The Conservative Strategist

APRIL 2022

A QUARTERLY INVESTMENT NEWSLETTER PUBLISHED EXCLUSIVELY FOR CLIENTS OF SEASONAL STRATEGY

An ocean of risk

> *"Russia's brutal attack on Ukraine has upended the world order that had been in place since the end of the Cold War, more than 30 years ago… [It] has put an end to the globalization we have experienced over the last three decades.*
>
> — Larry Fink, CEO BlackRock
> BlackRock annual shareholder letter March 24, 2022

There's a lot going on right now. Russia's brutal aggression in Ukraine and the accompanying refugee crisis in Europe. Persistent inflation and rising interest rates. And a resurgence of COVID in the country where it originated. For an investor, it's important to keep one's focus on what matters most.

Let's see if we can boil down the current uncertainties to a few questions:

1. How will the aggression in Ukraine be resolved?
2. Will inflation recede toward the Fed's 2% target, continue to stay in the upper single-digits, or climb even higher?
3. Will the Fed continue with quarter-point rate increases, or move to half-point increases and quicker monetary tightening?
4. Will the combination of higher energy prices, rising rates, and growing uncertainty for international businesses send the US and other key countries into recession later in 2022 or 2023?
5. Is the current COVID outbreak in China (Omicron BA.2) containable? Or is it on a path of spread to other countries?

No easy answers

No easy answers to any of these questions, and these are far from mutually exclusive issues. Take war and inflation. Not only is the cutoff of Russian energy supplies inflationary, but it's important to bear in mind that together, Russia and Ukraine account for 25% of global wheat exports, and Ukraine alone accounts for 13% of global corn exports. Unsurprisingly, wheat saw its sharpest weekly rise ever in the first week of March.

And consider inflation and interest rates. Inflation is simply the erosion of money's value, and interest rates are the cost of renting money. It follows then that if inflation rises, lenders must charge higher rates of interest to compensate them for the greater erosion. The connection can be interrupted or delayed by government intervention, but sooner or later higher inflation leads to higher rates.

Rates are soaring

We're seeing that today. The Fed has artificially suppressed rates for years to forestall recession. But now, a combination of forces, including pandemic-related supply shortages and war in Europe, are sending inflation far out of its zone of the past several years, and forcing rates to play catch-up on the upside. That's why this quarter saw the sharpest increase in rates in many years, leading to the worst bond market drawdown ever (see page 3).

How far can rates rise? It's quite unclear, because while rates depend on where inflation trends and ultimately settles, the move in rates also impacts where inflation moves. But clearly rates have much headroom. Consider this: The latest reported annual inflation rate is 7.5%, while the benchmark ten-year Treasury rate, even after a steady rise, is only 2.47%. So on a real (inflation-adjusted) basis, the Treasury is yielding *negative* 5.03%. Given that over time, lenders demand a positive real return for the risk of lending, this negative real return will not persist. It will be resolved either by a drop in inflation toward former levels, a steep rise in rates, or a combination of the two. ■

The Markets March 31, 2022	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	4530.41	-4.64%	-4.64%
International Stocks (Vanguard Index)	19.17	-6.13%	-6.13%
Emerging Markets Stocks (Vanguard Index)	29.21	-6.28%	-6.28%
Real Estate Stocks (Vanguard REIT Index)	36.02	-6.01%	-6.01%
Bonds (30 year US Treasury/Vanguard Index)	2.44%	-10.36%	-10.36%
Dollar (US Dollar Index)	98.36	2.49%	2.49%
Gold (London Afternoon Fix)	$1933.85	7.09%	7.09%
Money Market Funds (Vanguard Cash Reserves Fed)	0.17%	0.01%	0.01%*

*change in yield

Portfolio Planning

Berkshire and the lifeboat mentality

There have been a number of divergences and outliers in this past volatile and chaotic quarter. One of the chief outerperformers was Warren Buffett's *Berkshire Hathaway.* While the S&P 500 fell 4.64% in Q1, *Berkshire* actually gained 18.03%. That's an outperformance of 22.67%, which is wider than any *whole calendar year* since 2007 (see chart).

How to explain *Berkshire*'s return? Three reasons: 1) *Berkshire*'s internal strength, 2) changing market dynamics, and 3) investor behavior.

