressure applied to them over the long-term. Not a lot of people believe they will remain at current levels.

Those in the first camp point to commentary from the U.S. Federal Reserve on its policy interest rate, also known as the Federal (Fed) funds rate. This rate is important because it ultimately impacts how much consumers and businesses are charged for borrowing money. In his press conference on December 13, 2023, Fed Chair Jerome Powell hinted that rate hikes are likely over and that there could be several cuts in 2024 because the economy is slowing, and inflation is easing.

Then there are those in the second camp who believe that the U.S. Department of Treasury will have to go back to printing money to fund the government's already large and growing financial obligations, which in turn could lead to *higher* interest rates. This is because flooding the economy with dollars would result in stubbornly higher inflation, which the Fed would look to tame by raising the Fed funds rate, and because the Treasury Department would need to provide investors with an incentive to buy a burgeoning supply of new Treasury securities.

Higher rates seem far from the consensus view. Rather, investors are betting heavily on a lower Fed funds rate. A recent survey found that more than 60% of fund managers are expecting lower long-term rates, which the authors note is by far the highest percentage in the last two decades.

We are not sure if investors betting on lower rates will be accommodated. In fact, commentary within the notes from the Fed's December meeting seem to sow doubt about the prospects for rate cuts to begin this coming March as is widely expected. A prominent investment strategist said Fed officials appeared to be a "rather gloomy, worried bunch", which "seems out of line with the early and rapid pace of cuts the market is currently pricing in."

From an investment standpoint, higher interest rates could have a negative impact on stock prices. This owes to the fact that the value of a business is determined by how much cash it produces for the owners over its lifetime, with the estimated future cash flows discounted to the present day using an appropriate rate of return, otherwise known as the discount rate. The higher this rate, the lower the stock price typically.

In a recent memo, market sage Howard Marks wrote that he considers the forty-year decline in the Fed funds rate, from 20% in 1981 to 0% in 2020, to have been the most important event in the financial world in recent decades, because this "was probably responsible for the lion's share of investment profits made over that period." Marks went on to note: "Everyone who has come into the business since 1980 – in other words, the vast majority of today's investors – has, with relatively few exceptions, only seen interest rates that were either declining or ultra-low (or both)."

Why does this matter? Marks goes on:

"If the declining and/or ultra-low interest rates of the easy-money period aren't going to be the rule in the years ahead, numerous consequences seem probable:

- economic growth may be slower;
- profit margins may erode;
- default rates may head higher;
- asset appreciation may not be as reliable;
- the cost of borrowing won't trend downward consistently (though interest rates raised to fight inflation likely will be permitted to recede somewhat once inflation eases);
- investor psychology may not be as uniformly positive; and
- businesses may not find it as easy to obtain financing.

In other words, after a long period when everything was unusually easy in the world of investing, something closer to normalcy is likely to set in."

Many professional money managers have indeed lowered the discount rate they use to value businesses, believing that a lower than historical average rate represents the new normal.

What does it mean for you? We take no position on the direction of interest rates. Rather, your Business Partners first and foremost continue to require a 12% rate of return on investments and will only buy a company's stock if its market price is two-thirds or less of what we estimate to be its value. In addition, we seek to identify investment candidates that are growing through organic means and earn a high return on invested capital through a business cycle, financially strong, easy to understand, and owner-operated. These business characteristics are associated with exceptional long-term results and low risk in the stock market, provided the companies meet our valuation hurdles.

We believe this, combined with the current cash weighting, which is high because fewer businesses meet our hurdles at this time, reduces the potential impact on the value of your portfolios if upward pressure on interest rates does indeed happen. Our steadfast commitment to our investment philosophy since founding Warnke/Nichols over 30 years ago has served you well in this regard.

ON THE TOPICS OF PERFORMANCE…

While much has been made of the stock market's strong performance in 2023, what is lost on many is that the major indices have produced *negative* returns over the last two-year period.

On a total return basis, the market cap-weighted S&P 500, equal-weighted S&P 500, Dow Jones, and Nasdaq Composite were up 26.3%, 13.9%, 14.2%, and 44.6% in 2023, respectively. However, this misses the fact that these indices need to increase by 36.2%, 22.9%, 17.6%, and 65.1%, respectively, to recoup their losses in 2022.

Conversely, our group of portfolio stocks has produced *positive* results over the last two years, which speaks to the benefit of continuing to adhere to our discipline.

…AND VALUATION

Quantitatively speaking, Advisor Perspectives calculates that "the market", which they define as the S&P 500, is overvalued by a whopping 80-140%, depending on the valuation method used. From a qualitative perspective, journalist Herb Greenberg notes that a popular measure of fear and greed in the marketplace, on a scale from zero being extreme fear to 100 being extreme greed, currently sits at a "greedy" 98.

We heed Warren Buffett's wise advice: *Be fearful when others are greedy and greedy when others are fearful.*

IN MEMORIUM – CHARLES T. MUNGER

Buffett's long-time business partner and Vice Chairman of Berkshire Hathaway passed away late last year at age 99. He was a giant among money managers and thinkers worldwide.

In addition to voluminous tributes recently written, we also highly recommend reading *Poor Charlie's Almanack – the Wit and Wisdom of Charles T. Munger*. It is a collection of his best talks, quotes, and ideas. Benjamin Franklin was Munger's most notable role model, and Munger is one of ours. Here is a favorite sample:

> *Invert, always invert. Turn a situation or problem upside down … Instead of looking for success, make a list of how to fail – through sloth, envy, resentment, self-pity, entitlement, and all the mental habits of self-defeat. Avoid these qualities and you will succeed. Tell me where I'm going to die, so I won't go there.*

TURNING THE PAGE

As we bid adieu to 2023 and ring in the New Year, we thank you for your ongoing trust and confidence in us, and wish you all a happy, healthy, and prosperous 2024!

> *…while enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster.*
>
> \- Benjamin Graham, The Intelligent Investor

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