OSBORNE PARTNERS
Capital Management, LLC

2022's Painful Lessons

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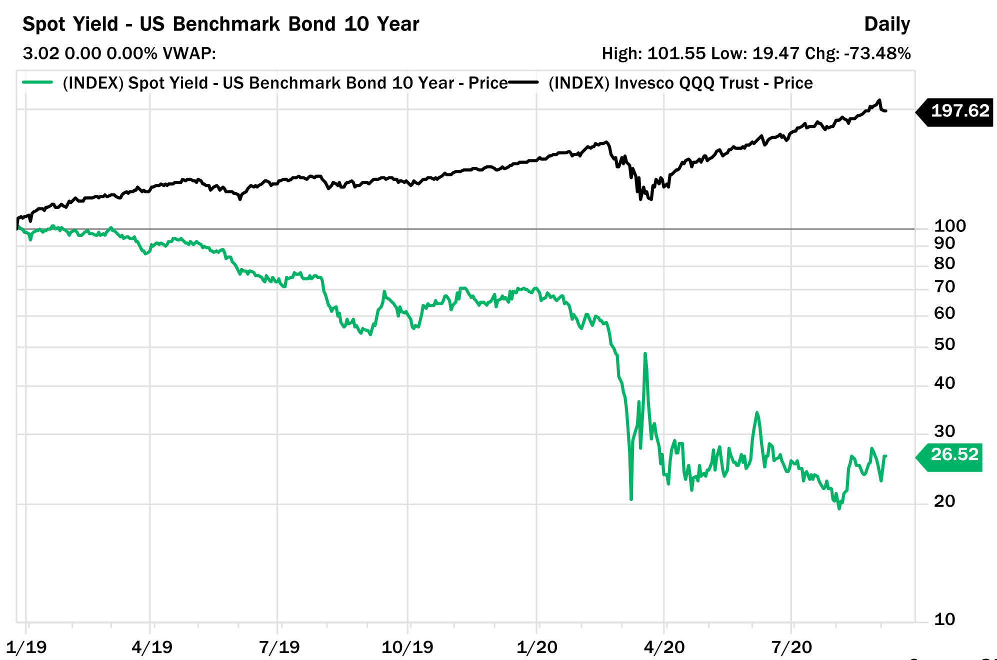
July 2022

In this piece, we review the important lessons that investors learned so far in 2022, and why our Investment Team strives to avoid these mistakes every day.

As the painful first half of 2022 ended, a number of previously held asset class records ended as well. In equities, the S&P 500 fell 20% during the first half of the year, along with the Nasdaq falling 30%, resulting in the worst first half of a year in over 50 years. At the opposite end of the risk spectrum, fixed income, which is used in portfolios for risk reduction and income generation, broadly fell 10% (Bloomberg U.S. Aggregate Index), a sizeable negative return not seen in centuries. In this uniquely negative and volatile period, investors learned a number of painful lessons – mistakes we strive to avoid every day as an investment team. Let's review what 2022 has taught investors.

Avoid using an investment discipline that is dependent on one or two variables:

