

April 2023



The Passionate Investor

1Q2023 Market Review and Commentary

Market Review *

- Equity markets outperformed fixed-income markets with the S&P 500 rising 7.50% (including dividends) and the Barclay's Capital U.S. Aggregate Bond index rising 2.96%.
- Small caps underperformed large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +2.74%.
- Growth outperformed Value during the quarter and full year (as determined by the Russell 3000 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**:+8.62%) and in local currency terms (+7.65%).
- The MSCI Emerging Markets Index underperformed developed, non-U.S. equity markets (international) in both U.S. dollar (+4.02%) and local currency terms (+3.84%).
- Most U.S. market sectors were mixed during the quarter. Information Technology (+21.82% YTD) and Communication Services (+20.50%) stocks were most distinguishable given their strength. Financials stocks were notable given their weakness (-5.56%).
- High yield bonds rose 3.15% during the quarter. The U.S. corporate bond sector climbed 3.31% during the quarter. 10-Year U.S. Treasury yields climbed slightly from 3.87% at the beginning of the quarter/year to 3.54% currently.
- The Japanese Yen fell 0.87% versus the U.S. Dollar while the Euro (+1.80%) and British Pound (+2.79%) both 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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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.

Market Commentary

Stocks exhibited pronounced volatility to begin the year but still managed to finish the quarter in strong fashion (the S&P 500 rose +7.50%). Buyers displayed strong demand for stocks in January as inflationary pressures that were near 40-year highs appeared to peak as 2022 closed. Small caps were especially exuberant (+13.69% through February 2, 2023) as investors began to believe normalization and an end to the Federal Reserve (the “Fed”) rate tightening phase was at hand. Stocks fell over most of the remaining quarter (small caps fell 13.08% through March 24, 2023) as the Fed quashed investors’ enthusiasm by strongly emphasizing their inflation worries and intent to keep interest rates at recent levels (or higher). Stock market fears were exacerbated when several regional banks failed, and former Swiss banking titan Credit Suisse required central bank help and was forced to merge with a larger peer. The market appeared to settle down by quarter end as the Fed formally announced that it would back-stop (i.e. secure all deposits at the banks) all banks that required help through the crisis.

S&P 500 – Trailing 1-Year and 1Q2023 Performance



Source: FactSet

Market Commentary...(Cont.)

Small cap stocks ended the quarter weak relative to their larger cousins in the S&P 500 index as the banking crises increased recessionary fears. Similarly, Energy stocks fell as future demand expectations diminished. Growth and technology-related stocks outperformed as investment favor rotated back to these sectors that were weak after last year's series of interest rate hikes and as the potential for lower rates in a recessionary scenario increased their perceived value to investors. International stocks in developed countries increased in value as investors (perhaps) sought to diversify investments outside of the U.S.; emerging market stocks were weak as investors favored the safety of more developed countries. Bonds enjoyed a good quarter as investors sought a safe haven during the brief banking crises and as inflationary pressures abated.

Stick To What You Know

Investors were surprised by an unforeseen banking crisis late in the quarter that caused considerable panic among market participants. Though large Swiss bank Credit Suisse was among the casualties, their problems were largely unrelated to the handful of stressed regional (small) banks in the U.S. Silicon Valley Bank ("SVB") surprised markets when its depositor base of largely venture capital-related companies withdrew their monies en masse over just a few days. The bank did not have enough money on hand to satisfy the demands of depositors, forcing a "bank run" and an "unofficial" bailout by the government (the term bailout is still debated). Quick measures to contain the damage by the Fed helped to abate stock market worries.

We would not consider or call ourselves disciples of famed investor Warren Buffett but rather students of investing generally. However, one of our favorite quotes of his recommends only investing in businesses you know (and understand) and avoiding those you don't (know). The idea of investing in companies that we know and understand is central to our focus on avoiding permanent losses of capital (as opposed to risk as defined by the volatility in stock prices). This idea or philosophy drives our investment strategy as we seek quality stocks we know and understand, focus on value stocks with a wide margin of safety that inherently suggests a stock price that is selling below intrinsic value, and a long-term time

"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.

Stick To What You Know...(Cont.)

horizon that affords patience and allows enough time for our investments to potentially bear fruit. In practical terms, our investment strategy leads to certain portfolio characteristics that help define us. As value investors, we focus on assessing a stock’s worth on its existing business that is “tangible” or measurable. We focus less on valuing “intangible” assets such as future “growth” that may never come or are not sustainable. This adherence to value means that our strategy typically has less growth or technology-related investments than many of our active investment management peers.

