CAMSTON
ASSET MANAGEMENT

Dear Friends and Clients,

Everyone is busy, and I find that generic commentary on a monthly or quarterly basis provides little value. I plan to only write to you when I feel that I have something important to say. Given the low amount of activity in the accounts since inception, I would like to share my sentiments on the investment of my own and your savings to help you better understand my thoughts and positioning.

I started my investment practice to protect and grow my family's and investors' savings. I view the money entrusted into my care as ***savings*** and not 'funds'; the distinction is essential. The term 'funds' seems abstract. In contrast, the word '***savings***' is concrete. It is easy for me to understand the importance of savings. When Grandma speaks of her 'life savings,' there is no mistaking what is meant. These savings must be respected and appreciated for the years of work required to earn and accumulate. I view all of the money entrusted to my care as the only money a family or institution may ever have. It is my responsibility to protect those savings before stretching to grow them.

I hope this letter provides you with more insight into who I am, how I allocate my own and your savings, and how I view the current investment landscape.

"All my life I've been hearing about this 'pound of cure.' How much does it cost by the pound?" - Ron Morgan

I believe the long-term success of an investment practice is to achieve an adequate compounded annual growth rate (CAGR) sufficient to meet the stakeholders' financial needs and provide a greater return than passive investment. To achieve this aim, I focus first on risk, not return.

It is my opinion that risk mitigation should be at the core of investment philosophy and practice. The ounce of prevention… I do not view risk mitigation as searching for low volatility relative to the mean return (Sharp ratio). My risk management goal is to limit significant downside losses. When focused on long-term investment returns, I believe that it is not the large or small gains or even the small losses that matter most to investment outcome but the significant losses that I must avoid.

Being right can bring considerable rewards when investing, but being wrong can bring disproportional negative results. I hope to highlight why I believe this to be true and how I am allocating our savings to use this to our advantage. The following table can illustrate the effects of losses as disproportional to gains.

Original $1000 Investment			Required Gain/Loss to Return to Original Value	
Gain/Loss	Percentage Gain/Loss	New Value	Percentage Gain/Loss	Gain/Loss
Loss	-100%	$ -	-	-
Loss	-90%	$ 100.00	900%	Gain
Loss	-80%	$ 200.00	400%	Gain
Loss	-70%	$ 300.00	233%	Gain
Loss	-60%	$ 400.00	150%	Gain
Loss	-50%	$ 500.00	100%	Gain
Loss	-40%	$ 600.00	67%	Gain
Loss	-30%	$ 700.00	43%	Gain
Loss	-20%	$ 800.00	25%	Gain
Loss	-10%	$ 900.00	11%	Gain
No Change	0%	$ 1,000.00	0%	No Change
Gain	10%	$ 1,100.00	-9%	Loss
Gain	20%	$ 1,200.00	-17%	Loss
Gain	30%	$ 1,300.00	-23%	Loss
Gain	40%	$ 1,400.00	-29%	Loss
Gain	50%	$ 1,500.00	-33%	Loss
Gain	60%	$ 1,600.00	-38%	Loss
Gain	70%	$ 1,700.00	-41%	Loss
Gain	80%	$ 1,800.00	-44%	Loss
Gain	90%	$ 1,900.00	-47%	Loss
Gain	100%	$ 2,000.00	-50%	Loss

Source: Camston Asset Management, LLC

This disproportional effect of losses is crucial to think about risk. Significant losses can considerably impact the ability to compound savings over time. The impact of these losses can be shown by looking at investment returns geometrically and not arithmetically. If we take a simple example of experiencing a 50% loss in year one and experiencing a 100% gain in the second year, your arithmetic average is a 25% [(-50+100)/2] return, not too shabby. However, the arithmetic average is not what matters to your savings. Time moves forward linearly, and your returns are not the arithmetic average. Your returns are the geometric average. Experiencing a 50% loss in year one and a 100% return in year two just gets you back to where you started. You do not have a 25% growth rate on your investment; you have no growth and two sunk years.

It is essential to think about stock market returns in the same way. The long-term geometric average return of the S&P500 is roughly 9.79%. If you experience a significant loss of >30% of your savings and can only achieve the average return in the following years, it could severely affect your compounded growth rate. The following table shows the impact of losses relative to gains by viewing the returns arithmetically versus geometrically.

