

The Passionate Investor

1Q2022 Market Review and Commentary

Market Review *

- Equity markets generally **outperformed** fixed-income markets with the S&P 500 falling 4.60% (including dividends) and the Barclay’s Capital U.S. Aggregate Bond index falling 5.93%.
- Small caps **underperformed** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned -7.53%.
- Value **outperformed** 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 U.S. dollars (MSCI EAFE**:-5.79%) and **outperformed** in local currency terms (-3.60%).
- The MSCI Emerging Markets Index **underperformed** developed, non-U.S. equity markets (international) in both U.S. dollar (-6.92%) and local currency terms (-6.06%).
- U.S. market sectors were mostly negative during the quarter. Energy stocks led all other sectors by a wide margin during the quarter (+39.03%). Communications services (-11.92%), consumer discretionary (-9.03%), and technology (-8.36%) stocks were notable given their weakness.
- High yield bonds fell 5.69% during the quarter. The U.S. corporate bond sector decreased 7.30% during the quarter. 10-Year U.S. Treasury yields climbed from 1.44% at the beginning of the quarter (and year) to 2.36% currently.
- The U.S. dollar rose versus the Japanese Yen (+5.40%), the Euro (+2.16%), and the British Pound (+2.79%) during the quarter.

* 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.



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CIO and Sr. Portfolio Manager

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 — Seth Klarman

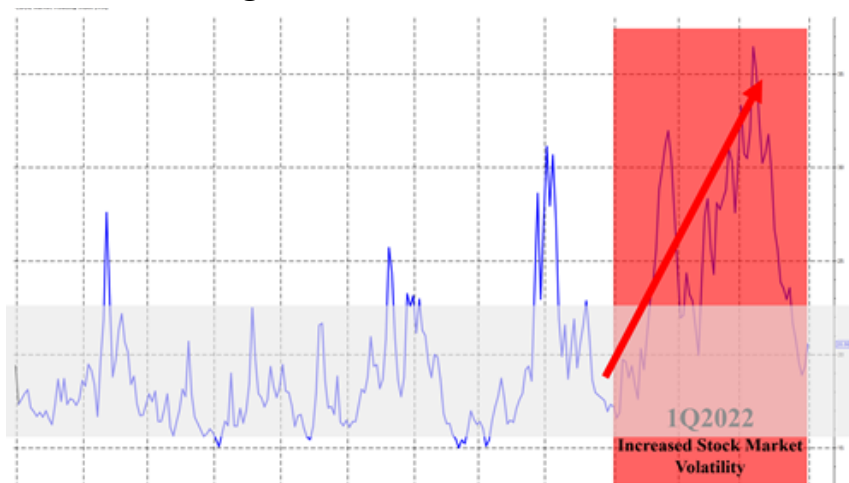
Company Description

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.

Market Commentary

U.S. stocks fell from their all-time highs last quarter as threats, both old and new, helped to usher in another period of exceptional stock market volatility (see CBOE Market Volatility Index chart below¹). The S&P 500 fell 5.60% during the quarter and briefly landed in correction territory² before settling at higher levels (see S&P 500 chart on the following page). The unforeseen invasion of Ukraine by Russia (the third largest oil producer globally) energized oil and commodities markets and exacerbated historically high inflation in the U.S. and abroad. Arguably more destructive to the prior period of relative calm was the growing perception that the Federal Reserve (the “Fed”) would raise interest rates faster and higher than previously expected (to fight inflation), leading investors to sell growth/technology stocks and fixed-income investments generally³. The threat of COVID also continued to weigh on stocks as new quarantines and lockdowns were reported in China.

