

April 27, 2022

INVESTMENT COMMENTARY

WE LOOK BACK AT 2021 AND FORWARD TO

THE REST OF 2022

PART II

THE UNAPPRECIATED AUTONOMY OF THE FEDERAL RESERVE SYSTEM

Executive Summary

On Thursday, February 24, 2022, Russian forces invaded Ukraine.

Russian missiles and tanks have now destroyed significant areas of several Ukrainian cities, including Chernihiv, Kharkiv, Kyiv, and Mariupol. In some cases, entire cities have been reduced to rubble.

Four million people have fled Ukraine, and more than a quarter of its population has been displaced.

People who have not fled Ukraine face dire conditions: they have little food and water and no electricity in many cases. Under the ongoing threat of violence, experiencing physical and psychological pain whose tragic intensity we have not witnessed since the end of World War II in 1945.

The United States and the members of the North Atlantic Treaty Organization have cut off many of Russia's banking channels.

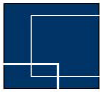
European corporations with substantial international operations, and American companies, such as [Chevron \(NYSE: CHV\)](#) and [Coca-Cola \(NYSE: KO\)](#), whose names are symbols of international reach and power, have ceased or paused operations in Russia.

Other corporations with global recognition, companies that have pioneered different ways of transacting everyday activities, such as [Mastercard \(NYSE: MA\)](#) and [Visa \(NYSE: V\)](#), have ceased operations in Russia.

If you live in Russia and have a [Mastercard \(NYSE: MA\)](#) or [Visa \(NYSE: V\)](#) card, this plastic will not do you any good shopping online or dining at a restaurant. Even if you have cash or rubles burning a hole in your pocket, you are out of luck if you crave a Big Mac and fries courtesy of the Golden Arches: [McDonald's \(NYSE: MCD\)](#) has ceased operations in Russia.

The United States and the North Atlantic Treaty Organization members have sharply cut back their oil and gas purchases from Russia. Germany, with great dependence on Russian oil and gas, has not made the same commitment to the embargo on Russian energy supplies as other NATO members have. Still, even a partial embargo on Russian oil and gas has pushed the demand for oil beyond its reduced global supply, sending the price of this commodity over the magical one hundred dollars per barrel level.

In 2021 prices in the United States for a wide range of commonly used products and services in the United States had been rising at their fastest pace since 1982. The Russian invasion of Ukraine had a widespread inflationary effect on the American economy, especially on petroleum products, which are components of thousands of finished goods and especially obvious when filling up the tank of your car at a



gasoline station. Gasoline now costs a lot more than it did a year ago and more than even a month ago.

The steep rise in gas prices may be a mere abstraction for [Jeff Bezos](#), [Bill Gates](#), and their respective ex-wives, [MacKensie Scott](#) and [Melinda French Gate](#). All members of the privileged boys and girls billionaire clubs have higher strata of worries, such as finding the right people for the foundations they sponsor.

Inflation is perhaps no more than a theoretical worry for an extremely small percentage (about one-eighth of one percent) of the individuals who file a tax return every year. These financial fortunate do not even have to worry if [Ruth Chris Steak House](#) structured its menu so that every item is priced a la carte.

Nor do these fortunate ever have to worry unless they were born with the parsimonious gene of saving money by purchasing non-refundable tickets when flying commercially.

In fact, when it comes to flying, these financially fortunate would probably never consider flying commercial. Instead, they would buy a fractional interest in a jet. If they were living in Tulsa, they would call the twenty-four hotline at [Omni International \(OMGT\)](#) and arrange for a jet available for departure within six hours. Some of my friends and clients take advantage of this service, saving much time, which is extremely valuable. They report their Omni experience as excellent. I have called Omni---it is a great experience---when some of our investments have done unusually well, and I want to indulge myself, just as I do when I enjoy a triple portion of mango sherbet at the Polo Grill in Tulsa.

Then, there are those who can hardly afford to dine at any restaurant. This group comprises, sadly, a growing percentage of the American population. When they venture out, they must seriously consider whether they can afford the king-size portion of [McDonald's \(NYSE: MCD\)](#) french fries instead of the regular size. For this group, a rise in the cost of gasoline is no fun.

For millions of Americans, people with ordinary incomes, filling up the gas tank can induce a sense of hopelessness and loss of control. These poor and middle-class taxpayers try to assure themselves that their end-of-the-year salary increase puts them in a comfortable economic position. Still, when they are in a mood buoyant enough to face the truth, they

know that inflation is rising faster than the salary increase they received last year.