1: Berkshire's internal strength

Berkshire runs two portfolios in one: Private operating companies, and public companies (common stocks). In Q1, it was firing on both cylinders. Some highlights:

Among the operating companies, *Berkshire Hathaway Energy* (BHE) shone in a quarter that was strong for all things energy. *Berkshire*'s already brilliant 2020 purchase of natural gas pipelines and storage facilities from *Dominion Energy* looks even more timely in light of the tragic events in Ukraine and the resulting stoppage of Russian natural gas to Europe.

As for the public companies, Buffett has been criticized for amassing such a concentrated position in *Apple,* now 45% of the public portion of *Berkshire*'s portfolio. But *Apple* hit an all-time high in early January, and its 5% decline since then is actually much milder than the typical tech stock.

Further, Buffett picked up stakes in several Japanese conglomerates a few years ago, a move some critics questioned. But in Q1, Japan value stocks held up well, and the companies, now 17% of the public portfolio, offered good ballast in an otherwise difficult quarter.

Berkshire's biggest edge in years

Berkshire Hathaway *vs.* S&P 500 — Total returns, 2007–2022 Q1

	Berkshire	S&P 500	Edge
2007	28.7	5.5	23.2
2008	-31.8	-37.0	5.2
2009	2.7	26.5	-23.8
2010	21.4	15.1	6.3
2011	-4.7	2.1	-6.8
2012	16.8	16.0	0.8
2013	32.7	32.4	0.3
2014	27.0	13.7	13.3
2015	-12.5	1.4	-13.9
2016	23.4	12.0	11.4
2017	21.9	21.8	0.1
2018	2.8	-4.4	7.2
2019	11.0	31.5	-20.5
2020	2.4	18.4	-16.0
2021	29.6	28.7	0.9
2022 Q1	18.0	-4.6	22.6

Berkshire Hathaway beat the S&P by more than 22 percentage points in Q1. That's a bigger margin than any full year performance since 2007. And in one quarter, it makes up for nearly two-thirds of Berkshire's underperformance in 2019 and 2020. *Source: 2021 Berkshire annual report, YCharts*

2: Changing market dynamics

Higher inflation and higher interest rates — that's been the simple story of investment markets in the past few quarters, particularly Q1. It's a dramatic shift from the low inflation/low-rate dynamic of the past several years. *Berkshire* is prepared fully for such a change.

On the private company side, it owns niche dominators with key competitive advantages ('moats') and broad pricing power. Think *BNSF Railroad, GEICO* and the aforementioned *BHE.*

Among public companies, moats again abound in *Berkshire*'s portfolio *(Coca-Cola, Kraft-Heinz),* as do energy companies *(Chevron, Occidental)* that benefit from higher inflation and financial companies *(American Express, Bank of America,* and *BNY Mellon)* that typically prosper as rising interest rates boost their net interest margin.

3: Investor behavior

The first two elements raised the value of *Berkshire*'s holdings in Q1. But they don't fully explain *Berkshire*'s rise in *price* in the quarter. Its price rose more than its value, as investors bestowed a higher valuation on its shares, raising *Berkshire*'s price-to-book value from roughly 1.32 at 2021 year-end to 1.54 in late March.

Three explanations for this, but the ruling metaphor is that of the lifeboat. As the market environment gets more risky, investors tend to pile into the lifeboats — those investments perceived as sink-proof.

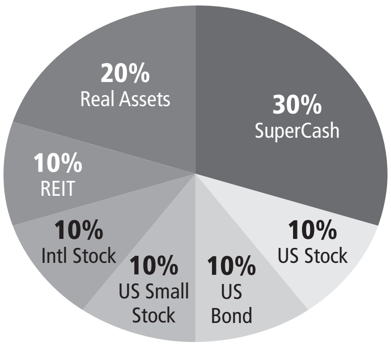
First, the rise in economic and geopolitical risks has spurred an investor flight to the highest quality and most stable companies. This explains why the likes of Berkshire have prospered

(Continued on page 4)

SuperDiversified Portfolios (SDPs)