**CBOE Market Volatility Index
 Trailing 1-Year and 1Q2022 Performance**



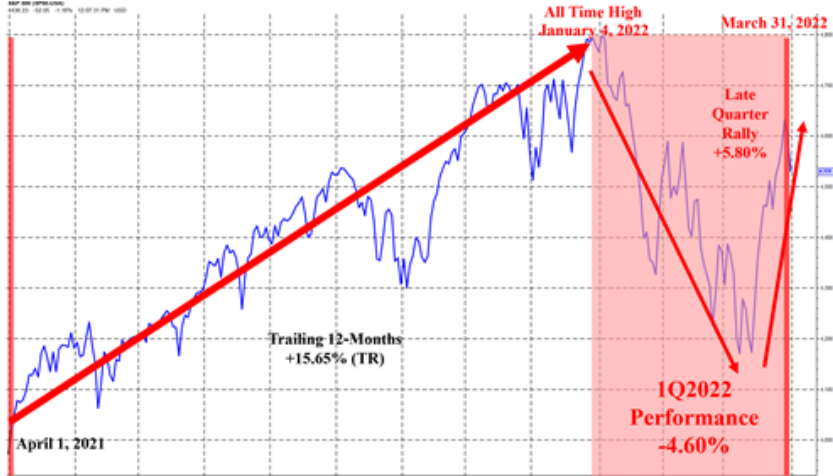
Source: FactSet

¹ The CBOE Market Volatility Index is a representation of the stock market’s expected volatility based on the S&P 500 index.

² When stocks collectively fall more than 10% from their most recently reached highs.

³ Higher interest rates generally decrease the value of growth/technology stocks; bond prices generally have an inverse relationship with interest rates.

S&P 500 – Trailing 1-Year and 1Q2022 Performance



Source: FactSet

Market Commentary...(Cont.)

Bond markets, typically seen of as a safe haven for investors during times of global economic threats and/or excessive stock market volatility, did not offer any respite. The Barclay’s Capital U.S. Aggregate Bond index fell 5.93% during the quarter due largely to the change in interest rate expectations. Still, riskier assets generally underperformed during the quarter. The high yield and corporate bond sectors which have exposure to “stock-like” credit risk both trailed the broader index. Among stocks, small caps and growth stocks underperformed relative to large caps and value stocks, respectively. Technology and communication services stocks, which have substantial exposure to technology-like growth stocks (e.g. Facebook, Netflix, Twitter, etc.) were among the worst performing sectors during the quarter. Elsewhere, the energy sector offered robust gains as the war and supply shortages continued to disrupt at home and abroad. International and emerging market stocks trailed domestic shares. The U.S. dollar continued to be a refuge and source of strength.

“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.

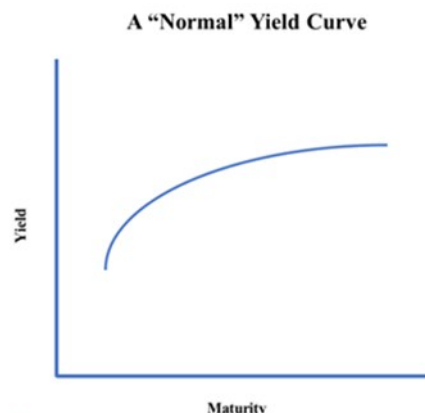
We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater 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.

Market Commentary...(Cont.)

Meanwhile, recessionary fears also crept higher at quarter end as many investors wonder(ed) if the Fed will overreach in its attempt to tame inflation – potentially causing the economy to spiral into recession. Despite interest rates having only been raised once (last month) by a mere 25 basis points (0.25%), bond markets anticipate more increases soon and at higher amounts. The oft-cited yield curve (see below) is believed by many experts to have the power to predict future recessions. The indicator has recently telegraphed slower growth at a minimum (which is by definition a primary intent of the Fed when it increases interest rate to lower inflation) and a potential recession at worst.