Year	S&P 500 Return*	Averages	
2000	-9.03%		
2001	-11.85%		
2002	-21.97%		
2003	28.36%	Arithmetic Average 2000-2020	Geometric Average 2000-2020
2004	10.74%		
2005	4.83%	8.09%	6.54%
2006	15.61%		
2007	5.48%	Arithmetic Average 2005-2020	Geometric Average 2005-2020
2008	-36.55%		
2009	25.94%	10.85%	9.47%
2010	14.82%		
2011	2.10%	Arithmetic Average 2010-2020	Geometric Average 2010-2020
2012	15.89%		
2013	32.15%	14.38%	13.85%
2014	13.52%		
2015	1.38%	Arithmetic Average 2015-2020	Geometric Average 2015-2020
2016	11.77%		
2017	21.61%	13.29%	12.65%
2018	-4.23%		
2019	31.21%		
2020	18.01%		

*S&P500 Return Data: NYU Stern School. *Historical Annual Returns on Stocks, Bonds, and Bills:1928-2020.* January 2021: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

When calculating CAGR over several years, the effect can be great. I am focused on investing long-term, so raising the geometric average is very important. Over this span (21 years, 2000-2020), we can see the difference between the geometric average and the arithmetic average by calculating the outcome of $1000 invested in 2000 through 2020. At a CAGR of 8.09%, the arithmetic average, our $1000 invested becomes $5,122.66 [$1000*(1+.0809) ^21]. However, that same $1000 invested using the (actual) geometric growth rate of 6.54% becomes $3,782.39 [$1000*(1+.0654) ^21]. A difference of $1,340.27 or 26.2%. The difference in returns is what

Mark Spitznagel of Universa Investments has termed "the volatility tax." And quite the tax it is! A 26.2% tax on your returns versus what would be assumed if you received the arithmetic average is nothing to sneeze at. Let's see how this "volatility tax" affects long-term investment results.

Arithmetic Versus Geometric Averages for the S&P 500 1928 - 2020*	
Arithmetic Average	Geometric Average
11.64%	9.79%

*S&P500 Return Data: NYU Stern School. *Historical Annual Returns on Stocks, Bonds, and Bills:1928-2020.* January 2021: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

Now we can see the impact of that same $1000 invested in 1928 and compounded at the different rates through 2020. The arithmetic average would compound our investment to a handsome $28,005,542.31. But because of the "volatility tax" imposed on our returns, the actual expectation would be $5,920,235.91.

If this "volatility tax" erodes our ability to compound, my focus must be on paying as low as tax as possible. I prefer to let volatility work to our benefit rather than our detriment. For that to happen, I must be prepared for downside volatility and decisively act when it occurs.

"Liquidity is only there when you don't need it." – Old Proverb, The Devil's Financial Dictionary

Some investors choose to be fully or near fully invested at all times. I am not one of them. Nor do I believe I have predictive power to time the market. I certainly do not know what the market will look like in the short term. I can't even tell you whether the market will be up or down at the end of the day. However, I do believe I have a variant conception of market timing.

I don't view building and holding cash/gold position(s) as market timing. Conversely, I believe if I were fully invested now, I would be attempting to time the market. I'll explain.

I believe that markets are cyclical. I don't pretend to know when this cycle will end, nor do I have any clue by how much any correction would be. We are experiencing a time now where assets are trading at top percentiles, and it seems imprudent not to proceed with caution. The good times eventually come to an end. When? Who knows?

When the market turns, I will be looking to take advantage of the opportunity downside volatility brings. If I plan to "buy when there is blood in the streets," I must first have money (cash) available to purchase. That is a crucial feature of the strategy. If I don't have the dry powder (cash) to invest when downside volatility strikes, I am simply another one bleeding in the street, trying desperately to tourniquet.

If I plan to remain 100% invested and take profits before the market turns, I may not have that luxury. Market declines have historically been sharp. At times of market panic, correlations can quickly go to one.

Without cash available, as opportunities materialize in a market downturn, I would be forced to evaluate the attractiveness of current holdings versus the new opportunities. New bargains present new opportunity sets and additional pressure to trim positions at an inopportune time. The companies owned in the accounts will likely be depressed from the pre-downturn level. Not looking as shiny and bright as they did, perhaps some blemishes previously underappreciated are highlighted. Some of the new bargains may appear better than what we own. Investment decisions become much more difficult during times of stress.

Therefore, I cannot simply evaluate what is available to purchase today, focusing on relative as opposed to absolute value. I must view my opportunity set over time. I don't believe what is available for sale today constitutes my complete opportunity set. As Seth Klarman of the Baupost Group said, "One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Limiting your opportunity set to the one immediately at hand would be like limiting your spouse to the students you met in high school."

I prefer to remain conservative when valuations are high and wait for an attractive price on a great company. Today I don't see many of those. Holding cash is a drag on returns, and it could be months or years before I find an attractive business at a reasonable price. Being too cautious can be the same as being wrong. However, I am willing to be patient and not invest in mediocre opportunities. I don't mind appearing wrong if I know that I am protecting your savings from permanent loss.