[President Biden](#) must structure our response to Russian aggression by recognizing the political reality of higher petroleum prices. Cutting off our use of Russian energy entirely and pressuring our European partners to do so will help Ukraine but alienate a good part of the voting public. This affects the Fed's decisions, which affects the cost of credit.

RISING INFLATION FORCES THE FED'S HAND

The avoidance of recessions is not part of the official mandate of the Federal Reserve. The control of inflation, in contrast, is the official and legislated dictate of the Federal Reserve. Achieving this goal can lead to unintended consequences, one of which is a recession. A recession is not inevitable, but when credit gets expensive, as it will after the Fed decides to raise the discount rate, the risk of recession rises. Not to mention the rate will increase again in 2022 and perhaps some in 2023.

It is not surprising that when [Jerome H. Powell](#), [Chairman of the Federal Reserve](#), received his daily pricing reports in the last quarter of 2021 and scrutinized the steepening rise of inflation. He knew he had to do something decisive to avoid runaway prices, rising prices that can feed upon themselves.

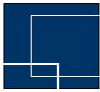
In the back of his mind, he must have been worried that aggressive steps to reduce inflation might lead to economic contraction, but he knew he had to subordinate that worry to conquering inflation. He also knew that the orthodox method of doing so was to raise the discount rate.

The consensus of the investment community knew as well that an increase in the discount rate was the Fed's likely answer to rapidly rising prices. The consensus believed that when the Fed would announce a discount rate increase of one-quarter of one percent.

On [Tuesday, April 5, 2022](#), [Powell](#) announced a half-point increase in the discount rate. The consensus was wrong.

Markets fell as investors realized that inflation was more serious than the consensus had assumed.

Investors had seen the same consumer price figures as [Powell](#) had. Information about inflation is not proprietary, classified, or otherwise shielded from public scrutiny. Investors



concluded the bigger than expected increase in the discount rate on April 5 suggested that the Fed's view of the inflationary landscape was more pessimistic than many investors had forecasted.

There is another way to look at the Fed's decision to hike rates. Decisive action on rates could dramatically cure inflation, making the Fed's rate increase a good thing.

The tug of war between inflation and any economic slowdown is playing out in the stock market. We have seen greater than usual volatility and tough performance in the first quarter of 2022 and thus far in April.

There may be more uncertainty than usual. It could very well turn out to be a challenging period, but things will work out fine.

However, it may also be useful to consider that if markets respond negatively to the Fed's campaign to end inflation, bargains in the stock market often present themselves when times are tough.

A QUICK REVIEW OF THE 2009-2021 PERIOD

For investors from 2009 through 2021, almost everything was going their way. Employment numbers showed steady growth, and corporate profits rose quickly.

The Consumer Price Index, a standard measure of inflation, registered only a few significant gains. There was some inflation, but not enough to cause any worry.

The financial landscape was becoming so positive that it created complacency and even recklessness among the investment community.

Former **Federal Reserve Chairman Alan Greenspan**, when speaking of the dot.com internet boom and bust of 2000-2002, was often worried that rising, unrealistic expectations had triumphed over rational thinking. He found investors vulnerable to "irrational exuberance." **Greenspan** forecasted that such a mindset could not go on forever as stories of quick riches became more fantastic and overheated prices ran further ahead of reality. He was prescient.

When the boom of 2000-2002 ended, many investors awakened to a painful truth: they were swimming naked as the tide went out.

Overconfidence and even recklessness replaced the fear and dismal outlook that prevailed when the indexes were at their lowest point in 2009. But toward the end of 2021, the market's collective mood echoed the final stages of the dot.com boom of 2000-2002: overconfidence and inadequate respect for risk now dominated investor thinking.

It is rational and okay to pay ten or fifteen-times earnings for one share of the common stock when profits grow ten percent a year. But beyond the fifteen times limit, we are entering a vast territory of risk where the probability of capital loss, whether realized or unrealized, becomes more likely.

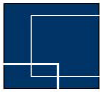
It is okay to buy shares of a company that experienced losses in its formative years and is now profitable. However, if we invest in a company that has experienced multi-year losses and no clear avenue to profitability, we are playing with fire.

Investors were indeed playing with fire in the last stages of the bull market from 2009 to 2021, and a perfect storm was booming; complacency and recklessness were about to collide with a rising wave of inflation.

The return of inflation challenged the seductive thinking that had taken investors captive. If the dollar had declined in value and did not have the purchasing power it once had, what else could be wrong? The recrudescence of inflation forced us to examine every aspect and assumption of our thinking. What, for example, was a reasonable price to pay for any common stock share of a publicly owned company? What price, if we took a cold, unemotional look at the balance sheet, the income statement, and other conventional signs of financial health, ought the earnings of one share of common stock command?

