ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

October 2, 2023

Dear Clients:

Warren Buffett described interest rates in 2013 as such: "Interest rates are to asset prices like gravity is to the apple." As of September 29, interest rates on US Treasuries had a minimum yield of 4.6% (5 year) and a maximum yield near 5.6% on less than one year T-bills. The last time US markets observed these levels of interest rates was 16 years ago, which was the first year Apple introduced the iPhone! The era of low interest rates may be coming to an end as the Federal Reserve attempts to reduce inflation and focus on price stability. As the economy moves from one interest rate regime to another, the assumptions used to determine asset prices will adjust accordingly. This principle of valuation served as a tailwind to assets prices over the last decade and a half, but also created reckless risk-taking and numerous misallocations of resources, with the most recent examples being meme stocks, various cryptocurrencies and zombie companies (only alive through the issuance of cheap debt). Looking forward, assuming rates do not revert back to historic lows, investors must give careful consideration to what they are willing to pay for the future cash flow of a particular security.

The most important attributes for fixed income investors are Interest payments from bonds and promised principal repayment. For some time, promised repayment became the only deliverable as income from bonds became microscopic. However, the rapid drop in bond prices has brought more attention to the volatility of bonds. The time between issuance and maturity for bonds is subject to price adjustments depending on the change in interest rates and the change in credit quality of the borrower. As of the end of Q3, the US Aggregate Bond Index will have produced almost 3 years of negative annual returns: -1.77% (2021), -13.02% (2022), -1.21% (YTD). While these numbers may be hard to digest, some investors may have been convinced interest rates would stay low for several decades thus purchasing even longer dated bonds. Over the same time period, the iShares 20+ Treasury Bond ETF, aka "highest quality issuer on Earth," produced the following results: -4.60% (2021), -31.24% (2022), -9.0% (YTD). Those unfortunate investors were chasing yield in the wrong places. With inflation numbers still above the target (2%) set by the Federal Reserve, the current path for interest rates should not be much different over the next 6-12 months.

As interest payments from owning bonds increases, investors are generating more income without taking on additional risk. The "chasing yield" behavior through either owning higher-yielding debt or adding more exposure to stocks is becoming less prevalent. Higher-yielding bonds are a result of two factors: companies with greater uncertainty on future cash flows to pay back their debtors, or investing in bonds with longer term maturities. Our firm has minimized this type of risk throughout the declining interest rate environment as we mostly purchased short-term, high credit quality bonds. We viewed the long-term outlook as unfavorable due to not enough yield for the amount of risk. We are considering extending bond maturities but maintaining high credit quality as yields reach levels that deliver cash flows more consistent with some investors' needs.

Unlike bonds, stocks are not issued with a maturity date or coupon. Dividends can be a benefit of owning stocks, but companies can suspend these for various reasons such as during COVID. The expected future cash flows including dividends, the growth rate of those future cash flows and the discount rate are the primary factors to determine the intrinsic value of a stock or group of stocks such as the S&P 500. All three of these components are facing near term pressures as the Fed uses its main source of influence to slow down the economy and consumer price increases. The test for companies will be how their business can adapt to changing consumer preferences and if their profit margins can be maintained from either controlling cost or raising prices. As mentioned in last quarter's investment commentary, the US stock market is top-heavy with 8 positions holding a roughly 28% weighting. This level of concentration in the index suggests the growth rates for these companies will be less impacted than the broader market. Perhaps their competitive advantages allow them to enjoy longer runways of higher profitability, but at some point the expectations become overestimated. The recent boost in prices from the mention of artificial intelligence is an example of excessive optimism as investors have limited information on the future profits of a new technology.

Rob Arnott, another well respected observer of markets, described interest rates as a "speed bump," which helps reduce reckless behavior. We embrace that view that markets need a rational pricing mechanism present to allow capital to move where it is most appropriate. Government intervention, while sometimes necessary, promotes further reckless behavior if certain businesses act with the idea that the system will deliver life support under stressful times.

Market Returns as of September 30, 2023

The total return on the CRSP Total US stock market index for year to date and trailing twelve months was 12.3% and 20.4%, respectively, as smaller capitalization stocks under-performed the S&P 500 TR Index which had returns of 13.1% year to date and 21.6% trailing twelve months. The total return on the MSCI-ACWI ex-USA stock index for the same time periods was 5.3% and 20.4%, respectively. Non-US stocks are cheaper relative to US stocks currently. We believe maintaining exposure to non-US markets offers diversification benefits and the potential for better forward returns.

The total return on the Bloomberg US Aggregate Bond Index for year to date and trailing twelve months was -1.21% and 0.64%, respectively. This index is comprised of all outstanding US investment grade taxable fixed rate bonds. As the US continues to run deficits annually, the amount of US government obligations will also become a higher weighting in the bond index. Currently, the US Aggregate Bond Index holds roughly a 70% weight of government debt consisting of 42% Treasuries and 27% mortgage backed securities (MBS).

Our View Going Forward

Stocks appear to be range bound until there is further clarity on the direction of the economy, the health of corporate earnings, and the path of interest rates. The economic data seems trending in the right direction to show progress on inflation, but the battle becomes more nuanced when taking inflation from the high 3s to a target of 2. This task does not lend itself to a smooth transition, thus we remain cautious about the pricing of stocks. There are so many other idiosyncratic risks (oil supply, escalating war, political noise, labor shortages, union strikes, government shutdowns, bank failures, housing market, etc.) which add to the uncertainty and day to day volatility. We maintain meaningful weights to stocks with solid earnings and balance sheets priced at lower earnings multiples. Allocations to index holdings will rise as index multiples decline, while allocations to active strategies will rise as index multiples move higher. We expect to maintain a tilt to higher quality fixed income but to begin extending bond durations to core intermediate positions in light of the rise in interest rates. Bond yields are beginning to offer reasonable compensation for the risk from duration extension.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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