Belleros Capital Management

The Passionate Investor

4Q2021 Market Review and Commentary

January 2022

*Market Review **

- Equity markets generally ***outperformed*** fixed-income markets with the S&P 500 rising 11.03% (including dividends; +28.71% YTD) and the Barclay's Capital U.S. Aggregate Bond index rising 0.01% (-1.54% YTD).
- Small caps ***underperformed*** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +2.14% (+14.82% YTD).
- Value ***underperformed*** Growth during the quarter (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- International or developed, non-U.S. equity markets ***underperformed*** U.S. markets in both U.S. dollars (MSCI EAFE**: +2.74%; +11.78% YTD) and in local currency terms (+3.96%; +19.25% YTD).
- The MSCI Emerging Markets Index ***underperformed*** developed, non-U.S. equity markets (international) in both U.S. dollar (-1.247%; -2.22% YTD) and local currency terms (-0.84%; +0.14% YTD).
- U.S. market sectors were mostly ***positive*** during the quarter. Information technology (+16.69%; +34.53% YTD) and materials (+15.20%; +27.28% YTD) stocks were most distinguishable given their strength. Communications services stocks were notable given their weakness (-0.01%; +21.57% YTD). Energy stocks led all other sectors over the full year (+7.97%; +54.64% YTD).
- High yield bonds fell 0.71% during the quarter (+0.99% YTD). The U.S. corporate bond sector decreased 0.17% during the quarter (-1.93% YTD). 10-Year U.S. Treasury yields climbed slightly from 1.46% at the beginning of the quarter (0.87% at the beginning of the year) to 1.44% currently.
- The U.S. dollar rose versus the Japanese Yen (+3.21%; +11.54% YTD) and the Euro (+1.88%; +7.06% YTD) but fell relative to the British Pound (-0.45%; +0.91% YTD).

** Unless otherwise noted, performances stated above reflect data provided by Standard and Poor's, Russell Investments, MSCI, and Barclay's Capital.*
*** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or international equity markets.*

Inside this issue

Tim Hai, CFA®, CAIA®
CIO and Sr. Portfolio Manager

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments."
— Seth Klarman

Company Description

Belleros Capital Management actively manages direct stock portfolios on a fully discretionary basis for institutional clients. Our primary goal is to help them outperform their benchmarks by exploiting short-term market inefficiency through a long-term investment strategy that produces investment portfolios that are differentiated in nature and is concentrated in its number of holdings. The strategy seeks to invest in the stocks of quality companies at a price that is sufficiently below our calculation of its intrinsic value. Additionally, the strategy is all capitalization in nature but tends to have a small and mid-capitalization bias that we believe is secular in nature.

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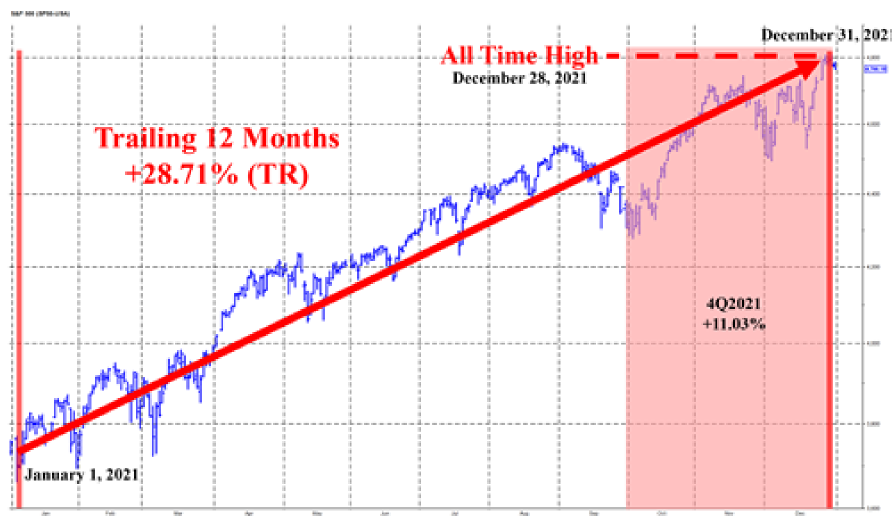
Market Commentary

