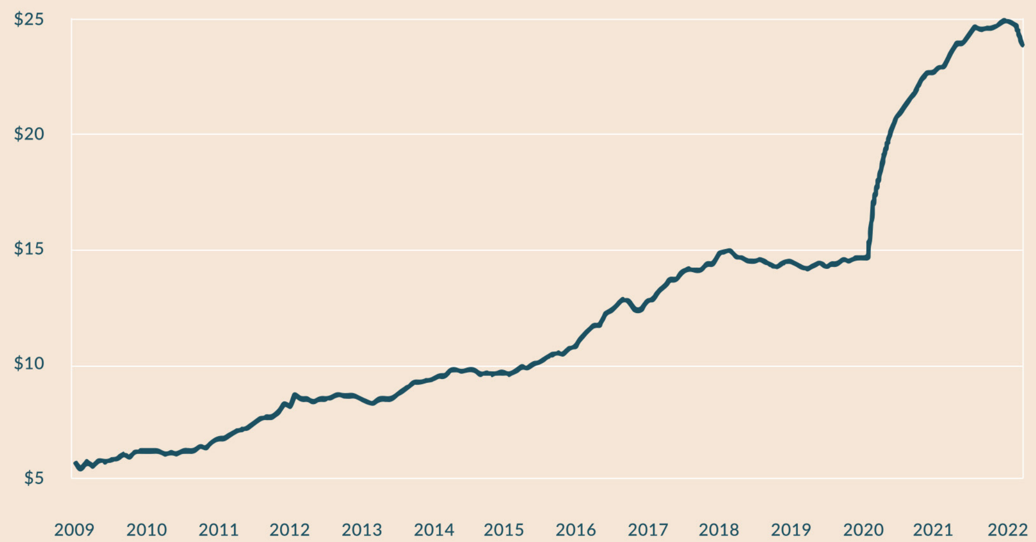
Stock market volatility has been relentless in 2022, testing even the most experienced investors' patience. Persistent inflationary pressures, the ongoing war in Ukraine, and uncertainty over the size and pace of the Fed's interest rate hikes have weighed heavily on consumer and investor sentiment. As we write, U.S. stocks have fallen into bear market territory.

We will explain later in this commentary why we think now is a time to be holding and buying quality stocks—not selling them. But first it is worth examining how we got here.

In the aftermath of the 2008 Global Financial Crisis, and again in the months following the Covid-19 pandemic, the world experienced an unprecedented liquidity event. The combined balance sheets of the Federal Reserve, European Central Bank, and Bank of Japan grew from $5.3 trillion to nearly $24 trillion, and quantitative easing programs kept interest rates artificially low. These forces combined to create a tidal wave of cash flows into equities and other risk assets, particularly since there was little-to-no yield to speak of in the bond market.

GLOBAL CENTRAL BANK BALANCE SHEETS SWELLED FOLLOWING THE PANDEMIC



Source: Blackstone

In particular, high-growth technology companies attracted a great deal of capital in a short period of time, in many cases driving valuations to extremes. Investors were also paying exorbitant premiums for unproven asset classes like cryptocurrencies, SPACs, and NFTs.

The setup looks different in 2022. Central banks around the world (apart from the Bank of Japan) are forecast to hike interest rates numerous times this year while shrinking balance sheets, and central governments have exhausted/ended nearly all fiscal stimulus programs. Liquidity is shrinking, and the 'easy beta' that has categorized investment in risk assets for years—where the rising tide lifted all boats—has largely run its course.

We saw early evidence of this shift last year, with the widespread bust of many SPAC initial public offerings and cryptocurrency coins. Through May 2022, shares of companies listed through SPACs were down an average of -59.5%, and many are now out of business. A noteworthy example is the scooter company Bird Global, whose SPAC initial public offering opened at $10/share in January 2021. Today the company trades at roughly $0.50/share, marking almost a complete wipeout.

The two largest cryptocurrency coins by market capitalization, Bitcoin and Ethereum, are down over -60% and -70%, respectively, from their peaks. Numerous coins have evaporated or been exposed as Ponzi schemes, and this week the high-profile crypto lender Celsius froze the accounts of 1.7 million users. We're content to watch this unravel from the sidelines.

The broad stock market experienced above-average returns during this period as well, but the gains for many companies were justified by earnings growth. S&P 500 corporate profit margins increased from 4.3% in Q1 2009 to an all-time high of 13.3% in Q4 2021, and currently sit at 12% as of the end of March 2022. Inflationary pressures are presenting a headwind to current earnings, but not by as much as many would expect given the media climate. 77% of S&P 500 companies beat earnings expectations in Q1, delivering a blended earnings growth rate of +9.2%, according to Factset. These are historically high figures.

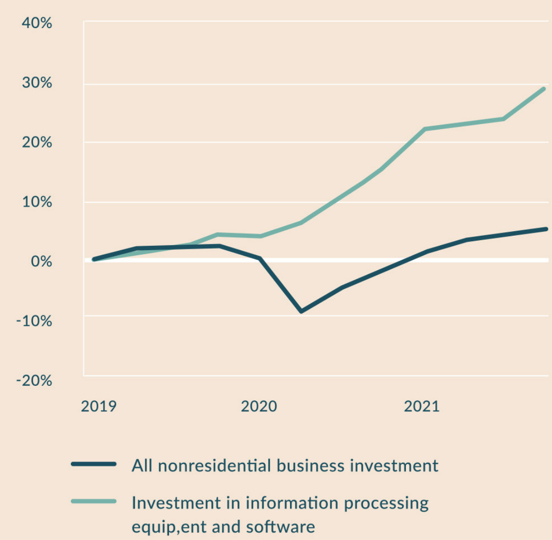
As difficult as volatility is to stomach at times, we think the selling pressure today has a silver lining: many solid companies with strong business fundamentals, cash flows, defensible margins, and robust balance sheets are now trading at what we believe are extremely attractive valuations on a forward-looking basis, with more earnings growth expected in 2022. We think this presents a unique opportunity for investors now.