Similarly, and with specific relevance to the banking crisis we just experienced, we are not big proponents or investors in banks and similar financial institutions. We have always believed banks to be opaque in their reporting of their assets and liabilities and have chosen not to invest in them because of this unknown risk. As a practical matter, it would require more resources than we have to properly research these investments to our satisfaction. Indeed, we are harkened by the fact that most if not all of Wall Street research and the government sponsored credit rating agencies failed to recognize the shortcomings of SVB (and others) despite their vastly disproportionate level of spending on research relative to our firm. Sometimes, our philosophy leads to short-term outperformance or underperformance based on the underlying exposures in our portfolios. However, we are confident that if we can avoid companies that can lead to a permanent loss of capital (as opposed to risk as defined by volatility), and we are patient and maintain a long-term focus, we may be able to add value on both counts.

The Gift That Keeps On Giving

Our long-time readers will recognize our cynicism when it comes to the U.S. Federal Reserve. Per the Federal Reserve Bank of St. Louis, “The Federal Reserve System was initially created to address... banking panics” and its broader responsibilities include “fostering a sound banking system and a healthy economy”. Suffice it to say, the Fed’s job, beyond its dual mandate of full employment and stable prices, is to prevent a bank crisis and to manage or moderate the economic cycle. The decisions they make (even routine ones) and their implementation can cause stock market volatility. Their job is difficult and can be thankless even when good and correct decisions are. But mistakes do happen from time to time, and these missteps can be a source of fear if not panic for many investors in the short term. Mistakes can amplify inherent stock market volatility to an excessive level and is a routine source of much of the stock market inefficiency we write about and discuss.

One need only look back to the past several decades to see examples of the Fed’s contribution to economic instability. The early 21st century housing boom. The Great Recession. Zero/near zero interest rates for over a decade. The current bout of once-in-a-lifetime inflation (transitory or secular?). Potential stagflation? The cause of the recent banking crisis can be traced back to the Fed’s low interest rate policy over the past decade (not including direct lapses in banking oversight). Bank mismanagement aside, SVB’s asset portfolio included typically safe U.S. Treasury bond holdings that fell in value as interest rates were pushed higher by the Fed over the past year. The sudden rise in interest rates surprised bank managers who did not imagine the magnitude of losses (in such a short period of time) as possible from “safe” government bonds. Regardless of one’s opinion on the merits of past Fed decisions, inefficiency typically follows every decision with a healthy level of volatility in tow. The one silver lining is that we view the Fed as a great source of the opportunities we seek to exploit in an inefficient stock market. In this case, we have seemingly been blessed by an abundance of opportunities attributable to the Fed.

“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.

Closing Remarks

Needless to say, we believe our primary thesis or investment philosophy that the stock market is inefficient (in the short term) is still intact. We believe that the Fed has been and continues to be a major contributor to stock market inefficiency and volatility – regardless of whether they made the right or wrong policy decisions. It follows then that we believe an opportunity still exists to add value beyond what an investor may receive from a passively invested investment portfolio. This does not mean that everyone can attempt to exploit this inefficiency or is guaranteed to add value through their efforts. Indeed, most studies suggest this and despite many flaws in the studies themselves, we would not disagree with their conclusions. This makes sense because if everyone could add value from their active investing efforts, aggregate value add would diminish to zero as we move closer towards an efficient stock market. Fortunately, the same studies do show that a minority of active investors can and do add value over time –persistently. For the many investors (we believe a strong majority them fit into this category) who are behind on saving for retirement and the many who risk outliving their wealth, this small percentage alone should be reason enough to have at least a portion of your investment portfolio actively managed. This is where we believe we can be of assistance. Please visit our website for more information on our investment philosophy and strategy (click [HERE](#) to read it). Enjoy the Spring!

“Never invest in a business you cannot understand.”
-- Warren Buffett

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

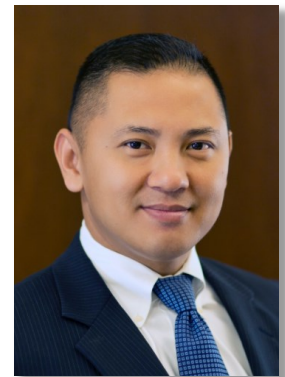
“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.” — Warren Buffett

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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