SDP1 outperforms in times of crisis

SDP1 ***Conservative***

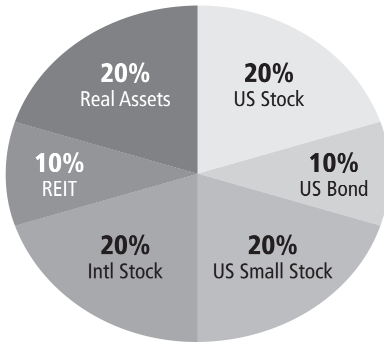


1st Quarter ***1.62%***

Last 12 Months ***13.40%***

It may surprise you to see a positive Q1 number in this section, but the SDP1 portfolio in particular is constructed to perform in times of geopolitical and financial stress. In particular, the 30% invested in lower-volatility SuperCash funds have held up well, while the 20% Real Assets allocation has soared.

SDP2 ***Moderate***



1st Quarter ***0.38%***

Last 12 Months ***15.21%***

That's half of the overall model portfolio that's risen sharply on balance, offsetting the poor showing of the other half, mostly consisting of conventional stocks and bonds. Related to this, SDP1 has beaten the narrower *Vanguard Lifestrategy Conservative Growth* fund by a record 7+ percentage points this quarter.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Bonds tank, commodities soar

Asset Class	Mutual Fund	Performance 1st Quarter '22	Performance Last 12 Months	
SuperCash	PIMCO Instl Low Duration	-3.01%	-3.68%	Best
	Merger	0.17%	-0.87%	Worst
	Calamos Market Neutral	-1.36%	1.97%	
US Stock	Vanguard Index Trust 500	-4.64%	15.48%	
US Bond	Vanguard Long-Treasury	-10.36%	-1.52%	
US Small Stock	Vanguard Small-Cap Index	-5.77%	0.56%	
Intl Stock	Vanguard Intl Index	-6.13%	-1.91%	
REIT	Vanguard REIT Index	-6.01%	21.29%	
Real Assets	PIMCO Commodity Real Return	26.86%	55.89%	

War and inflation have hit stocks, but it's the bond and commodities markets that have seen the sharpest moves. High-quality bonds are suffering record declines. Consider that in the first quarter alone, *Vanguard Total Bond* (VBMFX) fell 6.17%, while in the worst full year in its history (1994), it fell only 2.66%.

Meanwhile, Real Assets have surged. Benchmark *PIMCO Commodity Total Return* (PCRIX) rose nearly 27% in Q1, and we also saw strong returns on other assets within the Real Assets space. Gold miners rose nearly 20%, energy infrastructure rallied 19%, and renewables (BEP/BEPC) added more than 16%.

Fed hikes

Since 2000 (that's 22 years if anyone is counting), the Fed hasn't hiked rates by a half-point at any meeting. But in March, Goldman Sachs predicted that the Fed would have to hike rates by a half-point in each of its next two meetings.

Morgan Stanley's and Jefferies' bond experts later endorsed that view.

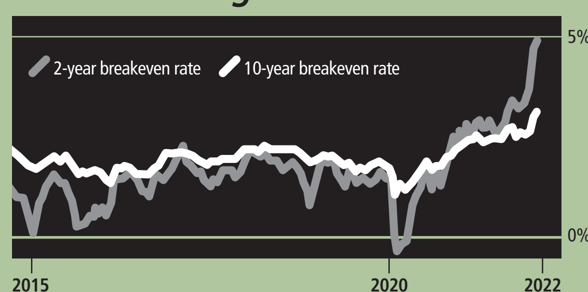
Then Citigroup went a step further, and predicted that the Fed would raise rates by a half-point at each of the next four meetings. And Citi added that if inflation should rise from here, we could see a three-quarter point or even a full point hike to quell rising prices.

Finally, sources close to JP Morgan's Jamie Dimon, arguably the country's most prominent banker, say he expects the Fed to execute 12 to 15 rate hikes, and raise rates by as much as 3.75 percentage points — an increase from 6 to 7 hikes forecast as recently as January.

That's how far behind the curve the Fed stands, after years of inaction, a mere quarter-point rate hike in the last meeting, and the aggravating factor of energy and food shortages.

Yet the bond market seems oddly unperturbed…

Inflation expectations, short- and long-term



Traders in the $30 trillion bond market seem worried about where inflation will go in the next two years, but not so much in the next ten. This can be measured by the difference between fixed- and floating-rate Treasuries, the so-called breakeven rate. Breakeven for the two-year timeframe currently hovers around 5%, while the longer-term breakeven is at a much more reasonable 2.6%.

