January 2023

The Passionate Investor

4Q2022 Market Review and Commentary

*Market Review **

- *Equity markets generally **outperformed** fixed-income markets with the S&P 500 rising 7.56% (including dividends; -18.11% YTD) and the Barclay's Capital U.S. Aggregate Bond index rising 1.87% (-13.01% YTD).*
- *Small caps **underperformed** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +6.23% (-20.44% YTD).*
- *Value **outperformed** Growth during the quarter and full year (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 **outperformed** U.S. markets in both U.S. dollars (MSCI EAFE**: +17.40%; -14.01% YTD) and in local currency terms (+8.77%; -6.52% YTD).*
- *The MSCI Emerging Markets Index **underperformed** developed, non-U.S. equity markets (international) in both U.S. dollar (+9.79%; -19.74% YTD) and local currency terms (+6.66%; -15.16% YTD).*
- *Most U.S. market sectors were positive during the quarter. Energy (+22.81%; +65.72% YTD) and Industrials (+19.22%; -5.48% YTD) stocks were most distinguishable given their strength. Consumer Discretionary stocks were notable given their weakness (-10.18%; -37.03% YTD).*
- *High yield bonds rose 7.97% during the quarter (-12.71% YTD). The U.S. corporate bond sector climbed 3.31% during the quarter (-15.15% YTD). 10-Year U.S. Treasury yields climbed slightly from 3.86% at the beginning of the quarter (1.44% at the beginning of the year) to 3.87% currently.*
- *The Japanese Yen (+8.84%; -14.58% YTD), the Euro (+8.94%; -6.15% YTD), and the British Pound (+7.76%; -11.19% YTD) all rose versus U.S. dollar 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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"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.

Market Commentary

The S&P 500 rose +7.56% during the quarter but still closed out 2022 with its worst performance since 2008. Most other stock segments (i.e., small caps, international; etc.) similarly recaptured lost ground in the 4th quarter and recorded large losses for the year. Unlike in 2021 when inflationary concerns were still debatable between transitory (those who believed that inflationary pressures were short-term in nature) and secular camps (those who believed the inflationary pressures were more longer-term in nature), market participants have generally accepted the latter. The U.S. Federal Reserve (the "Fed") was a member of the former and has since had to play catch up with the inflation reality on the ground that has not been higher in over 40 years. Persistent COVID-related supply chain disruptions and the unexpected Russian invasion of Ukraine have exacerbated the problem with rising prices. In response, the Fed raised interest rates seven times in 2022 and has signaled that it plans more tightening measures in 2023 to bring already moderating (though still rising) inflation levels into its range of comfort.

S&P 500 – Full Year and 4Q2022 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.)

Perhaps the most surprising story of the year is that the bond market (as measured by the Barclay's Capital U.S. Aggregate Bond index) fell by double digits. Almost as surprising was the timing of the weakness, which occurred during a period of significant stock market losses. Investors typically look towards fixed-income investments as a safe harbor in times of stock market or economic uncertainty. Though bonds also had a reprieve during the quarter (+1.87%), they did not offer safe harbor in 2022 (-13.01%). Likewise, bonds with (i.e., corporates, high yield, etc.) and without (i.e., U.S. Treasury notes) credit exposures (which resemble stock risks) rebounded during the quarter but underperformed over the full year. The 10-year U.S. Treasury note in particular was reported to have had its worst year of performance in over 200 years. Similarly, most international currencies rose during the quarter relative to the U.S. dollar but fell considerably over the full year (relative to the U.S. dollar) as international investors were attracted to rising interest rates and the comparative safety of the dollar.

White Noise

We "re-discovered" Bloomberg Radio ("BR") recently to help stay abreast of market news. But if we were really honest, it was more of a bid generate some white noise to help us focus as we get back in the office work environment. We knew BR offered an almost un-yielding focus on macro-economic news that catered to the Wall Street investment crowd relying on that news to make predictions and manage client money. Their content (as well as that of competitor CNBC) skews heavily to the benefit of top-down, momentum traders who are short-term focused. Programming is also heavily focused on passive/index investing and to the extent that there is any active investment discussion, it again is top-down focused and involves quantitative managers or hedge funds. Stock discussions also hew towards mega-cap, growth, and technology-related companies in particular (e.g., FAANG-type stocks). In short, although BR keeps us abreast of the economy and stock market generally, and what our industry colleagues are up to, they do not offer us a lot in terms of value that is additive to our investment strategy. This is not a knock-on BR as that is their business model. They cannot be all things to everyone, and their content is more useful for some than it is for others. We're okay with that.

"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.

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A Guaranteed Recession?

Market chatter has revolved over the past few years between discussions of inflation, interest rates, and recession. As many participants see the worst of inflationary pressures in the rear-view mirror, and a potential end to rising interest rates in near future, the discussion has begun to focus on the potential for a recession in the year ahead. That the recession is a possibility at this point in the economic cycle should not be surprising to most observers. Tightening monetary policy, especially in response to inflationary pressures, can result in a recession if executed in the extreme (seven straight interest rate increases may qualify here). Central banks are not especially known for their ability to guide the economy smoothly. Also, our old friend the (inverted) yield curve has been predicting a recession for much of the past year (please click HERE for a more in-depth discussion we previously had about yield curves).

