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A Quick Word

Though my goal is to deploy our capital into high-quality defensible businesses that can weather a downturn such as the one we're currently experiencing, the publicly-quoted shares of those businesses are not exempt from the heavy selling that generally accompanies these times of crisis. With that said, we have a significant competitive advantage in our longer investment timeframe. Though there's no doubt that some or all of the businesses in which we're invested will experience a *temporary* decrease in their earnings, in crises the market tends to offer shares for sale at significant discounts to even conservatively estimated future cash flows. So while most investors fear a drop in the price of the shares they own, the reality is that for long-term investors, those fears create exceptional opportunities.

We have taken advantage of these opportunities and have begun building a new position. We've also been able to increase our ownership stakes in several of our existing investments. It is my hope that we'll be able to initiate one or two more positions in other outstanding businesses before the end of the second quarter.

Market Recap

By now, it is becoming quite apparent that we are living in unprecedented times. Many compare COVID-19 to the Spanish Flu at the beginning of the 20th century. Perhaps the comparison is apt as far as the virus' contagiousness, symptoms, or higher mortality rate than the ordinary flu. However, as I mentioned last month, a comparison cannot be made as to the economic effects each had and will have on the world economy. There is simply no comparison to our current situation in modern history.

As of this writing, there have been just two initial unemployment claims reports encompassing the second half of March, when many states had initiated their stay-at-home orders to combat the virus. In those two weeks, there were a total of 9.93 million people that filed their first claim for unemployment insurance. For scale, that figure is greater than seven months of initial jobless claims filed between the first week of January and July in 2008, when the economy was already in recession. To compound this, state unemployment agencies were recently overwhelmed and unable to service all filings and requests indicating that figure is to some extent artificially low.

In order to combat the severe economic impact we're likely to see, the Federal Reserve stepped in with a substantial quantitative easing program. The Fed committed to purchasing $700B in US Treasurys and $200B in mortgages, a similar balance sheet expansion as the program executed between late 2008 and early 2009 commonly referred to as "QE1".

As more data became available, the Fed realized more needed to be done, and Chairman Powell announced that the central bank would be wading into corporate debt as well. The Fed will be executing both a Primary and Secondary Corporate Credit Facility. Under the Primary Facility, bridge loans of generally 4 years or less duration can be made directly to large, investment-grade borrowers with interest deferred for 6 months. Under the Secondary Facility, and in an unprecedented move, the Fed will begin buying corporate debt of investment-grade borrowers in the open market. This includes those “fallen angels” whose bonds are rated one notch above junk. Even more surprising is this program also includes investment-grade corporate bond ETFs. If former fed chair Martin was the “fellow who takes away the punch bowl when the party is getting good”, then chair Powell is the guy who kicked open the door with a keg under each arm.

To add to the Federal Reserve’s monetary response, Congress is responding to the crisis with the largest emergency fiscal stimulus plan in history worth approximately $2 trillion, dwarfing the 2008 financial crisis’ $700 billion “Troubled Asset Relief Program”. Provisions of the plan include $1,200 paid to every American making under $75k, $367 billion for a small-business loan program, and $500 billion for saving some of the hardest-hit industries, states, and cities. The program could increase the US’ debt load by almost 10%, and the administration is considering the proposal of an additional $2 trillion infrastructure program.

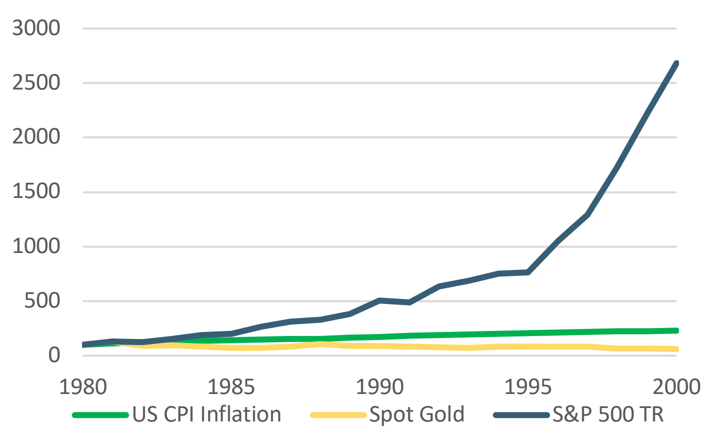
Looking Forward

While there’s no doubt that the capital being injected into the economy by both Congress and the Federal Reserve will be helpful, the small-cap market in which we invest is likely to be particularly hard hit by this crisis. Smaller US companies are currently, on average, carrying considerable debt loads made more formidable by the fact that almost 40% of the Russell 2000 constituents earn net losses each year. As the crisis squeezes firms’ top lines, interest expenses and debt covenants will become more and more burdensome.

I generally abstain from making macroeconomic predictions as they are likely to turn out to be about as accurate as my March Madness brackets (I’m not winning any office pools here). However, it is important to contemplate the secondary effects of all the current fiscal and monetary stimulus the economy is receiving. Should the economy come roaring back in a “V-shaped recovery” as many are hypothesizing, and with over $3 trillion in total stimulus paired with interest rates near zero, we must entertain the possibility of a return of inflation. This becomes even more possible if Congress adopts the White House’s additional $2 trillion infrastructure spending suggestion.

Throughout history, investors have cited gold as the best investment to hold in inflationary periods. After all, the money supply can change quickly, but the supply of gold changes very slowly. So the logic follows that the value of gold in dollars should rise in inflationary periods. However, this has proved time and again to be inaccurate. In the 1980s, US inflation totaled 64.4% whereas the average spot price of gold from the beginning of the decade to the end actually decreased. Similarly, in the 1990s, inflation totaled 33.5%, but the price of gold again declined over the same period. Lastly, in the 2000s, inflation continued to slow, with a total of 28.3% in the decade. Gold, on the other hand, went on a tear resulting in a total increase of 235%.

Growth of $100 Invested vs. Inflation (1980 – 2000)



There are many possible explanations for this detachment between inflation and gold prices, namely that gold is driven by more powerful supply and demand factors. Nonetheless, the best investment in inflationary periods continues to be US businesses. In the 80s, the S&P 500 delivered a total return of 214%; in the 90s, 320%.

More specifically, the firms that tend to perform best are those with significant competitive advantages or strong pricing power such that increases in input prices can be passed along to customers. These are exactly the sort of businesses that I search for.

More than likely, we have not seen the end of the market decline due to COVID-19, and more opportunities to purchase these sorts of businesses at attractive prices will present themselves. During the first quarter, on average roughly a third of our partnership's assets have been held in cash. This proportion has been steadily decreasing throughout the quarter, and I hope to have opportunities to deploy most if not all our remaining capital before the end of the second quarter.

Best regards,

Conor Mahlmann
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