Once moved by companies with exciting stories but little substance, investors began to think aloud about the wisdom of buying companies whose prices were vulnerable to the slightest disappointment. Investors began the mundane return to reality, and for those with dreams particularly out of whack with reality, this return was traumatic.

Companies whose share prices had been aggressively promoted by Wall Street faced a particular come to Jesus' experience. No longer could a company claim a fantastic price without any earnings. Companies such as **DocuSign, Inc. (NASDAQ: DOCU)** enjoyed several years of impressive revenue growth. But the company had no earnings. Investors revised their appraisal of **DocuSign (NASDAQ: DOCU)**, and



from its peak of \$298.04 on [Wednesday, July 21, 2021](#), it closed on [Thursday, April 14, 2022](#), at \$99.14.

THE FED'S POSITION OF UNDERSTATED PRIVILEGE

The textbooks from our earliest days of education in middle school and high school suggested that the American political system was based on a system of checks and balances. These textbooks implied our government was so well designed that it would be difficult for any of the three governmental branches to wrest power away from the other branches.

This teaching omitted the role of the Federal Reserve.

We were also taught that there would be a transfer of power only when we had elections. But here again, what we were taught contradicted reality.

The Chairman of the Federal Reserve System does not need to win any election to gain his position. Moreover, once he has the President and Senate behind him, the Chairman enjoys four years of power and prestige. The United States was founded on the concept of democracy, but the problem was that the electorate had no say about who the Chairman of the Federal Reserve would be. It was not the people's choice.

The public had played no role in the choice of [Powell](#) as Chairman of the Federal Reserve. Instead, the President of the United States had nominated [Powell](#) to be Chairman of the Federal Reserve. The Senate approved the President's nomination, which is the usual course of action. Once the Chairman's nomination is approved and secure, he or she does not answer to anyone except for the annual report to Congress. Of course, if married, he or she must answer to, or at least cooperate with, a husband or wife. Some obligations are immutable. Some things never change.¹

The Federal Reserve System is a peculiar hybrid; it can be considered a branch of the federal government and an independent central bank: it makes far-reaching monetary policy decisions without requiring approval by the President or anyone in the executive and legislative branches. It does not receive funding appropriated by Congress. The twelve-year

term for the Board of Governors members spans multiple presidential and congressional terms.

The Federal Reserve Board is full of scholars with Ph. D degrees who have taught at the university level and believe that the public cannot possibly understand the complexities of our economic system, such as the Fed's power to expand or contract the money supply. When the Fed fears inflation, it will take measures to contract the money supply, such as raising the discount rate. When the Fed wants to encourage economic expansion, it will make credit cheaper. These concepts are beyond understanding, Fed members believe, for much of the public.

The President of the United States has much power and prestige and could be the most powerful person in Washington, DC. Still, we ought not to discount the influence of the Federal Reserve and its Chairman, who can move markets with one sentence. The Chairman does not have to obey the President and listen to the public. It would be politically wise to defer to the President on some matters. And it is always prudent to show respect for the public's intelligence, even though this respect is often shallow and insincere. Most importantly, the Chairman does not have to obey the President's wishes because he does not have to bow to the public or worry about re-election.

A way to look at the respective powers of the President and Chairman is this: the President, as Commander in Chief, can launch a war; however, the Federal Reserve can influence the behavior and lifestyle of millions of Americans with one decision: a decision to raise or lower interest rates.

A PERSONAL HISTORY: HOW I LEARNED TO LOVE AND UNDERSTAND THE FEDERAL RESERVE SYSTEM AND ITS MAGICAL WAY OF CREATING AND DESTROYING MONEY

It was quite some time ago. I was a freshman at Swarthmore College in Swarthmore, Pennsylvania. It was the first day of classes. I was about to attend the first course in my four-year educational experience, a course titled Introduction to Political Science (I still have not figured out why Political Science is considered a science. It is not a science. It does not

with her views on climate change and pollution. She withdrew her nomination. Usually, there is no opposition once the President gives his imprimatur to a nominee for the Chairman or member of the Federal Reserve Board.

Footnote:

1:On [Tuesday, March 15, 2022](#), [Senator Joe Manchin](#), D., West Virginia, voiced opposition to [Biden's](#) nomination of [Sarah Bloom Raskin](#) to the Federal Reserve Board, saying he was uncomfortable



have the same rules as science does, such as the sequence of steps that begin with an observation and end with a conclusion, which may confirm or reject a hypothesis). I was sitting in the classroom, waiting nervously, appraising the other students, trying to guess which ones had scored a perfect 800 on the math and verbal sections of the SAT. The clanging of a bell announced the start of the class just as the professor walked into the classroom. He set his notes on the lectern, introduced himself, and began to speak.