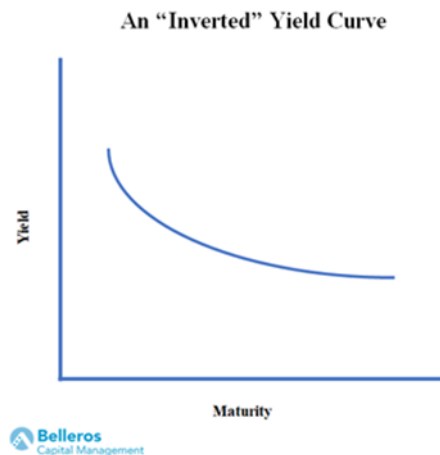
The Yield Curve

The yield curve is a graphical representation of interest rates and maturities offered on bond or fixed-income contracts of the same credit quality. In college it was often referred to as the term structure of interest rates. A common yield curve example exists on the information board posted inside most commercial banks. A typical board might publish the annual percentage rates or “APRs” of certificate of deposits (i.e. CDs) or mortgage loans, alongside their maturities. While there are many bond market variations of the yield curve, investors have traditionally paid most attention to the U.S. Treasury yield curve with particular focus on bonds with maturities between two- and ten-years. The yield curve is “normally” upward sloping (see chart below), signifying that bond investors typically require or demand greater interest rates over longer investment time periods. A “normal” yield curve is said to reflect a good or stable economy.



The Inverted Yield Curve

Interest rates on shorter-dated bonds can sometimes rise above those with longer maturities. In such a case, the yield curve is said to be “inverted” as depicted in the chart below. Economists and professional investors alike pay close attention for signs of a potential yield curve inversion as they are reputed to have the ability to predict recessions. A full inversion in the U.S. Treasury bond yield curve (i.e. with maturities between two- and ten-years) has “predicted” each of the past eight recessions in the U.S., going back as far as 1970 and including the Great Recession of 2007.



For What It’s Worth

Despite the seeming correlation between recessions and the yield curve, experience tells us that we need a healthy amount of skepticism. Although each of the past eight recessions were preceded by an inversion of the yield curve described above, not all inversions predict recessions. This is not an exact science. First of all, to this day, there is still substantial disagreement about what is the right yield curve to use for recession prediction purposes. Should U.S. Treasury bonds be used? What segment or maturities along the yield curve should we focus on? Many experts suggest the two- and ten- year segment, but [a very convincing minority suggests even shorter maturities.](#)

Yield curves are dynamic and change continuously, so the duration of an inversion may be fleeting. The two- and ten-year maturities of the U.S. Treasury yield curve inverted on April 1, 2022 but quickly normalized in the days that followed. Was this enough time to predict a recession? Should it last for a week, weeks, or months?

“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.

For What It’s Worth...(Cont.)

Even then, there is no clear consensus of when you can expect said recession to appear after the prognosticative signal has been made. Again, many experts suggest a year until a recession is reached after an inversion. But this is not exact either. The 2006 inversion preceded a recessionary environment by 16 months (using official declarations).

Famously (or infamously), the most recent yield curve inversion occurred in 2019 just before the COVID pandemic arrived. Are we to assume that the yield curve predicted COVID? Probably not. Irrespective of this, count us as not entirely impressed by yield curves and their predictive powers. As alluded to above, the inverted yield curve is prone to issuing false signals. And because there hasn’t been one recipe that’s been settled on that guarantees a future recession within a modestly granted time period, the result is noise. We would expect to see excessive stock market volatility as the market is driven by opposing views of how, what, why, and when. If you understand our modus operandi, you will know that that is what truly excites us.

Closing Remarks

We continue to be conflicted regarding potential recessions and all things macro-economic in nature, and their effect on the stock market. While we are cognizant of the pain many investors and households may feel from these threats to our economy and pocketbooks, we also recognize that they are also sources of the volatility we seek to exploit as a part of our long-term investment strategy. We believe we can add value for our clients (over the long-term) through the implementation of our strategy. In this way, we hope to alleviate or mitigate some of the pain or disruption they may experience otherwise. And perhaps that is the best way to respond when life hands you a bowl of lemons (in the short-term). Keeping a calm demeanor, staying disciplined, and allowing us to execute our long-term investment strategy is (we think) the best way to make the lemonade you can savor over the long-term. All the best during these eventful days. Enjoy the Spring!

“Correlation does not imply causation.” -- Unknown

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

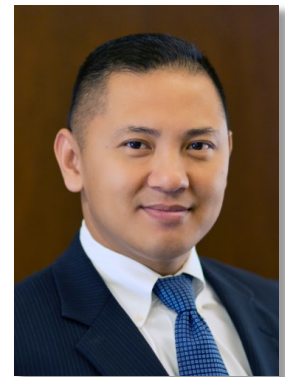
“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.” — Warren Buffett

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.

Disclosures

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