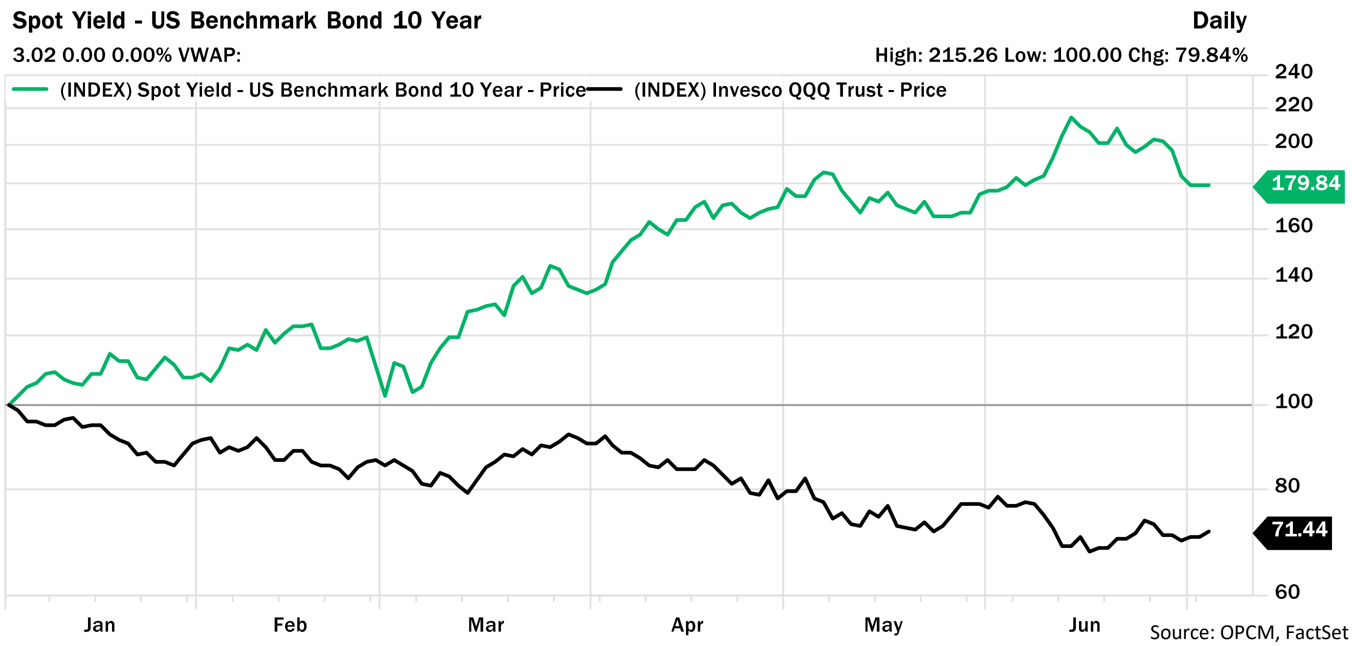


Source: OPCM, FactSet

December 2018 to September 2020 – Interest rates fall (green), growth-focused Nasdaq rises nearly 100% (black)

From 2008 through 2021, a cascading series of events from the global financial crisis (2007-2009), to a European debt crisis (2011), to a profit recession (2015), to a trade war (2018), to a global pandemic (2020-2021) required global central banks to keep short-term interest rates at abnormally low levels in order to avoid a recession. With interest rates pegged at a record low rate for over a decade, investors specializing in "growth investing" saw returns (and valuations) for their investing style consistently climb over the years.

Growth equities are typically valued on future earnings using a discount rate based on present interest rates. With short-term rates so low, future earnings were "discounted" at an abnormally low rate for years causing valuations to rise. When valuations rise, growth investing becomes more and more dependent on interest rates staying low. But when low interest rates reverse, growth equity strength also reverses.



Year-To-Date 2022 – Interest rates rise (green), growth-focused Nasdaq falls nearly 30% in only six months (black).

For example, in the recent growth cycle, software companies were very popular– earnings were consistent, and low interest rates enabled valuations for the industry to climb from an average of 3.7 times enterprise value-to-sales (EV/S) to 10.7 times over five years. As interest rates rose sharply from late 2021 to June 2022, software stocks (and almost every other growth industry) saw their multiples deflate. In the case of software, by mid-June 2022, the group had traded down to only 5x EV/S.

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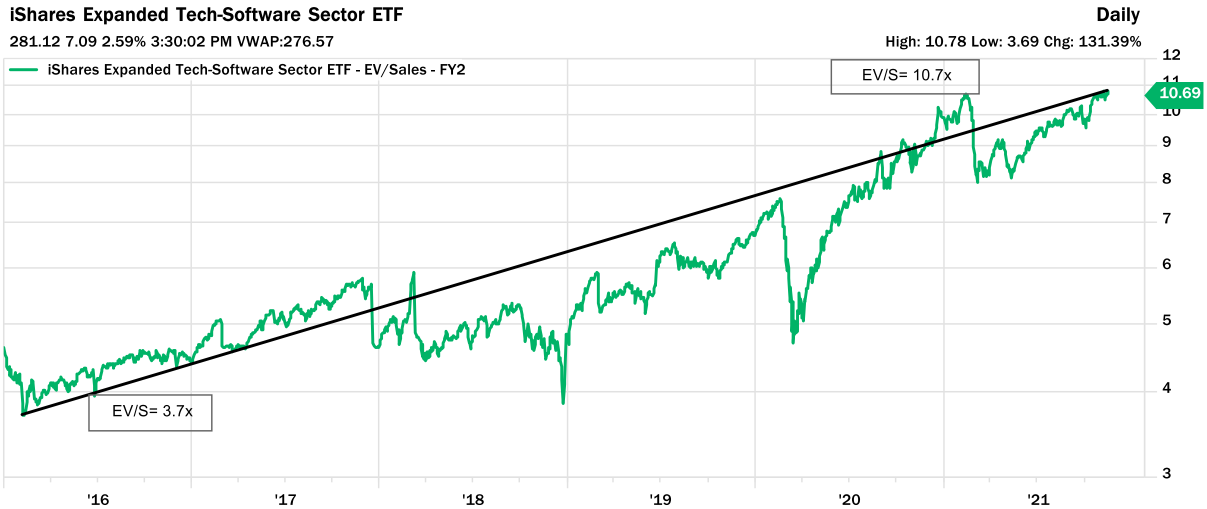