The professor was not dynamic, and neither was the subject. He summarized the first two chapters of the textbook, which included a tally of elected officials in the House of Representatives and the Senate. Nice numbers to know. Maybe I could rattle them off when I met a good-looking female student at a dance or a party which, upon reflection, seemed to be so tame when compared to what goes on today at many college and university campuses. (I believe I went to college at the wrong time).

Despite my sleepy state, I did gather that the government, based on checks and balances, was ingeniously designed to be free of conflict, promote efficiency, avoid corruption, and assure independence for the three branches of government: legislative, executive, and judicial. Any problem the country or the government faced would be solved in a logical, emotionally antiseptic environment, free from conflicts of interest and corruption.

Everything sounded laudably efficient. The government operated without friction and power struggles.

The professor delivered the concept of a government so well-conceived and constructed as to leave no room for special interests and the abuse of power. Unfortunately, the theory was not accompanied by any real-life references. I was only seventeen years old; I did not have much experience in the real world and did not have the street smarts to decide whether the textbook world and the professor's view of governmental harmony were in sync with how reality worked.

But something did not feel right. The picture that the professor painted seemed to be too perfect, and the harmony between the three branches of government was wonderful but not realistic.

Nevertheless, the professor's view of government as one with the stress-free qualities of heaven was so reassuring and calming, seeming to almost guarantee an easy, guaranteed path

to one hundred percent governmental efficiency. This Pollyanna picture of the American government could remind anyone of the guaranteed peace of mind formulas offered by the popular psychological books that reached the *New York Times* (NYSE: NYT) best-sellers list every week

The professor did not take the class into the rough and tumble of politics. Instead of the apparent obligatory analysis of checks and balances, I wanted to experience the bargaining and horse-trading in the smoke-filled back rooms, even if our experience would be confined to the vicarious.

I wanted, for example, to experience the heated, tortuous negotiations between the right-wing of the Democratic Party and *President Lyndon B. Johnson* that led to the passage of the Civil Rights Act of 1964. Nor would we see the negotiations between the Pentagon, Congress, and the President over the size of the annual defense budget.

As the professor droned on, I thought perhaps things were not how my inexperienced mind imagined them. Maybe I was in a control group, and Swarthmore had hired a marketing firm to use the class for an experiment. Perhaps students who had a breakfast of one-thousand calories or more were on my side of the room. On the other side were students who had enjoyed fewer than one-thousand calories for breakfast. The marketing people wanted to see which group retained more of the lecture.

The professor inadvertently endowed the atmosphere with a special kind of powerful and mindful relaxation. Despite my best efforts, a feeling of drowsiness began to overcome me. I was about to fall asleep, which would have put me in grave danger. This drowsiness was unfortunate. In a class of fewer than twenty-five students, I reminded myself that it was not wise to fall into a deep slumber or even a mild sleep. The professor would surely notice my presence or lack of presence.

Somehow a warning system took over, and I sat up straight, alert enough to grasp the concepts delivered in the last few minutes of the class and to avoid the backlash that would have come if the professor had noticed that I was asleep, even after the loud bell had rung.

The clanging of a bell fully awakened me. I exited the room and headed to Introduction to Economics 101, a course that I hoped would be more stimulating than my adventure into political science. I knew that the economics professor had



worked in government and had hoped he could marry theory and reality. I was not disappointed. Economics soon became my favorite class.

When we approached the subject of money and banking, I could mesh my interest in American history with what I was learning about the Federal Reserve System.

After one class, whose focus was the anti-inflationary mission of the Federal Reserve, I began to think of a late nineteenth-century American political conflict. Some people, representatives of big eastern corporations, believed that a dollar linked to the price of gold was a source of stability. In contrast, represented by the Democratic party believed this arrangement would leave farmers and other struggling groups vulnerable to inflation.

In a magnificent speech before the Democratic Convention of 1896, [William Jennings Bryan](#) said, "You shall not crucify us on the cross of gold," which captured the nineteenth-century struggle between those who wanted to fix the dollar to the price of gold and those who did not.

The Federal Reserve was established in 1913 with the memory of runaway inflation and the Panic of 1907 seared into the American mind.

As the Swarthmore professor spoke, I had a better idea of why the Federal Reserve Board was created: managing inflation would always be its number one priority. His class escaped from the sanitized view of politics, and we were now living in the exciting world of reality, even if our experience was vicarious. Our economics professor had worked in Washington and knew how power worked in the city.