BR suggests that most market prognosticators expect a short and shallow recession over the next year. So, will we experience a recession over the next 12-months? And, more importantly, how will that affect the stock market? We don't know and we certainly don't forecast such things unlike some of our peers. However, if we could play the devil's advocate role for a moment, we would recommend some caution here. We are not supporting one viewpoint or another but our experience tells us to be careful when markets or market participants, seemingly, all agree and all but guarantee an economic outcome (a BR indicator recently suggested a recession was all but inevitable). Also, there are some stubborn realities that may prevent a recessionary reality from occurring. Historically low unemployment and the strong and resilient job market in the face of rising interest rates being a big one of them.

And The Stock Market?

Many prognosticators predict lower lows in 2023 and a weak stock market in the year ahead (though better than 2022's) as the economy succumbs to a recession. Many believe last year's low was only a hint of what's to come and they point to the fact that a stock market low has never been reached prior to an official Recession being announced. That reasoning does strikes us as a little curious. The National Bureau of Economic Research (the "NBER") is the official group of economists that convenes to determine the beginning and end date of recessions. Decisions are made after a recession has begun (they do not forecast) and a complete decision including revisions may not be completed until after the recession is over.

"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.

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And the stock market?...(Cont.)

Typically, the NBER uses several data points in determining a recession but as we understand it, there is no official litmus test or secret sauce. In recent years, the definition of what constitutes a recession has been a little fluid (the COVID recession comes to mind). Two consecutive quarters of negative GDP growth is typically mentioned as one of those data points, but the NBER says it is not an overriding factor and its occurrence isn't always coincident with an official recession determination.

The official determination of recession seems to us a bit contrived and open to human error when it is decided upon by people. We wonder if, although an official recession hasn't yet been called, it is possible that we've already experienced an unofficial recession and continue to experience one? We did experience two consecutive quarters of negative GDP growth in 2022 (again, no guarantee of an official recession). And, in a bifurcated or split economy where experiences are varied between the rich and the poor, could 40-year highs in inflation affect some more than others? Despite rising wages, many households have and are still struggling, and have arguably been living in a non-technical recession. On a net basis, their costs are higher than they've ever been, and their wallets are stretched. Many have spent their COVID-related stimulus and are perhaps extending credit to purchase necessities. The answer might seem an obvious yes to many.

Could it be then that we've already experienced a recession and that it has already been reflected in the stock market lows of last year? Could the foreshadowed recession have already occurred in 2022. Could the aforementioned low unemployment and strong job market already have prevented a technical recession in 2022? If the basis for prognosticators who believe a short and shallow recession is coming in 2023 is predicated on low unemployment and a strong jobs market, then maybe we've already experienced that slowdown or mild recession in 2022. Relatedly, if this is the most anticipated recession of all time as many guests or personalities on BR have said, could the possibility of recession already be reflected in stock market prices? Again, we're not fore-casting the economy or stock market and we're certainly not saying that the stock market can't experience more headwinds or re-test their lows in 2022 as corporates earnings fall and operating margins contract - but we would at least suggest that perhaps a slam dunk recession or poor stock market in 2023 is not so guaranteed.

"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

We do not have the answers to those questions posed above. But it would seem that that is the case for our peers as well. One topic that BR reported well highlighted the futility of economic forecasting in 2022. In 2022, market prognosticating – even for the seasoned professional – was about as useful and successful as weather forecasting (our analogy). But we would not limit this idea to the past year. No one has an information advantage when it comes to the future. If so, fortune telling would be called future telling. Prognosticators make their forecasts by reading the tea leaves which are in plain sight to everyone…its all in the interpretation. So, is it all that surprising that market prognosticators are about as accurate as fortune tellers? Not really in our opinion. We prefer the logic of our investment strategy which we believe can (but not guarantee) add value for investors with a long-term investment time horizon.

The past year was a difficult one for stock and bond investors alike. Most investors probably failed to outperform their benchmark or even lodge a gain during the year. We say "most" because at least some investors' portfolios presumably were in the black or at least outperformed their benchmark. More than likely, these investors' strategy was actively managed and perhaps diversified enough to have exposure to assets that did perform well in 2022. Having the ability to actively manage our portfolios and deviate from the broader stock market is our "Raison D'être" or reason for being (excuse our French). Being active managers at least allows us a chance to outperform the market (or shoot ourselves in the foot) in an otherwise bleak year. For those of us who experienced a challenging year, it's important to understand that one year is too short a period of time (to judge performance), especially if you have a long-term time horizon. Over the long-term, poor results in any year is hopefully overshadowed by many years of better returns, allowing us to potentially reach our goals. But there we go again – always the optimist. Tigers cannot change their stripes. We wish everyone a wonderful, healthy, and fruitful 2023. Please contact us if you have any questions or needs. All the best.

"You have enemies? Good. It means you've stood up for something, sometime in your life." -- Winston Churchill

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Investment Strategy

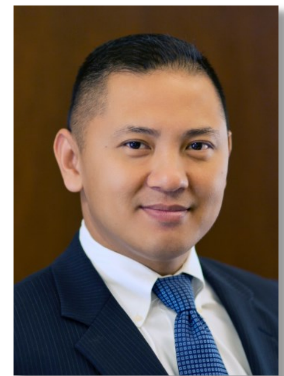
*We seek to exploit stock market volatility in the short-term through a **long-term**, active investment management strategy that seeks to purchase higher **quality** stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known 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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