Source: OPCM, FactSet

Many "famous" growth-oriented hedge funds and investment managers, who were dependent on interest rates being pegged at abnormally low levels, were hailed as investment geniuses during 2021 as they were poised to post another year of strong performance. However, once interest rates started to rise, their performance quickly reversed and steep losses were posted for most during 2021. As interest rates continued to normalize higher, most of these managers have found themselves down 30% or more in 2022. Several firms who were caught taking too much risk have shuttered after suffering losses of over 40-50% since the start of the year.

The first half of 2022 taught investors to use investment disciplines that can perform well in multiple environments and not be overly dependent on any one variable for success.

Valuation always matters in the end:

Eventually, "valuation always matters." A simple phrase, but an important one in investing, whether the asset class is real estate, art, or equities. In all asset classes, there are periods when valuations match fundamentals, and periods when valuation disconnects from fundamentals. After trading well below long-term averages during the pandemic, valuations began to matter less in late 2020 and 2021, which resulted in a valuation overshoot for many asset classes. The valuation overshoot reversed later in 2021, and by June 2022, valuations returned to below long-term averages.

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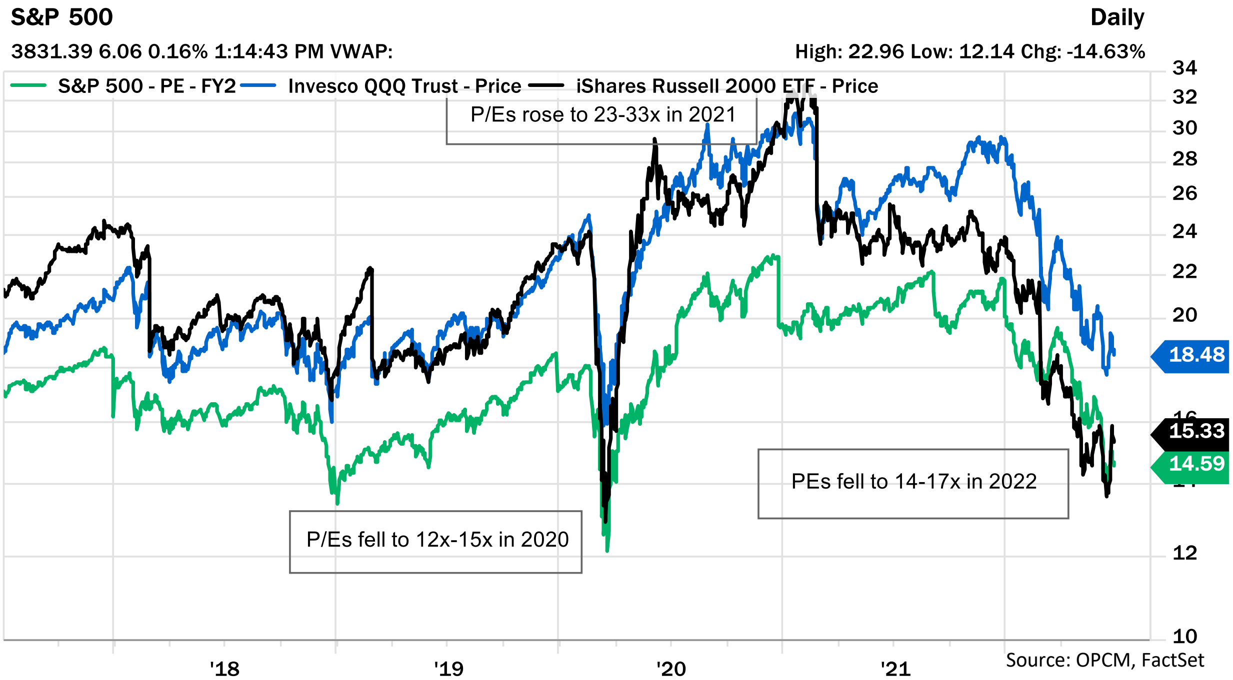

Over the past 9 quarters, P/E valuations for the major U.S. equity indices have nearly round tripped from 12-15x to 23-33x and back. Nasdaq 100 (blue), Russell 2000® (black), S&P 500 (green).