There had been no mention of the Federal Reserve System by the political science professor. Even more curious was that they did not discuss the Fed's privileged position: the Federal Reserve branch was virtually free from the checks and balances that governed the other Federal government components.

As we continued to study the Federal Reserve, I could understand why some bright young people who understood how our government really worked would believe that it would be wonderful to be the President of the United States. But better yet, it would be best to be the Chairman of the Federal Reserve System. When it came down to taking action

of the most significant importance to the economy, the Fed did not need permission from anyone, including the President, to make decisions that would affect millions of Americans.

The Fed encompassed many activities: it did much more than create and destroy money. Its influence was felt in many areas, such as its supervision and control of the money markets, lending treasuries overnight, and then buying back the securities minus a loan fee.

If this was arcane, I had to remind myself that billions of dollars are traded daily using the repo or reverse purchase method with a low probability of any problems occurring. (The experience of the more economically unfortunate with the word repossession, long for repo, comes when two burly men with an extended trailer come to seize the car of a borrower who has defaulted on his car payments. Repossession of a vehicle financed through a loan from a bank or other financial institution was far different from the repossession of treasuries lent to one government bond dealer by another.)

TODAY'S INFLATION IS NOT A NOVEL EXPERIENCE FOR THE UNITED STATES

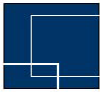
Before the advent of fracking, the United States was critically dependent on foreign oil. When the Arab oil embargo of 1973-1974 struck, gasoline prices quadrupled, creating a powerful inflationary wave that persisted well into 1979 when [Paul Volcker](#) became Chairman of the Federal Reserve Board of Governors.

PAUL VOLCKER CRUSHES INFLATION, BUT RECESSION FOLLOWS

[Volcker](#) moved into his plush office on Massachusetts Avenue as inflation roared ahead. In 1967 the Consumer Price Index was 100, and by 1970 it was 116.

Everyone feared inflation. You could hedge by buying land, gold, and silver, but the middle class and the poor did not have enough money to hedge, except by purchasing a house.

With inflation, the value of a house rose (not everywhere: a purchase in Camden, New Jersey, a city of daunting squalor, drug use, and high levels of permanent unemployment, would have been disastrous).



On the other hand, acquiring a home in Aspen, Colorado, San Francisco, or in The Research Triangle of North Carolina would have been fortunate. If you had bought a house with a mortgage attached, you most likely owed the bank a lot of money.

But when inflation exists, you will make payments toward principal and interest in depreciating dollars and get to write off interest payments against your taxable income. This furthers the argument that the middle-class benefits from inflation with its home a high percentage of its assets.

There may be one problem, a problem of temptation. Borrowing money from a bank or a credit union means that interest expense yields a sizeable write-off against taxable income. The maturity of the mortgage is often decades into the future, giving the homeowner great discretion over his or her annual cash flow, and may encourage the homeowner to relax her financial discipline and spend money on unnecessary purchases.

Sometimes such spending produces credit card bills that cannot be paid off within the time allowed by the monthly business cycle imposed by [American Express \(NYSE: AXP\)](#), [Discover \(NYSE: DFS\)](#), [Mastercard \(NYSE: MA\)](#), and [Visa \(NYSE: V\)](#). The result is often disastrous: the credit card company hikes the interest rate on delinquent payments, making it more difficult for the consumer to meet monthly payments, setting off a hard-to-escape cycle. (This cycle is not inevitable. Millions of consumers pay their monthly credit bills in full and in time to avoid interest charges).

In [Volcker's](#) acceptance speech, he emphasized the dangers of inflation, citing a proliferation of speculative activities, such as investing in art objects and in large or second homes as inflationary hedges. He emphasized that using borrowed money to create inflationary hedges introduced much risk into the consumers' lives.

The message was clear when you listened closely to [Volcker's](#) speech, paying attention to what he said rather than what you wanted to hear. The Fed would do all it could to stop the relentless explosion of higher and higher prices that had taken hold of the economy; no matter what the consequences.

Consumers were now assuming that prices would rise no matter how high they were. So, if a higher price stared consumers in the face, they would go with the flow, follow the path of least resistance, and pay the new higher, inflated price.

The cost, the consumers believed, will be higher tomorrow. These consumers were often correct: anxious businesspeople and consumers, well-conditioned to frequent rises in the price of virtually everything, abandoned their budgets, buying everything they needed or wanted.

Runaway inflation, [Volcker](#) worried, was becoming a real possibility. Consumers and businesses were no longer postponing purchases or negotiating over things they wanted.