To avoid disproportional or permanent losses, I must identify the risks that would cause these losses and do my best to avoid them. Therefore, I must understand how an investment will generate returns and what could potentially disrupt those return prospects.

I have always been a fan of Chuck Akre's reference to his "three-legged stool." His three-legged stool consists of an extraordinary business, talented management, and great reinvestment opportunities and histories. I agree with Mr. Akre's approach to finding attractive investment opportunities, and I also have a second "three-legged stool" when I think of investment returns.

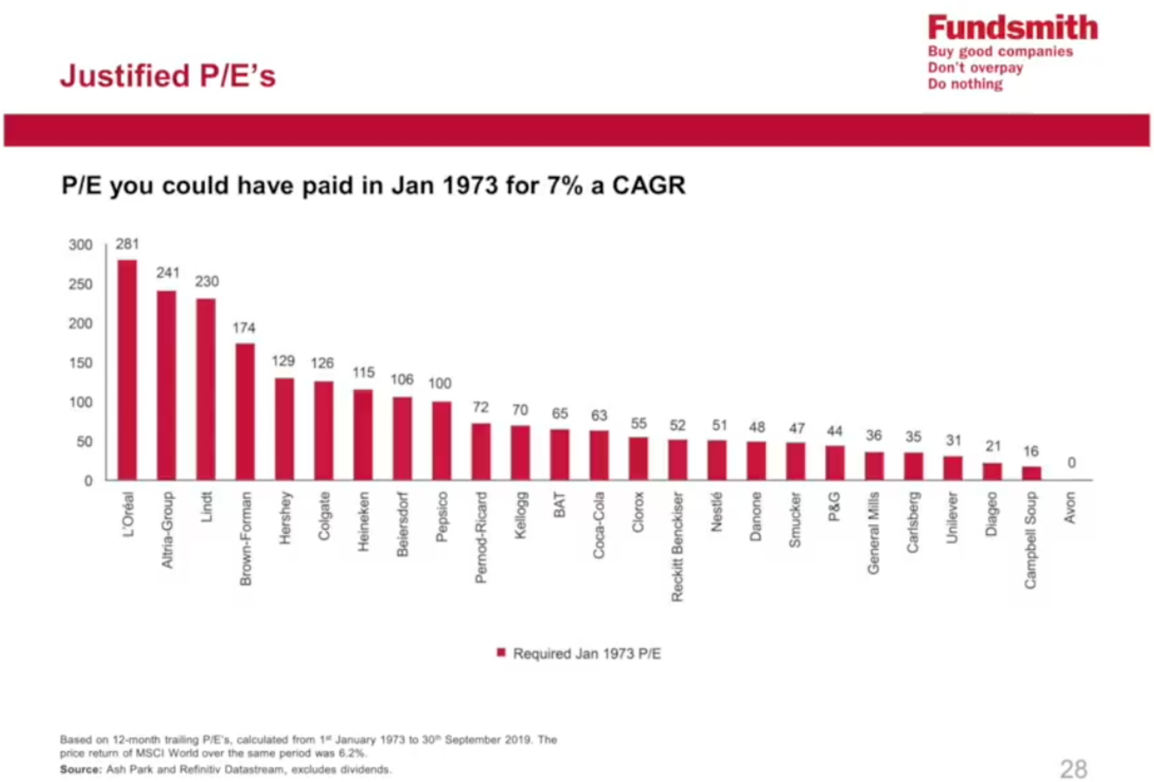
"It takes character to sit there with all that cash and do nothing. I didn't get to where I am by going after mediocre opportunities." – Charlie Munger

In a concentrated strategy, the errors must be non-fatal. When making an investment decision, I must make sure I am confident in the margin of safety. To achieve confidence, I must understand how I will achieve satisfactory returns. My view is that returns primarily derive from three inputs, my three-legged stool: multiple expansion (or contraction), dividends and stock buybacks, and earnings growth.

Multiple Expansion (Contraction) + Dividends & Buybacks + Earnings Growth

First, there is no "right" multiple to pay for a stake in a company. It is all subjective and dependent on the type of company, its future expectations, and how others view the prospects of that company. Multiples can be deceiving as well. The events of the past year have made this point very clear. For example, businesses that benefitted from the pandemic, such as companies that provide personal protective gear, have seen a jump in earnings far from their historical averages. Without an appreciable rise in share price along with earnings (which the two do not always move in lockstep), the current earnings multiple may look very reasonable. However, it could be expensive when viewing its historical average and what we could reasonably expect the business to earn in the future. The converse is also true.

To further illustrate my point that there is no "right" multiple to be paid, I highlight a slide that Terry Smith of Fundsmith shares each year at his annual shareholder meeting. This slide shows the justified price-earnings multiple (P/E) that one could've purchased the companies and still achieved a 7% annual compounded annual growth rate.