History has repeatedly shown that one of the most important components to achieving higher than average returns is an investor's starting valuation point. Lower starting valuation generally equals higher longer-term returns and vice-versa.

The first half of 2022 taught investors that valuation matters over the long-term even if the consensus forgets that fact in the short-term. Our investment team monitors valuation and Reward-to-Risk Ratios (RRR) for our portfolio daily. These RRRs are an important factor in our strict buy and sell decisions.

Most implosions have a common theme – leverage:

What happens when you marry an aggressive investing style with aggressive holdings and leverage? The first half of 2022 has witnessed some surprising and epic investment firm implosions and shockingly poor returns. Stories surface weekly about the latest star hedge fund to collapse after posting back-to-back down 30% or down 40% years. More recently, numerous crypto hedge funds are in the news for returns that are so poor, it's hard to believe the numbers are even possible.

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Leverage cuts both ways – increasing returns in bull markets, but amplifying losses in bear markets. Years of abnormally low rates and increasing market valuations meant many firms and individuals disregarded or minimized the inherent risk of leverage. The liquidations and shockingly poor returns at many hedge funds and firms are the result of abusing leverage, eschewing diversification, and disregarding valuations.

Simple math shows these results are readily available with the use of leverage. To use some previous examples in this piece, assume you are the star hedge fund manager for the Skyrocket Fund. Investors have entrusted you with $2 billion to manage in your "concentrated growth strategy." You take the $2 billion and buy a concentrated group of software and other high growth technology stocks. However, at the same time, you borrow $4 billion from your prime broker to "amplify" the strong returns you expect in the growth stocks you own. So now you have $6 billion invested. Next, record low interest rates start to normalize, and your growth stocks, with former P/E valuations of 40, deflate to a more normal 27. The fundamentals of your holdings are unchanged, but the valuations have normalized due to rising interest rates by falling from 40 to 27 (down 32%). A negative 32% return is very similar to the return of the Nasdaq in 2022, except for one major problem – your negative 32% return is on investments totaling $6 billion. You just lost 32% of $6 billion…or $1.92 billion. The investors who entrusted you with $2 billion, now have $80 million. The Skyrocket Fund essentially lost their entire asset base.

The last six months has taught investors that if leverage is simply avoided, one of the most common culprits in poor performance is eliminated.

There is a major difference between investing and speculation:

At the end of most bull markets, typically some level of speculation arises. Sometimes it takes the form of a frothy IPO market, other times the speculation is more serious. 2020-2021 ended up being more reminiscent of the latter. While the S&P 500 peaked at a P/E of 23 times forward earnings, and the equally weighted S&P 500 barely touched a P/E of 20, the combination of previously mentioned record low interest rates, and a pandemic-induced recession which brought with it government stimulus checks to consumers, enabled numerous small speculative bubbles to inflate.

