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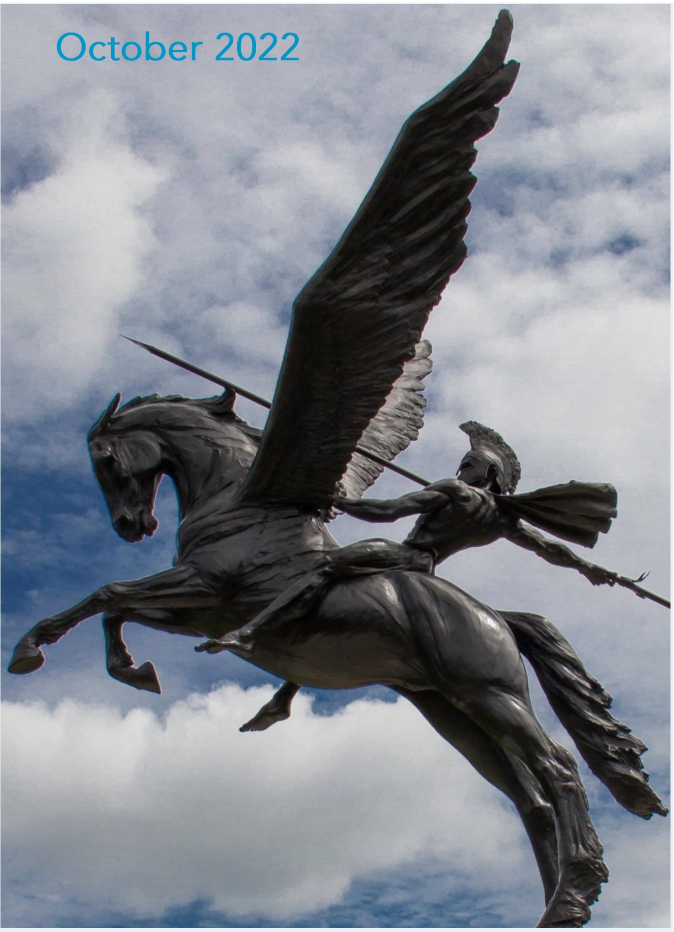

Belleros Capital Management

The Passionate Investor

3Q2022 Market Review and Commentary

Inside this issue

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*Market Review **

- *Equity markets generally* ***underperformed*** *fixed-income markets during the quarter with the S&P 500 falling 4.88% (including dividends) and the Barclay's Capital U.S. Aggregate Bond index falling 4.75%.*
- *Small caps* ***outperformed*** *large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned -2.18%.*
- *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* ***out-performed*** *U.S. markets in local currency terms (MSCI EAFE**: -3.52%) but underperformed in U.S. dollars terms (-9.29%).*
- *The MSCI Emerging Markets Index* ***underperformed*** *developed, non-U.S. equity markets (international) in both local currency terms (-11.42%) and U.S. dollar (-8.09%).*
- *Most U.S. market sectors were negative during the quarter. Consumer discretionary (4.36%) and Energy (2.35%) stocks led all other sectors during the quarter. Communications services stocks (-12.72%) were notable given its weakness.*
- *High yield bonds fell 2.74% during the quarter. The U.S. corporate bond sector decreased 5.17% during the quarter. 10-Year U.S. Treasury yields climbed from 2.98% at the beginning of the quarter to 3.86%, currently (they were 1.44% at the beginning of the year).*
- *The U.S. dollar rose versus the Japanese Yen (+6.54%), the Euro (+6.29%), and the British Pound (+8.08%) 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.*

"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

The Federal Reserve's (the "Fed") lifting of interest rates to combat inflation helped lead riskier assets such as stocks (generally) to underperform during the quarter as investors reassessed the potential for a recession in the US. Both US (the S&P 500 fell 4.88%) and international stocks including developing and emerging markets (-9.29% and -11.42% in US dollars, respectively), lost ground as confidence in a "soft landing" or "goldilocks" setting diminished (an economic scenario where interest rates are raised high enough to temper inflation, but not high enough so as to cause a recession). Indeed, the Fed has openly admitted it is willing to risk a recession in its effort to reduce inflationary pressures. Somewhat surprisingly, small cap (-2.19%) and growth stocks, generally considered to be riskier investments, lost ground at a slower rate than their large cap and value stock peers.

S&P 500 – Trailing 1-Year, YTD, and 3Q2022 Performance

Source: FactSet

[1] Both figures are total returns.
[2] When stocks collectively fall more than 20% from their most recently reached highs.

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Market Commentary…(Cont.)

Bonds fell 4.75% and failed to offer protection to risk sensitive investors during the rising interest rate environment (bond prices generally fall as interest rates climb; the opposite is also true). Riskier bonds with more stock-like risks also underperformed as corporate and high-yield debt tumbled -5.17% and -2.74%, respectively. Four consecutive hikes to interest rates (three of which were 75 basis points or 0.75% in magnitude) helped push 10-year US Treasury yields to a heady 3.86% (currently) from 1.44% in January. The US dollar continued to benefit from rising domestic interest rates as it outperformed most major currencies including the European euro, British pound, and Japanese yen. The British pound at one point fell to near parity (a one-to-one ratio) with the US dollar (a level that was never thought possible) as domestic issues combined with the strong US dollar to weaken it.