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[1] Fundsmith. [Fundsmith]. (2021 Mar 3). *FUNDSMITH Annual Shareholders' Meeting February 2021* [Video]. YouTube. https://www.youtube.com/watch?v=IojZCeUjhRg

As Mr. Smith shows here, that you could've paid a very high multiple for some outstanding businesses and still achieved a healthy compounded annual growth rate. I believe this to be somewhat cherry-picked and not representative of companies in general. Counterexamples abound, such as the high-flying stocks of 1972, Polaroid with a P/E ratio of 91, or Avon with a P/E ratio of 65. Both companies having their values slashed by 91% and 86%, respectively within a few years, prove that valuation matters.

Just as a high multiple does not indicate a company or market is overvalued, a low multiple does not imply an undervalued company or market. A company often carries a low multiple because its prospects for the future are not bright. The company may be in secular decline or headed for bankruptcy. A company may be genuinely undervalued, but purchasing a company based on a low valuation alone does not necessarily lead to a satisfactory return. "Value traps" or perennially undervalued securities have been the bane of many investors over the years.

Therefore, the multiple paid for a company is not necessarily an accurate determinate of future return. However, conservative estimates for a company are easier to achieve or exceed. I look to not overpay or purchase at a very high multiple to protect our savings from multiple contractions. As Christopher Browne of Tweedy Browne stated, "The consequences of the stock market revaluing overpriced stocks is often what Graham and I call 'permanent capital loss.'" I must avoid permanent capital loss; not over-paying is one step toward that aim.

As outlined above, the second leg of my return stool is dividends and share repurchases. I believe these to be somewhat more reliable than trying to determine how the crowd will rate our companies in the future, but they still do not have predictive power. I believe the biggest determinate of how management will allocate capital is their past actions. As the saying goes, trust not in what people say but what they do. I seek a management team with a long history of reliably returning excess capital to shareholders. Reliable return of capital that management cannot effectively deploy can be a valuable source of investment return.

As with most things in life and investing, past performance is not indicative of future results. Just because management has a long track record of reliably returning excess capital to shareholders does not mean that the future will be the same. As we discovered this past year, factors outside management's control can drastically impact their ability to generate and return excess capital reliably. Although this is something that I look for before investing in a company, I do not rely on it.

The third leg of my return stool is earnings growth. By this, I do not necessarily mean earnings per share growth, which can be manipulated through non-GAAP adjustments. I am focused on real earnings growth reliably converted into the free cash flow growth available to investors.

I believe the following formula accounts for a significant amount of expected earnings growth:

$$\text{earnings growth} = (\text{reinvestment rate}) \times (\text{return on capital})$$

Can a business earn high returns on the capital it employs and is there ample opportunities to invest? High return on capital is the key to long-term business success. Competitive forces may erode this advantage over time, but I seek to invest in companies that consistently earn a high return on the capital employed in the business. So, in an ideal world, if a company can achieve these high returns, I would want them to retain all the earnings and not return any to me.

I believe that earnings growth will be the most determinable gauge of long-term investment performance if the company's return on capital is consistently maintained. I focus on businesses that show the ability to earn these high returns for an abnormally long time.

Looking at these three "legs of the stool," I can begin to determine the attractiveness of an investment decision. The best investments are when I can purchase companies with high returns on capital with lots of opportunities to continue investing that capital in growing the business and its earnings. And to buy these companies when the multiple is extremely attractive. This alignment is rare, so patience is critical.

Warrant Buffett has said that one should think of their investing life as a punch card. You only get twenty punches available throughout your lifetime, so only invest when things are incredibly favorable. I take this advice to heart. I act with extreme patience. I am only willing to make an investment decision when I am sure that it is time to use one of those precious punches.

"Because things are the way they are, things will not stay the way they are" – Bertold Brecht

The return factors above rarely align in our favor. What does the world look like today? Are things aligning so I can purchase meaningful stakes in great companies?

The short answer is no. The majority of the companies I seek to invest in are selling for valuations that I believe are at fair value or above, in some cases dramatically above. More broadly speaking, market indicators and speculator behavior make me think that now is a time to proceed cautiously. When I see signs of imprudence by general market participants, I must conduct myself with a much greater conservativeness and patience.

I do not attempt to predict the future but rather prepare for its inherent uncertainty. I do believe that markets (and much else) are cyclical. When we get to a point where economic gauges reach, or near, their highest percentiles, it is time for me to become more conservative. A single data point in itself will not paint an obvious picture. It can be meaningless and deceiving. But as data points begin to align, the picture starts to form. But due to the future's inherent uncertainty, the image will never be clear.