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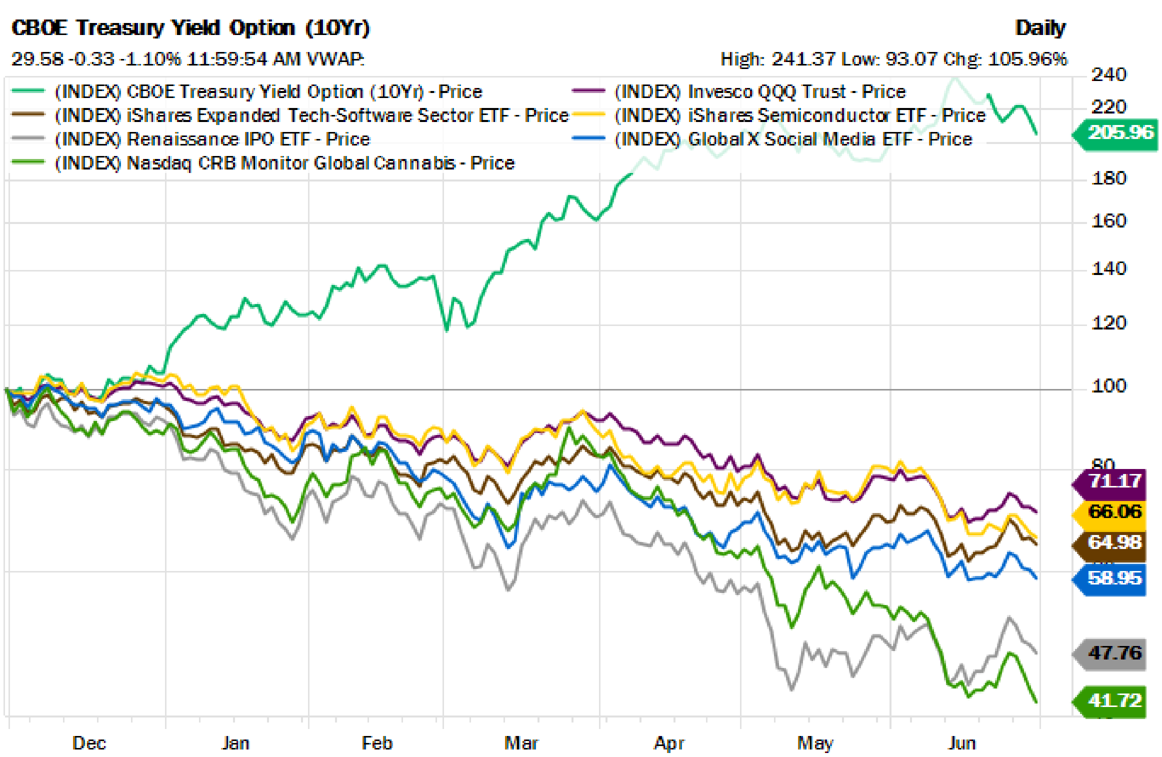
In the aftermath of most crypto coins, non-fungible tokens, SPACs, memes, and IPOs cratering, losing investors trillions of dollars, another vintage of investors learned the difference between investing and speculating. Typically, "investing" requires a few basic characteristics for the target investment to even be considered – you can start with requiring the investment to have an actual product, revenue, margins, company management, and reasonable debt. Then move on to fundamental, balance sheet, and valuation analysis. The speculation of 2020-2021 was the most egregious since 1999-2000. Investors were speculating on coins with no purpose, tokens with no value, SPACs with no acquisition target or targets that did not have the characteristics to be a public company, and public companies with very little future prospects in dying industries.

The low interest rates, stimulus checks, and work-from-home ("speculate-from-home") environment eventually normalized, and the speculation cycle ended. While most of the investments mentioned above are now worthless, even some of the less speculative, but volatile areas experienced a brutal first half of 2022.

Source: OPCM, FactSet



An unprecedented period of near zero interest rates prompted rampant speculation. Many of these speculative investments that our investment team wrote about and warned about in the past had no actual intrinsic value and are now down 30-50% in 2022 alone.