2021 ended with an eerily similar feel to last year's close. The S&P 500 index of large capitalization stocks rose +11.03% during the quarter (+28.71% for the year) and ended another turbulent year near all-time highs. Interest rates remained near historic lows. Once again, COVID (in the guise of the Omicron variant) and all its trappings (masks, mandates, testing, isolation, etc.) was the 800 lb. gorilla in the room despite the majority of Americans having been vaccinated. High inflation, arguably present last year as well (e.g., housing, wage, etc.), added to the gloom as prices rose considerably for many goods and services.

S&P 500 – 4Q2021 and Full Year 2021 Performance



Source: FactSet

The S&P 500 outperformed virtually every stock or bond sector over the past year. Bonds trailed stocks in part because of inflation and the threat of higher interest rates to come. Small cap stocks compared poorly to large caps as COVID continued to affect investors' appetite for the shares. Both international developed and emerging market stocks (in local currency and U.S. dollars) trailed domestic shares by a considerable margin as foreign investors sought safety and better returns in U.S. markets. The U.S. dollar strengthened versus most other currencies (over the full year) for similar reasons.

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Tug of War

COVID and inflation had the largest influence on the stock market last year. However, each impacted stocks in different ways. Small-capitalization value stocks, in particular, benefited early in the year as the economy continued to normalize after the original 2020 COVID wave. The Delta and Omicron variants that materialized over the summer and holiday season (respectively), generally weighed on these same stocks as the year progressed. The emergence of inflation and its random flareups throughout the year seemed more positive for these shares as many of these companies were seen as being nimble and capable of adjusting to higher prices.

Conversely, larger capitalization, growth-oriented stocks out-performed as shares of technology and internet-related companies benefited from the continued COVID environment that extended remote interaction for commerce, work, and socialization. Many of these same stocks performed poorly as inflationary fears appeared sporadically throughout the year. It is generally believed that the high interest rates that often accompany inflation also lowers the value of companies and their stocks. Growth, and technology stocks in particular are thought to be more adversely affected by rising interest rates as a large amount of their intrinsic value is derived from future periods.

A Concentration Risk

The S&P 500 index is considered by many investors to be the best benchmark for their individual portfolios because of its breadth (500 plus stocks) and diversification. However, many might be surprised to know that the index is very concentrated in its holdings based on several measures. As of December 2021, the index was heavily concentrated in its top ten positions at 29.3%. Also, the index's 29.2% exposure to information technology stocks (one of the best performing stock sectors over the quarter and year) contributed heavily to its outperformance in 2021. However, further review of the index's top ten holdings suggests its exposure to technology stocks to be even greater than at first glance.

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
— Benjamin Graham

Investment Philosophy

Market Efficiency (or Inefficiency)

Stocks are inherently volatile assets due to the sheer number of participants involved, the diversity of their motives, and the wide range of emotions they employ. Stocks are frequently prone to excessive volatility when emotions particularly run hot. We believe this excessive volatility is a sign of short-term stock market inefficiency. However, we believe the stock market is more efficient over the long-term as rational investment behavior reasserts itself. Similarly, excessive volatility causes the market prices of stocks to deviate from their intrinsic values.

As time progresses, the market prices of stocks generally return to their intrinsic values. We believe that stock market inefficiency as represented by excess volatility is exploitable and represents an opportunity for profit. In our experience, excessive volatility can and does extend to all manner of companies and stocks. Even the best companies and their stock can be affected by stock market inefficiencies and come to exhibit excess volatility, creating exploitable investment opportunity for the astute investor.