[Volcker](#) did not like to see a tidal wave of rising prices. He could decide to do nothing about inflation and hope it would run its course. However, putting one's head in the sand may have been a good strategy for an ostrich but not for the person in charge of the American economy.

Inflation would not go away by declaring that it did not exist. A pragmatist, [Volcker](#) believed that inflation would only worsen if unchecked. Inflation, without government intervention, could quickly become a runaway, self-fulfilling inflation.

In his darkest thoughts, [Volcker](#) even worried that if inflation were left unchecked, the country might have to deal with stagflation: declining productivity occurring with rising prices.

Yet if he aggressively raised the cost of money---by raising the discount rate, increasing reserve requirements imposed on banks, or through other methods---such moves could cause a recession.

[Volcker](#) knew that action was imperative, and he believed that he had only two choices. Neither choice was easy. Each commanded a high price for the success of stopping inflation.²

He believed, nevertheless, that the better or less harmful of the two tough choices was to raise interest rates.

Footnote:

² [Volcker](#) even feared that credit tightening could produce a dyspeptic economy---an economic condition in which prices rose

and productivity declined. (The stag, the first four letters of the word inflation, had nothing to do with the status of a person who goes to a social event without a date and is "going stag").



President Jimmy Carter's views differed dramatically from Volcker's on how to cool an overheated, inflation-compromised economy. Carter had re-election on his mind. Even if inflation worsened, he would not want the Fed to tighten, possibly causing a recession that would weaken his chances of keeping the Presidency in 1980.

Volcker's priority was quite different. He would raise rates aggressively to stamp out inflation, even at the cost of a deep recession. Unintended but quite probable, the crushing of the economy would be Volcker's secondary concern.

In meetings with President Carter, the Fed Chairman would soften his stance on the need to eradicate inflation, paying respectful attention to Carter's arguments. But he rarely wavered in his number one priority: eliminating inflation.

Raising the interest rate at the discount window: This was the Federal Reserve's usual technique to hit inflation in the solar plexus.

It effectively sets powerful waves of more expensive money rising higher and higher throughout the economy. With trips to the discount window at the Fed much more expensive, banks will then pass on their higher costs for money to their customers, who then impose their higher interest charges for their financing.

Paul Volcker was a part well-trained economist and part shrewd politician. He knew he had to stop inflation in its tracks.

The best way, the most effective way to do this, was to raise interest rates. But to be explicit and forthright, this plan was politically unwise. A public addicted to cheap money would be alarmed by a clear proclamation to raise interest rates.

He would have to take an indirect approach. He knew that if the Federal Reserve could require member banks to set aside more reserves against their loans, the money supply would shrink, making it more costly to borrow money.

This indirect approach to raising interest rates was not one of the conventional weapons the Fed had used to tame inflation.

When Volcker appeared before Congress and was asked whether he intended to raise interest rates, he would reply, disingenuously, that he aimed to increase the reserves that banks must set aside against the loans they make.

His intent, he would aver, was not to raise rates. In off-the-record conversations, he would admit that targeting reserves was another technique besides raising the discount rate, making money more expensive, tempering borrowing, slowing down the economy, and defeating inflation.

This response did not fool the cynics, but it provided excellent cover for Volcker's public image.

It may seem implausible, or as teenagers say, even weird, but somehow Volcker's understanding of language and strategy reminded me of my dietician's patience as I struggled with the temptation of chocolate cake.³

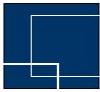
Suppose you force the member banks of the Federal Reserve to hold a higher cash percentage against the loans they make. When the money supply is constricted, borrowing money becomes more expensive, and expansion slows down.

Volcker had respect for the subtleties of language and the importance of presentation. He could use the same words to deliver two messages, with the meaning of one wildly different from the other.

Footnote:

³ Volcker's skill with language reminded me of my dietician's frustration, struggling painfully with me in the few sessions that my ego permitted, avoiding terming me obese or fat. Instead, she declared that if I could achieve discipline in a small arena of the diet battle, that is, in tempting desserts such as chocolate cake and cherry pie, I would be in diet heaven. I knew that if I made her drink truth serum, her indictment of my diet habits would be comprehensively damning. In my monthly sessions, I knew that when I would confess to eating chocolate cake, I could see her making heroic efforts to control her impatience with my failure to follow her diet directives

and suddenly stop her rant. Seemingly, out of step with her preceding remarks, almost amounting to a non sequitur, she would proclaim, almost sheepishly, "but you have shown, Fredric, a remarkable increase in self-discipline." I would have been thrilled to have heard that I was aware of my problems and had not only been on a serious ascent to self-discipline but had achieved such a great state. This was not about to happen, especially with my dietician's critical personality. I had learned to adjust my expectations about returns in the stock market, but I had a more challenging proposition with expectations about positive reinforcement with my dietician.