Source: bloomberg.com

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Berkshire and the lifeboat mentality

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while investors have deserted the highly speculative companies in the *ARK Innovation* ETF.

Investors have also fled growth companies for value companies, because of the way each group is valued. Growth companies are valued according to their long-range cash flows, and higher rates discount those flows. Value companies, meanwhile, are valued more according to the sum of their parts. Here inflation can be a friend.

Finally, as interest rates rise and capital becomes more constrained, investors place a premium on companies with ample liquidity. Given *Berkshire*'s $140 billion in cash, and its performance during the 2007-2009 financial crisis, with Buffett making lucrative deals amidst investor panic, it's only right that investors place a high value on the flexibility that Berkshire's current liquidity position provides.

Is Berkshire still cheap?

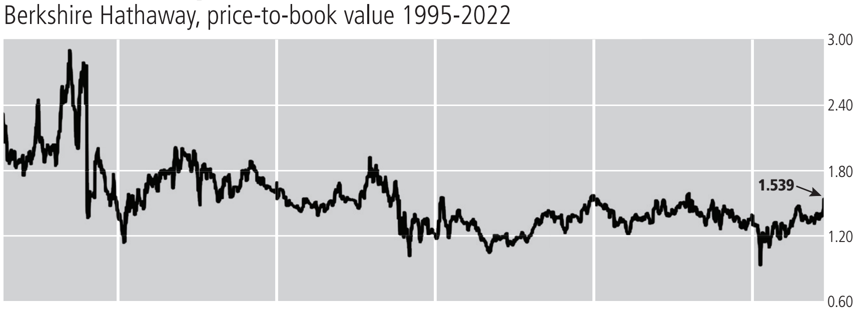
Given *Berkshire*'s astonishing outperformance this quarter, it's reasonable to question whether it's now overpriced. To determine this, it's best to look at *Berkshire*'s price in relation to its book value. There are all kinds of problems with valuations according to book value, the chief one being that book value does not recognize intangible assets. As we have moved from an asset-based economy to a knowledge-based economy, book value has less relevance. But in an apples-to-apples measurement of a company's valuation compared to its own history, book value at least provides some context.

And for *Berkshire*, the accompanying graph shows the stock moving toward the pricier end of its ten-year range. For the past ten years, the stock has fluctuated 98% of the time between 1.0 and 1.6 times book value. At the current 1.54 times book, it is in the topmost decile of that valuation range. If we stretch out the range to the past twenty years, we see book value spiking to the 2.0 area in a couple of instances. That would make the current 1.54 less worrisome.

Still, we're taking advantage of the current run-up to lighten *Berkshire* in accounts that may be overallocated to the stock, with an eye toward shedding even more exposure should the run continue.

Berkshire expensive now?

Berkshire Hathaway, price-to-book value 1995-2022



Based on its book value, Berkshire Hathaway hasn't been this expensive since 2018, and is nearly as pricey as it's been since the Great Financial Crisis. Before then, it traded in a somewhat broader range, and even saw its stock in a mini-bubble of sorts during the late 90s boom. Source: YCharts

The future for Berkshire

Longer-run, we have both concerns for *Berkshire* and confidence in it.

The concerns? One is the concentrated *Apple* stake. We would like to see *Berkshire* shed some of that position and achieve better balance in its public stock portfolio. *Apple* is a lifeboat for tech investors; *Berkshire* is a lifeboat for older-line, value-oriented investors. The problem with lifeboats is they can get too crowded.

We're concerned too that Buffett may announce his retirement in one of the next two or three annual meetings (held in early May). This may not hurt the stock in the long run, but it will likely dent it in the ensuing weeks and months, as uncertainty abounds.

The confidence? We think Buffett has done a fine job in building a structure and culture that will survive him and in fact thrive. (The market may disagree, at least for a while). For instance, the two investment officers to whom he has delegated management of a portion of the stock portfolio, Ted Wechsler and Todd Combs, have done so well (better than Buffett himself) that over the past decade, he has increased their assets from $2 billion to $34 billion — and rising. ■