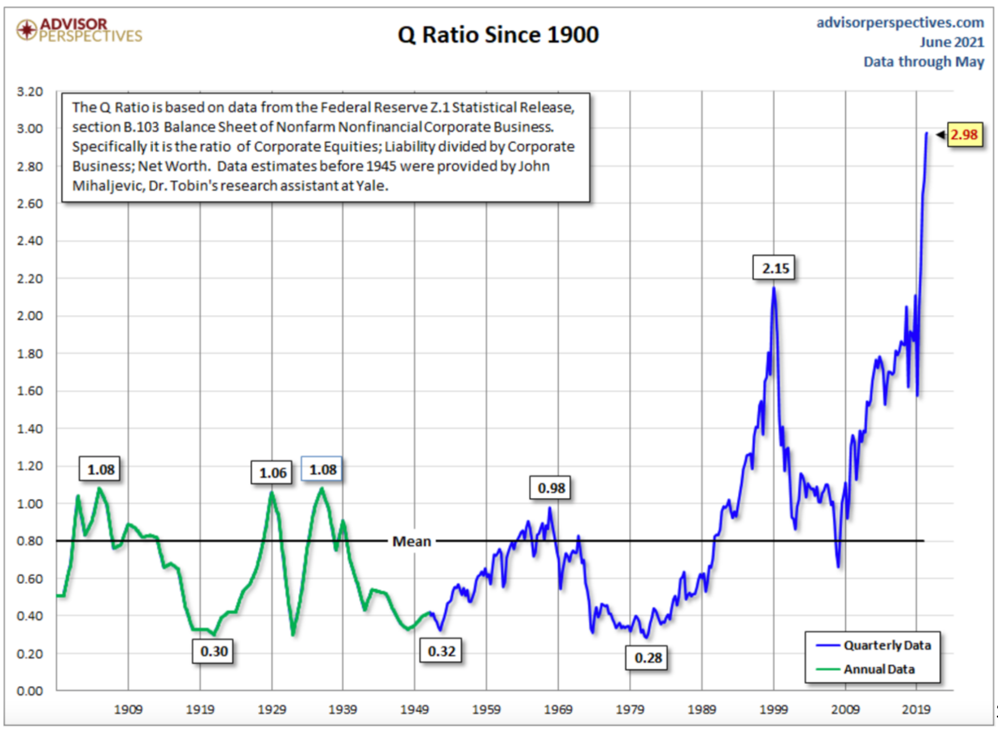
At the 2017 Berkshire Hathaway annual meeting, Warren Buffett stated, "Every number has some degree of meaning. It means more sometimes than others... It's not that they're unimportant… They can be very important. Sometimes they can be almost totally unimportant. It's just not quite as simple as having one or two formulas and then saying the market is undervalued or overvalued."

I believe that the market data points are now closer to the "more important" range of the spectrum. At least for how I should conduct my affairs. The following are just a few data points that have led me to this opinion.

Tobin's Q

Q Ratio (Market) = Market Capitalization of all Companies/Replacement Value of all Companies

For either a firm or a market, a ratio greater than one would theoretically indicate that the market or company is overvalued. A ratio that is less than one would imply that it is undervalued.[2]



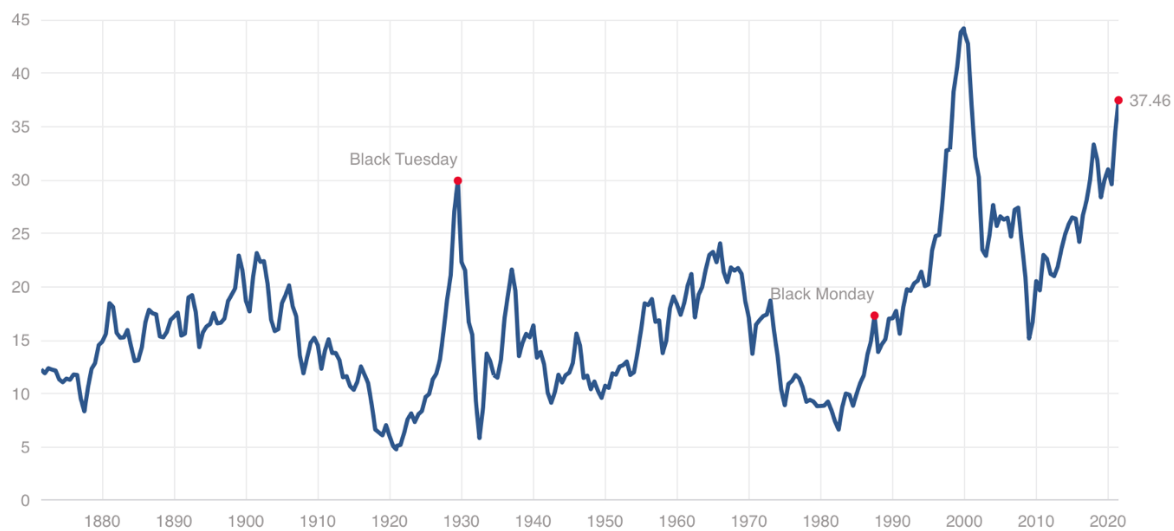
[3]