OUR STRATEGY IS DESIGNED TO CAPTURE GROWTH OVER YEARS—NOT WEEKS OR MONTHS

No one can know where the market will head in the short-term, or how long downside volatility will persist. But we can identify longer-term trends and areas of the economy where value is likely to be created over time, which serve as keystones for our security selection process.

The ongoing digitization of the economy, for instance, is not likely to be influenced by the path of inflation and interest rates. The migration to cloud computing is almost universally requisite for individuals and organizations in today's economy, particularly as work becomes hybrid, networks have gone mobile, and memory storage grows cheaper. 'Digital everything' has also significantly expanded demand for cybersecurity products and services, which does not appear likely to abate any time soon. It follows that companies are increasing spending on information processing equipment and software at a far greater pace than every other category of business investment:

CAPITAL EXPENDITURES, CHANGE SINCE Q1 2019



NOTE: ADJUSTED FOR SEASONALITY AND INFLATION

Source: Department of Commerce

Many high-growth companies in this space saw valuations rise to unsustainable and unjustified extremes over the past two years. The ongoing selloff has removed much of the froth, but it has also created attractive entry points for companies with proven revenues and business models. We see long-term investment opportunities in cloud service providers, cybersecurity firms, and the hardware companies supplying advanced equipment.

Healthcare is another category with what we believe to be attractive long-term growth prospects. Demographics are likely to drive demand for healthcare regardless of the market or economic cycle. Baby boomers no longer make up the biggest segment of the population, but the category is still massive and also at a stage where demand for a myriad of services in medical care, testing, tools, implants, prescriptions, insurance, and recordkeeping is almost certain to chart higher over time. Our portfolio is positioned in several companies operating in these areas.

LOOKING AHEAD TO THE REST OF 2022

We think consumer and investor sentiment has swung too far to the negative relative to economic and corporate earnings fundamentals.

In a recent *Wall Street Journal*¬-NORC poll, 83% of respondents said the U.S. economy was in a poor or 'not so good' state. 35% of respondents also reported being unhappy with their financial situation, which marks the highest level of dissatisfaction since 1972.

But the poll also found that people *are more unhappy today than they were in the midst and aftermath of the 2008 Global Financial Crisis,* when the jobless rate was double-digits, major financial institutions were declaring bankruptcy, and millions of people were losing their homes and livelihoods. Today, household finances are in historically good shape and the U.S. economy has more open jobs than it does unemployed people.

The disconnect between sentiment and the state of the economy is rooted in higher food and gas prices. The daily interaction with higher prices has many people leaping to the conclusion that the economy is in freefall, which is not fully supported in the data. At this moment, the U.S. economy is in better shape than most appreciate:

- For the year leading up to May, the economy added at least 400,000 jobs per month, the strongest period of job gains dating back to 1939.
- The May Manufacturing PMI was 56.1%, which marked an increase of 0.7% from April and firmly suggests the economy remains in expansion mode. The manufacturing sector has been expanding for 24 straight months.
- The U.S. services sector also posted strong activity in May, with the Services PMI registering at 55.9%. Services have also expanded for 24 months straight.
- Total U.S. home equity increased almost 20% in the first quarter to $27.8 trillion, a record high, which is contributing to healthy household finances.

Inflation remains a sticking point, however, and it has largely overshadowed any positive news about the economy. The Labor Department reported that the consumer-price index (CPI) rose 8.6% year-over-year in May, its fastest rate of increase since December 1981. A lion's share of the price increases came predictably from energy, which saw prices rise 34.6% from a year earlier. Monitoring the changes in gas prices over the course of May made this element of inflation very visible.

Grocery prices also saw their biggest increase since 1979, as exports have been disrupted due to the war and other supply chain issues still related to the pandemic. The impact of drought and disease on certain crops and meats has also factored into higher prices. Elsewhere, airfares were up 12.6% for the month as the cost of jet fuel continues to rise, hotel prices surged 19.3%, and restaurant prices were up 7.4%.

Consumers loathe inflation, and media narratives naturally exaggerate the issue and stoke fear. But as Jay Hoag, a highly respected tech investor points out, *"the fact that all of these risks and potential challenges are being talked about in great detail and with great frequency is actually a potential positive.* He adds that *"the greater the downdraft in investor psychology, and the more negative the press coverage, the more convinced we are [that it is] an incredible time to play offense from an investment standpoint."*

Many recognize this type of thinking as a variation on Warren Buffet's *"be greedy when others are fearful"* philosophy. It defines how we see the market today. We think there is a unique opportunity to stake positions in companies with secular growth tailwinds, strong free cash flow generation, and above-average profit margins.

The end of the 'easy beta' era just means focusing on these qualities will be more important than ever as we move forward in this cycle, and getting it right will be key. As Hoag notes, *"history has shown us that periods of broad and rapid decline set the stage for exceptional future returns from exceptional companies."*

If you have any questions about this market commentary, your portfolio, or would like to discuss current market volatility further, please do not hesitate to reach out to us.