"We steer clear of the foolhardy academic definition of risk and volatility, recognizing, instead, that volatility is a welcome creator of opportunity"
— Seth Klarman

Investment Philosophy

The Main Source of Risk to Long-term Investors

Belleros Capital Management believes that the investment community's definition of risk as volatility is inappropriate and generally does not apply to all participants. Although the effects of volatility can be particularly disastrous to investors that have near-term income or liquidity requirements, long-term investors can and should be less constrained by it. As opposed to gambling or speculation, we believe that investing is by definition a long-term strategy.

We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater risks such as a permanent loss of capital, the risk of outliving one's wealth, or the failure to meet their long-term investment and retirement goals.

A Growth or Technology Sector Proxy?

The S&P 500 currently classifies several constituents in its list of top ten holdings (see table below) as consumer discretionary or communication services stocks even though they are widely considered to be technology-related and have historically been considered to be so (as mentioned in the 2018 reclassification changes below). Adding the weights of Amazon.com, Tesla, both share classes of Alphabet, and Meta Platforms (formerly Facebook) to the current information technology weight raises the overall "technology" exposure of the index to almost 41%. This cursory review of the just the top ten holdings hint at an even greater overweighting to technology related stocks. It is no surprise then that a recent study by NASDAQ suggests a very high correlation (93%) between the NASDAQ 100 (an index that is heavily allocated to large capitalization growth and technology stocks) and the S&P 500 between December 2007 and March 2021.

Top Ten Stocks in the S&P 500

Rank	Symbol	Company Name	Weight	Sector
1	AAPL	Apple Inc.	6.78%	Information Technology
2	MSFT	Microsoft Corporation	5.95%	Information Technology
3	AMZN	Amazon.com Inc.	3.58%	Consumer Discretionary
4	TSLA	Tesla Inc	2.11%	Consumer Discretionary
5	GOOGL	Alphabet Inc. Class A	2.08%	Communications Services
6	FB	Meta Platforms Inc. Class A	1.98%	Communications Services
7	GOOG	Alphabet Inc. Class C	1.93%	Communications Services
8	NVDA	NVIDIA Corporation	1.72%	Information Technology
9	BRK.B	Berkshire Hathaway Inc. Class B	1.48%	Financials
10	JPM	JPMorgan Chase & Co.	1.25%	Financials
			28.86%	

Source: Slickcharts.com as of 1/7/22

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An Actively Managed Portfolio?

The S&P 500 annually changes its line up to better reflect the largest 500 public companies in the U.S. Sometimes the changes are few and mundane but in other years they may not be. In September 2018, the index underwent a major classification change by moving a considerable number of its constituents in the information technology and consumer discretionary sectors into a newly formed communication services sector (formerly referred to as Telecommunication Services). Although several of changes were implemented, the most impactful included the reclassification of Google and Facebook (now known as Alphabet and Meta Platforms, respectively); two of the largest stocks in the index.

More recently, the providers of the index are contemplating changes that may materially reduce its technology exposure further. The previous changes (and the currently proposed one) have been implemented under the cover of reclassification to better reflect the underlying operations of the companies. However, with the S&P 500's technology-like exposure already approaching a 50% weight, and given the index's propensity for changes, the conspiracy theorist might be inclined to ask if this proposal really represent just a clandestine attempt to reduce the appearance of a very real tech stock overweight. We believe it may be appropriate to reconsider one's use of the term "passive" when describing the index. It may also be inappropriate for benchmark use because it is much less diversified than many think it to be and because it cynically resembles a growth and technology fund.

"Wide diversification is only required when investors do not understand what they are doing."
— Warren Buffett

Investment Philosophy

Diversification (or Not)

Belleros Capital Management believes the idea of portfolio diversification is counter-intuitive and works against our active management goals. The idea of diversification is meant to limit the impact of stock market volatility. We believe stock market volatility represents an investment opportunity that is exploitable. Therefore, limiting the opportunities we seek to exploit would seem rather perverse. Diversification is a sliding scale. Too little and you risk putting all your eggs in too few baskets; too much and your portfolio and expected return mimics the broader stock market (index).