[2] Hayes, Adam. "Q Ratio: Tobin's Q." *Investopedia*, 23 Feb. 2021, https://www.investopedia.com/terms/q/qratio.asp
[3] Mislinski, Jill. "The Q Ratio and Market Valuation: March Update." *Advisor Perspectives,* 3 June. 2021, https://www.advisorperspectives.com/dshort/updates/2021/04/07/the-q-ratio-and-market-valuation-march-update

Shiller P/E Ratio

The CAPE ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle. The CAPE ratio, using the acronym for cyclically adjusted price-to-earnings ratio, was popularized by Yale University professor Robert Shiller. It is also known as the Shiller P/E ratio. The P/E ratio is a valuation metric that measures a stock's price relative to the company's earnings per share.[4]

Following an 82% rally from the March 2020 lows, the S&P 500 commands a Shiller P/E ratio of nearly 37 times inflation-adjusted, 10-year average earnings. That towers over the median 15.8 times valuation over the past 150 years and is eclipsed only by the 1999 to 2000 period for the most expensive on record.[5]



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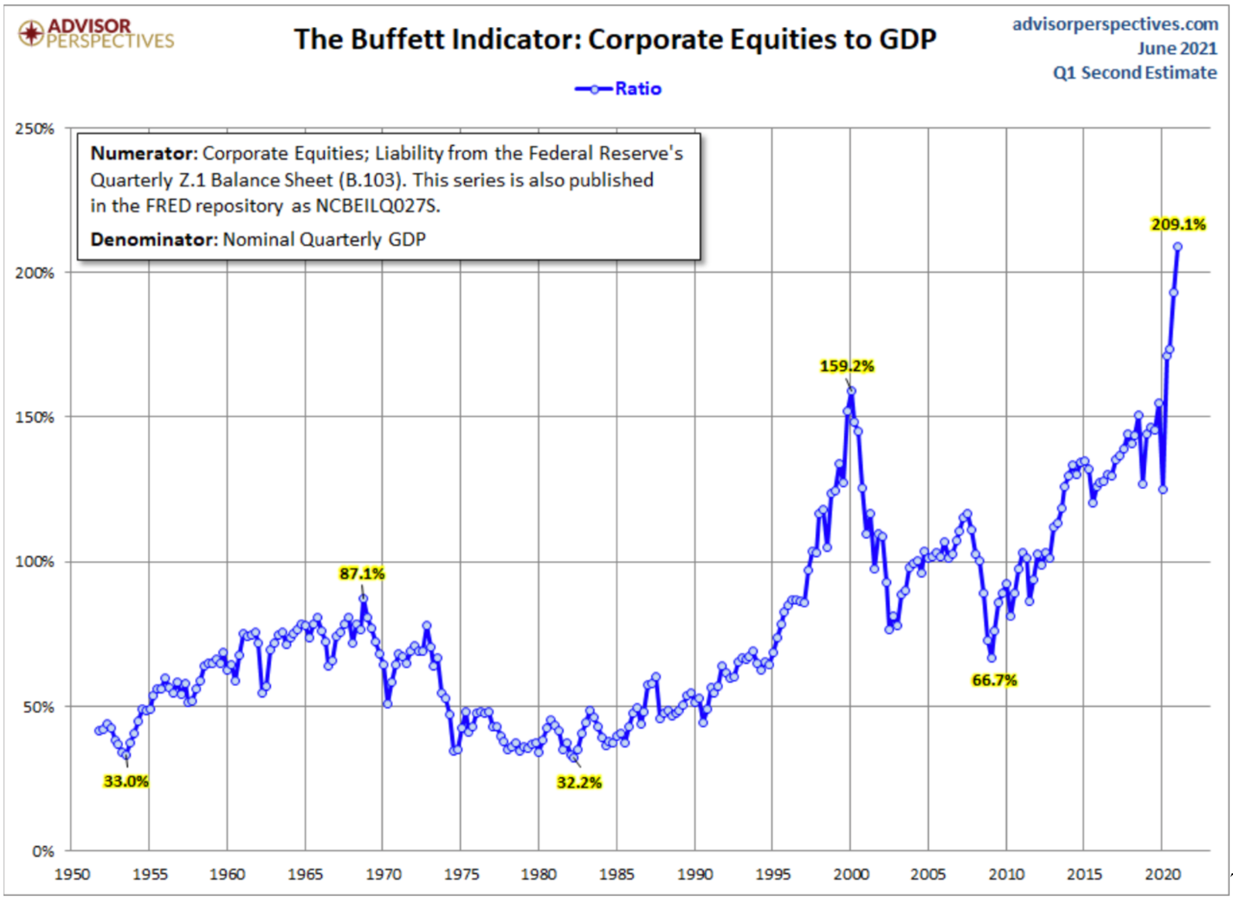
[4] Kenton, Will. "CAPE Ratio Definition." *Investopedia*, 23 Oct. 2020, https://www.investopedia.com/terms/c/cape-ratio.asp