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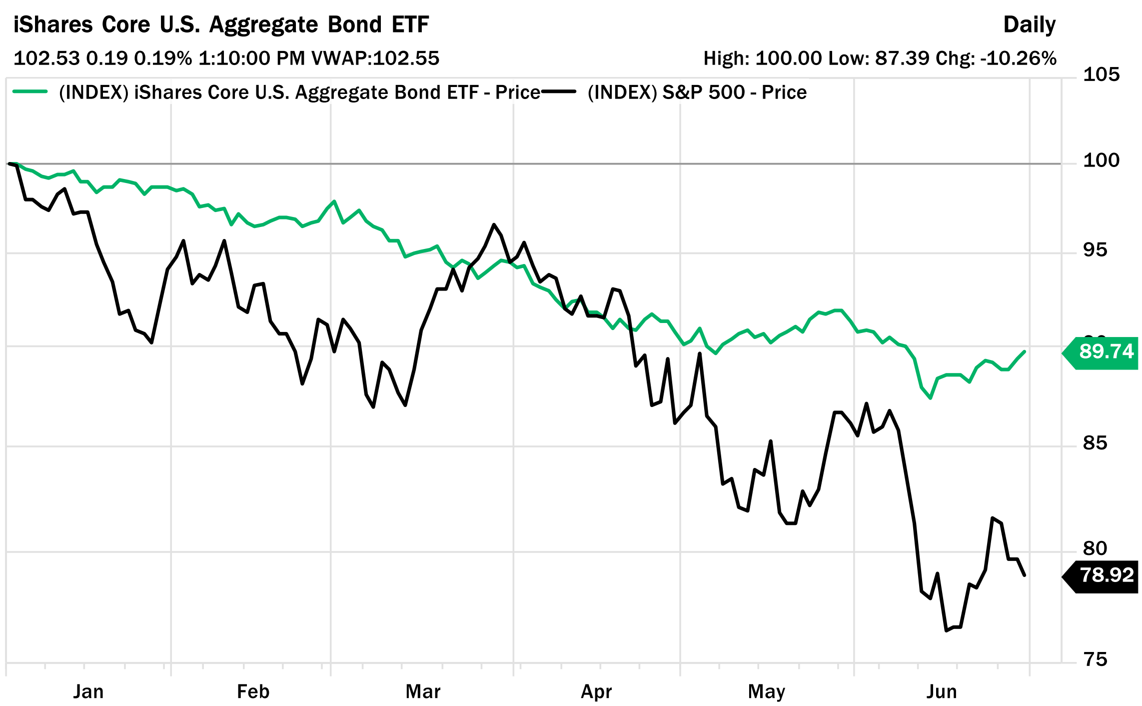
Under no circumstance does Osborne Partners speculate. Every investment in every asset class in your portfolio passes through a rigorous process of quantitative screening, fundamental analysis, balance sheet/leverage/debt analysis, valuation analysis, and economic cycle analysis prior to adding the investment to your portfolio. Our discipline is style agnostic, and dependent on purchasing these investments with high reward-to-risk ratios and monitoring the investment thesis through the holding's lifecycle – typically one to five years.

The simple 60%/40% model does not automatically deliver 7% returns per year:

For the past 20 years, more conservative investors heard the mantra of owning a "60/40 portfolio." An investor would own 60% of their portfolio in U.S. equities and 40% in U.S. bonds, and the discipline would churn out 7% annual returns with only moderate risk. Unfortunately, those consistent, historic returns were generated as U.S. equities valuations were tame and rising, while fixed income posted one of the longest and strongest bull markets in history, culminating with record low interest rates. Additionally, only investing in two asset classes provides less protection against various market outcomes such as inflation or currency movements or strong real estate markets. What happens when interest rates begin to normalize as equities underperform? 2022 happens.



Source: OPCM, FactSet

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The days of earning a consistent, positive 7% annual return in a 60% S&P 500 and 40% Aggregate Bond portfolio ended in 2021. So far in 2022, this seemingly conservative investment style is down over 16%.

2022 taught investors that a portfolio comprised of multiple asset classes is needed to truly reduce risk, while stocks and bonds are easily capable of moving in the same direction.

One of our most important jobs:

Most envision our investment team as a group of CFA® Charterholders who sit in front of multiple computer screens and use Excel spreadsheets all day to select the best investments for our multi-asset class portfolios. Meanwhile, the Portfolio Counselors are experienced CFP® practitioners who build financial plans for you and update you on your portfolio. However, there is an aspect to our jobs that is equally important.

On the investment management side, the avoidance of assuming too much risk, and eliminating any temptation to add too much risk to the portfolio is a key component – a large portion of our performance history is derived from monitoring risk, avoiding speculation and overvaluation, and proper sizing of individual investments. In many years, our outperformance is derived from investments we avoided versus individual "big winners." For example, in 2022, in domestic equities, we do not own any of the five worst performing equities in the S&P 500. In observing the ten largest companies, as a firm we do not own Amazon, Tesla, or Nvidia which are down 36-48% in 2022.

On the financial planning side, one of the many roles of our highly experienced Portfolio Counselors is to be a calming voice during volatility by reiterating our multi-asset class discipline that helped clients during difficult markets in 1962, 1966, 1970, 1974, 1982, 1987, 1990, 1998, 2000, 2008, 2011, 2018, 2020, and 2022. Just as important is helping clients avoid the temptation to speculate outside of our management – i.e., crypto, memes, SPACs, and "innovation products."

We view our relationship with clients as a team effort between you, your Portfolio Counselor, and the investment team. If we all use 2022 to confirm the right and wrong way to manage portfolios, the pitfalls, and how emotions factor in, we will continue to be successful in both bull and bear markets.

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