One could admire his discipline in choosing the right word to fit any occasion, especially when he had to work with a decision whose effects were far more serious than how much chocolate cake you could enjoy.

If Congress questioned him on the wisdom of raising rates, he would repeat that his goal was not to raise rates but to control the money supply.

Everyone would be happy at the end of the annual hearings before a grandstanding Congress. Congress would come across as educated and selfless, [Volcker](#) would appear knowledgeable, maybe even omniscient, and the public would feel relieved as they told themselves that any belt-tightening would be mild.

In his *Secrets of the Temple, How the Federal Reserve Runs the Country*, [William Greider](#) recounts the shrewd thinking behind [Volcker's](#) method of raising interest rates.

By targeting the reduction of M1, the most common measure of the nation's money supply, the Fed would achieve its goal of raising interest rates without telling the American public exactly what it was trying to do. The Fed could then say that 'market' pressures drove up interest rates. However, the Fed would not be telling the whole truth: the 'market' pressures directly produced the Fed's tightening. (William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country*. Simon and Schuster, 1989.)

So, [Volcker](#) embarked on an unorthodox avenue to raise interest rates through increasing reserve requirements. His strategy worked. Maybe too well.

Within months inflation fell decisively, but the country paid a steep price to stop inflation.

With credit more expensive, businesses dialed back expansion, production fell, unemployment rose, and the economy succumbed to a brutal recession.

Will [Powell](#) follow the [Volcker](#) playbook, which calls for swift, bold action against inflation? What will [Powell](#) do if inflation speeds up? If inflation falls decisively in the coming months, will [Powell](#) ease off the brake of discount rate increases? It is difficult to tell.

Inflation is not a novel experience for the United States. We have experienced significant and relentless rises in prices many times and survived the challenge of inflation. We have endured slowdowns, but we have resumed growth, and the economy has reached new heights.

POWELL HAS AN IMPRESSIVE RESUME

Like [Volcker](#), [Powell](#) has an impressive resume and is dedicated to fighting inflation.

[Powell](#) played an essential role in creating the [Paycheck Protection Program](#), a \$670 billion program designed to lend money to businesses crippled by the departure of customers after Covid-19 struck.

There were, of course, some unintended beneficiaries, such as the [Boston Market](#) restaurant chain, two prominent law firms, and one professional basketball team. They did not need the money this program provided, unlike millions of people thrown out of jobs because of Covid-19.

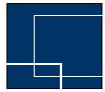
[Powell's](#) resume came in handy after the first waves of Covid-19 volatility arrived from Wuhan in January 2020. [Powell](#) had worked at [Carlyle](#), a hedge fund, and [Dillon Read](#), a white-shoe investment bank. He understood the uses, advantages, and dangers of debt and the sensitive interplay between the Federal Reserve, Treasury, and the two dominant debt-rating agencies, [Standard and Poor](#) and [Moody's](#).

[Powell](#) understands leverage, money, and the intricacies of the Federal Reserve System. He has overseen the Treasury department division that auctioned off billions of public debts. There are few experiences affecting money that [Powell](#) has not faced.

Like any Chairman of the Federal Reserve, he has challenges. I am sure he will meet them. We have been through several challenging periods. We will get through this one as well.

Sincerely,

Fredric E. Russell



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END OF PART II

ESSENTIAL FACTS ABOUT THE WAY WE
INVEST OUR CLIENTS' MONEY

Fredric E. Russell has a BA from [Swarthmore College](#) in Swarthmore, PA, and an MBA from [Washington University](#) in St. Louis, MO. He also holds the CPA certificate, and he has taught accounting and finance at the university level. He believes that his love for writing and usually correct grammar comes from spending four years learning the English language at [Deerfield Academy](#) in Deerfield, MA, and spending countless hours in the [Swarthmore College](#) library reading the books of authors with great styles between the surreptitious study of women he thought about approaching for a date on the following weekend.

We manage our firm with the understanding that we have an obligation to tell our clients why we invest in certain companies, companies that reflect our investment strategy. This obligation is subordinate to doing our best to make money for our clients. Still, it is important to make it clear to our clients what our strategy is, emphasizing unusually well-managed companies with competitive advantages likely to persist for at least five years. Without any unnecessary complications, attempting to write an entertaining and informative manner, respecting the time and intelligence

of our clients—is critical in creating an attractive product and service for our clients.