We believe excessive diversification (in addition to high investment-related fees) is a main contributor to poor active management performance relative to passive/index investing. We believe investors who seek excess returns above and beyond what one could expect to receive from the broader stock market should choose an investment manager that minimizes fees and seeks to differentiate their investment portfolio to ward off the indexing-like characteristic of diversification.

"Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments."
-– Warren Buffett

Please contact us to learn more about our investment strategy and how we try to add value for our clients.

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Closing Remarks

We are encouraged by how the year ended and by what 2022 may bring. Although we do not make forecasts or prognostications about the future (we typically consider this low probability speculation), we do believe COVID and inflation are factors that will remain front and center in 2022. We also expect interest rates to rise during the year as the Federal Reserve increases its guard against inflation. Additionally, we can never discount other issues which may choose to assert themselves throughout the year (China, Russia, or perhaps something unknown to us at this time). This noise, no doubt, will create some stock market dislocations and inefficiencies (i.e., volatility).

Given these potential disturbances, one may think we have our work cut out for us. However, we would not want it any other way! Recall, our investment strategy takes advantage of opportunities that generally occur when the stock market is volatile. We believe that volatility is a sign of stock market inefficiency that can be exploited over the long term. Taking advantage of these opportunities can allow us to add value for our clients and, in turn, help them to reach their long-term goals. As such, we are hopeful that 2022 will prove friendly towards active investing and value investors generally, and our investment strategy in particular. We wish you the best in the new year to come.

"When I see a bird that walks like a duck and swims like a duck and quacks like a duck, I call that bird a duck."
-- James Whitcomb Riley

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Investment Strategy

*We seek to exploit stock market volatility in the short-term through a **long-term**, active investment management strategy that seeks to purchase higher **quality** stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known as "**value** investing"). These characteristics help us defend against what we believe is **the biggest risk in investing: a permanent loss of capital.** In addition, we intend to show our discipline and conviction in our investments by employing a concentrated portfolio mandate that is differentiated and allows us to focus on only the best investment candidates available. Further, we seek to show our conviction through our portfolio weighting scheme which skews exposure to the best investment candidate.*

- Active investment management
- Long-term investing
- Seek higher quality opportunities
- Value investing
- Minimizing permanent losses of capital
- High conviction
- Invest with confidence
- Disciplined approach
- Volatility is an opportunity
- Concentrated stock portfolio
- Differentiated from the index

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments." — Seth Klarman

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." — Warren Buffett

Biography

Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 25 years of experience in the investment industry
- 11 years of equity portfolio management experience
- 6 years experience overseeing public equity and fixed-income assets for a $10 billion multi-employer pension plan
- 8 years exp. manager research and due diligence
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996

Tim has 25 years of diversified investment experience that includes the research and direct investment management of stocks and bonds for high net worth and small business clients. Additionally, Tim has experience in manager research and due diligence, having helped oversee and manage a $10 billion institutional pension fund. Tim had direct oversight of the pension fund's equity and fixed-income investment portfolios that were managed by outside investment managers. Tim had specific oversight over the pension fund's $1.2 billion concentrated managers program that sought to extract value add from some of the country's best investment managers through a mandate that required high conviction and a limited number of stock positions.

Tim received his B.S. in Finance from the University of Maryland, College Park and his MBA from Loyola College of Maryland. More recently, he also completed coursework in international investing and currency management with the Oxford International Investment Programme at the Said Business School at the University of Oxford, United Kingdom. Tim holds the Chartered Financial Analyst ("CFA") and Chartered Alternative Investment Analyst ("CAIA") designations. He is a member of the CFA Institute and the CFA Society Washington, DC. He is also a member of the Washington, DC Chapter of the CAIA Association.

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Disclosures

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