What A Difference A Year Makes.

One year ago, much of the discourse surrounding the economy and stock market involved an argument between those who believed existing inflationary pressures were transitory in nature, brought about mostly by short-term COVID-related supply constraints, and those who believed it a longer-term phenomenon. The inflation rate then was a comparatively mild 5.39% (year-over-year for September 2021) and the stock market (up 15.92% through September 2021) was enjoying strong tailwinds in an upward climb. All-the-while, COVID and its variants were still a general threat to society. The other camp insisted that inflation was a serious danger that had the potential to become an even more menacing and persistent threat. The 2021 Fed (of the "transitory" camp) then seemed close to admitting that inflation was at least a minor problem and was signaling a reversal of several monetary tools it introduced during the COVID crises.

"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 Year In Reverse

Today's economic and investment landscape looks starkly different from last year's. The argument regarding the inflation threat is largely settled as the rate of inflation has grown persistently stronger over the past year (8.26% year-over-year for August 2022; the most recent data point available). That inflation exists or its potential to become a long-term threat no longer seems outlandish. The Fed's messaging has changed from a "dovish" stance where growth and job creation are top priorities promoted through easy monetary policy (i.e. lower interest rates) to becoming "hawkish" where inflation is of the utmost concern. The economy has gone from growth mode after intense fiscal and monetary tools were used to improve a weakened COVID economy, to a focus on combatting rampant inflation through increased interest rates. In a sign of dire times, stagflation[1], an even worse economic threat than a recession, has been reintroduced into the American vocabulary and can be more commonly heard from prominent stock market prognosticators.

How Can We Help?

Needless to say, all of the above events have led to a quite volatile market that has largely reversed last year's gains. We don't believe market timing is the solution to the poor performance (Please click HERE to understand why). We also do not believe passive investing is a viable option as a recovery may take years. We believe our pro-active investment approach of active, bottom up, and value-based investing to be the best option for our clients (please click HERE for a full description of our investment philosophy and refer to the end of this newsletter for our investment strategy). Our investment strategy allows us to be very precise in terms of how, when, and where to invest. During periods of excessive volatility, we review our options to determine which we believe are the best investments available. We then make changes, accordingly, and (re)invest at more opportunistic prices that can add value over the long-term. As such, a highly volatile stock market represents a source of opportunity that may benefit clients over the long term.

[1] Stagflation is an economic phenomenon that combines characteristics common during a recession (slowing or negative growth, and rising unemployment) and inflation (higher prices). It is commonly viewed as a worst-case scenario.

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More Importantly

We believe we best serve our clients by helping them maintain investment discipline and a commitment to a long-term investment strategy. Discipline helps investors make emotionally difficult investment decisions in the face of falling stock prices. Discipline also helps investors to avoid emotional urges that may lead to short-term trading schemes like market timing, which can lead to real and permanent losses of capital (as stock prices are falling) in addition to potentially larger opportunity costs as stock prices rebound. As your investment manager, we make these difficult decisions on your behalf to hopefully minimize potential losses and to take advantage of short-term investment opportunities when they appear. We believe that investment discipline can be our best friend when the stock market is performing poorly.

"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.

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"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.

Closing Remarks

Despite the recent weakness in stocks (and most other asset classes as well), we are optimistic that we are closer to a bottom than a top. However, our view acknowledges that stocks have already fallen 20%-25%, peak-to-trough, and encompass several stock market proxies. But things could continue to worsen before they get better. We can never underestimate the potential for a double dip recession or stock market as things appear to get better but do not for whatever reason. Granted our experience over the past year with monetary and fiscal policy (and their implementation) has not given us unbridled confidence. But this is personal opinion (not scientific) and hope based on gut-feel (albeit with the benefit of 25+ years of investing experience). It should be taken with a grain of salt and not be used for speculative purposes.

We are seeing anecdotal evidence that supports our thesis based on the growing list of buying opportunities. However, we also acknowledge that some markets still do not seem oversold yet based on the number of attractive opportunities available (e.g. the S&P 500). This potentially means there is more room for the "stock market" to fall (though not necessarily "all" stocks). But how long the inflation malaise will last is a wild card. Does it ebb from here or is it really secular in nature? We try not to underestimate inflation and appreciate that it may take a while to fight. But we also acknowledge that there is a difference between what, how, and when things occur in the economy and when the same occurs for the stock market. The stock market is often described as a leading indicator[2] of economic activity, and it certainly appears to be the case right now as it trades lower ahead of any recession. We shall see. Best wishes to all as we get into the festive part of the year.

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go."

-- Benjamin Graham

[2] A set or subset of data that is said to be prescient with respect to the economy.

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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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