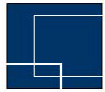
Some investment managers will say directly or imply that what they do is unusual, maybe even unique. These managers use self-congratulatory language and describe their methods as proprietary, giving their work a connotation of superior intellectual value. We do not claim to originate our strategy or execute it better than anyone else, but we work hard to be faithful to our strategy. With constructive challenges and well-intentioned assertive feedback among our colleagues, we seek to probe what makes a company work. We hope that with thorough research, we will shelter our clients from unfavorable developments and risks, some obvious and easy to spot, some camouflaged, and some that management may want to discount or even hide.

We have made mistakes, and I am sure that we will continue to make mistakes, but by assiduously respecting our methods, we will continue to refine them to be more effective. We will not change our strategy. We believe it makes sense in all markets and across all business sectors.

Managing money and acting as a well-intentioned fiduciary is an ongoing challenge. There are hundreds of sources of information. There are many steps to take before a deliberate commitment to buy or sell a security. It is essential to have a philosophy and a strategy for managing money to respect these pressures. No strategy is perfect, sidestepping every risk in a global economy that gets more complex every day. But we believe our approach makes sense. It is not an original concept. Many have used it, and some have pioneered it. It works as follows:

In executing our strategy, the first goal is to research across every business sector, study companies, and attempt to locate companies that we believe possess competitive advantages.

What makes a competitive advantage is a subjective exercise. Some would argue that some companies in our client portfolios have a collection of competitive advantages greater than others in our portfolio. Some



might argue that some companies have no competitive advantage or that any competitive advantage is transitory and vulnerable to many developments and risks.

In the 1980s, [Intuit \(NASDAQ: INTU\)](#) began to wrest market share from [H&R Block \(NYSE: HRB\)](#). Building on the rapid acceptance of the personal computer, [Intuit](#) made it possible to file taxes using well-conceived software. In contrast, [H&R Block \(NYSE: HRB\)](#) was slow to see the fast adoption rate of the personal computer.

[H&R Block \(NYSE: HRB\)](#) is based in Kansas City. In 1989 we were shareholders, and I made two visits to the company to meet [Henry Bloch](#) and other top management. They were courteous and well-informed in every aspect of their business, which had been wildly successful. But they did not seem to grasp the competitive threat that doing taxes by software might pose. Did they believe that low and middle-income taxpayers would continue to bundle up all their tax documents, drive to a spartan office in a strip center, drink some stale coffee, and sit patiently with a person whose tax training was subpar? Usually, this tax "specialist's" training consisted of a few weeks of classes at the company's headquarters in Kansas City. These [Block](#) employees often had no background in accounting and even less in the bewilderingly complex tax code revised and made more complicated year after year.

In contrast, [Intuit \(Nasdaq: INTU\)](#) understood the power of economies of scale. Once you spent money on research and development to produce a good software program, you could amortize the program's cost over thousands or maybe even millions of customers so that research and development for the program could yield a low per-unit cost.

Granted, [owning shares in H&R Block \(NYSE: HRB\)](#) had made many investors rich. But during my visits, it seemed that the company was not acutely attentive to the power of the computer and its revolutionary effect on their business. As a shareholder, that made me nervous. What also worried me was that the company's [President, Thomas Bloch](#), whom I met on my second visit, did not seem to be the ultra-competitive personality that usually occupies the corner office. I enjoyed meeting with him: he was personable and knew the business inside and out.

[Intuit \(Nasdaq: INTU\)](#) is an example of a company with deep and long-lasting competitive advantages in the 1980s. In contrast, [Intuit \(Nasdaq: INTU\)](#) made filing taxes extremely convenient. You could easily do your taxes by following the software program's prompts while drinking your Quik-Trip coffee. Creating the software was [Intuit's \(Nasdaq: INTU\)](#) first major competitive advantage. It enhanced this advantage by linking its wildly popular QuickBooks with TurboTax, its software offering for individuals and small businesses, which could be used to file business and individual tax returns.

QuickBooks could also be linked to the offerings of other companies. In fact, QuickBooks links with more than seven hundred software programs produced by companies other than [Intuit \(Nasdaq: INTU\)](#). We might think of all these links or tie-ups as another brick in a fortress that is well-protected against the competition. The reason for this logic? The more products or services a company can offer, the more a company creates a convenient one-stop shopping experience. The more enticing you can offer, the more you make a customer dependent on your offers. That is especially true when the links save time and other expenses. Information from [Intuit's \(Nasdaq: INTU\)](#) QuickBooks software flows effortlessly into the company's TurboTax software, giving TurboTax an important competitive advantage over the tax software offered by [H&R Block \(NYSE: HRB\)](#) and other competitors.