[5] Grant, Phillip. "Support Group." *Almost Daily Grants,* 7 Apr. 2021, https://www.grantspub.com/almostDailyHTML.cfm?dcid=837&article=1&email=Beau%40camstonmgmt%2Ecom

[6] "Shiller PE Ratio." *Multpl,* 17 Jun. 2021, https://www.multpl.com/shiller-pe

Buffet Indicator

The Buffett Indicator measures the stock market's total value to U.S. economic output. Nicknamed the Buffett Indicator because, in an interview with Carol Loomis in 2001, he said it is "probably the best single measure of where valuations stand at any given moment."



[7]

[7] Mislinski, Jill. "Market Cap to GDP: An Updated Look at the Buffett Valuation Indicator." *Advisor Perspectives,* 17 Jun. 2021, https://www.advisorperspectives.com/dshort/updates/2021/04/08/market-cap-to-gdp-an-updated-look-at-the-buffett-valuation-indicator

Bankruptcies

Despite the effects of the COVID-19, government-mandated lockdowns and closures, and record unemployment numbers throughout the year, U.S. bankruptcy filings fell to a 35-year low. As Reuters reported: U.S. bankruptcy filings for 2020 hit their lowest level since 1986 as a flood of government support programs offset at least temporarily the full brunt of the coronavirus pandemic and related recession.[8] Chapter 11 filings, a form of bankruptcy used by businesses that involve a reorganization of affairs, did rise by 29%.

Zombie Companies

Zombie companies, or companies that are indebted to the point that they earn enough to continue operating and service debt but not pay it off, have been steadily increasing for several years. The pandemic has increased that number even further. Of the 3,000 large companies, roughly 600 are eligible for this dubious distinction. These companies carry greater than $2 trillion in debt. A change in the business or economic environment could spell disaster for one or all of these companies. A rise in interest rates could wipe out the fortunes of these companies. Whether or not that comes to pass is another question. The number of companies in a perilous position leads me to worry about the effect of their failure(s) on the market. This pandemic has highlighted the interconnectedness of our global economy. The failure of one, some, or all of these companies could have unforeseen consequences.

The Chase for Yield

With interest rates near historic lows, governments are penalizing prudence. Additionally, the willingness of investors to take on risks for low reward is reaching levels not seen since 2007. Yields on the triple-C-rated component of the Bloomberg Barclays High Yield Index reached a record low of 5.66%, with the 479-basis point spread over Treasurys marking the narrowest premium over "super safe" government bonds since July 2007.[9] These "junk bonds" have earned their moniker. Companies in this subset are often saddled with crushing amounts of debt and represent a genuine threat to permanent loss of capital. The willingness of investors to take on that risk at these yields is beyond my comprehension. The margin for error in these situations is thin. As I stated above, the failure of one, some, or all these companies could lead to more systemic consequences.

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[8] Reuters Staff. "U.S. bankruptcy filings hit 35-year low thanks to government pandemic aid." *Reuters,* 5 Jan. 2021, https://www.reuters.com/article/us-usa-economy-bankruptcy/u-s-bankruptcy-filings-hit-35-year-low-thanks-to-government-pandemic-aid-idUSKBN29A264

[9] Grant, Phillip. "Reach Out." *Almost Daily Grants,* 11 May. 2021, https://www.grantspub.com/almostDailyHTML.cfm?dcid=859&article=2&email=Beau%40camstonmgmt%2Eco

Crypto/Blockchain/NFTs

I don't pretend to understand the complexity of what is happening in this space. It is far outside my circle of competence. But I can't help but feel that what is happening with these "assets" is more speculative than fundamental. When coins made explicitly as a joke are rising over 500% in a month, it is hard for me to think the speculators in these assets are doing so on well-reasoned principles. These same coins have reached market capitalizations that dwarf companies that produce real-life commodities, you know, things that can actually be used.

Perhaps I am too naïve to understand their true utility. I'm sure I don't understand the space enough to appreciate its impact on the future. In my opinion, if crypto and blockchains represent a fundamental shift in our future, then right now is the equivalent of trying to pick the right car company in the early twentieth century or the right tech company in the late twentieth. A task that proved to be extremely difficult, and even those that did had to have the mental fortitude to maintain their conviction through a pretty difficult time.

Perhaps this time will be different. But there is one refrain that I cannot get out of my head when I think about the speculation in this space. "A fool and his money are quickly parted."

Work from Home

The impact of work from home is still to be determined, and clearly, there will be winners and losers. What is known is that companies have learned there are other ways of getting things done. Workers have learned a whole new way to contribute, altering the work-life balance.

Some companies will remain completely remote, and others may integrate more options for remote work. It seems clear that there will be an impact on the commercial office space. By how much, I have no idea, but I believe it is reasonable to assume that vacancy rates could reach 10-20%, depending on the area/region. If that is a reasonable assumption, then that would have a severe impact on commercial real estate.

As Nassim Taleb said, "If you own a looooot of commercial real estate, you must fool yourself into believing that people will suddenly forget that remote work is a possibility & that they can indulge in its convenience. A mere 20% drop in demand can lower prices by >70%." [10]

Property demand has a disproportional impact on prices.

I don't know the actual impact of working from home. Nor do I know if any adverse outcomes in the commercial real estate market will have a meaningful effect on the stock market or other asset classes. But I believe it is another important data point to consider.

[10] @nntaleb. "If you own a looooot of commercial real estate, you must fool yourself into believing that people will suddenly forget that remote work is a possibility & that they can indulge in its convenience. A mere 20% drop in demand can lower prices by >70%." *Twitter,* 23 Dec. 2020, 7:38a.m., https://twitter.com/nntaleb/status/1341739853550133253?lang=en

Inflation & Interest Rates

With unprecedented artificial low-interest rates, government stimulus, supply chain disruptions, and a rapidly opening economy with higher-than-expected demand, there are justifiable concerns about inflation, transitory or otherwise.

Inflation is a rise in the price level of goods and services, resulting in a reduction in the purchasing power of money. Price levels can be thought of as follows:

$$\text{Price Level} = \frac{\text{Money Quantity x Money Velocity}}{\text{Supply of Real Goods/Services}}$$

To briefly break the equation down.

The "money quantity" is the total amount of money in the system. The money quantity is the most easily measured of the variables in our equation.

The "money velocity" is the rate at which money moves through the economy. The money velocity is much harder to utilize in our formula because of human psychology. It's not that it can't be measured, it can, but I don't want to know what it is today; I need to know where it <u>will be</u> in the future. Money velocity could slow because people may become more cautious and choose to save more. It could be a temporary slowdown in spending due to a pandemic, or people may be less cautious and start spending aggressively, increasing the velocity. The future liquidity preference of all market participants is impossible for me to measure.

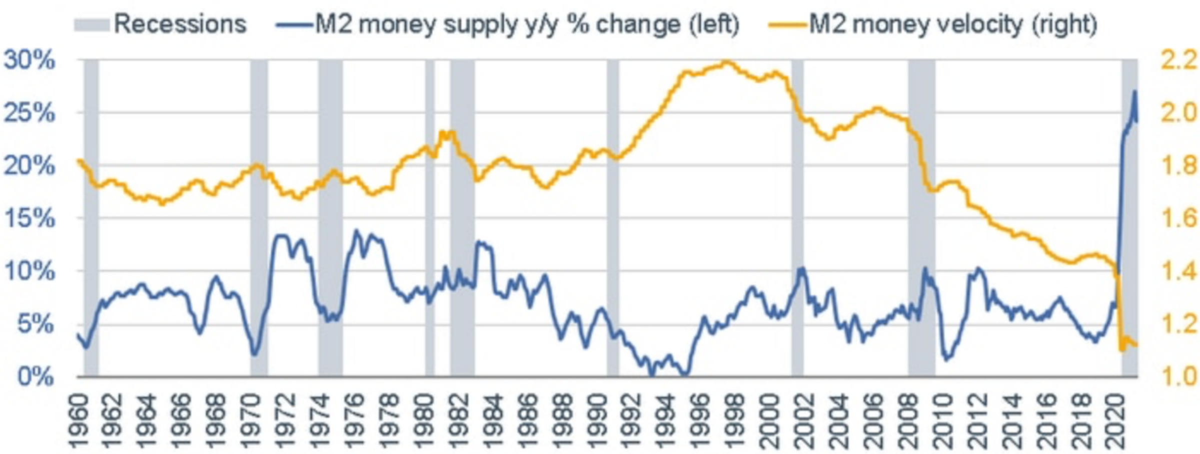
The "supply of real goods/services" is hard to determine and best estimated. For any determination to be made about future supply levels, and that is all that I am concerned about, I would need to know the demand for what goods will be and the availability of resources to produce those goods.

Since two of the three inputs into our equation will be estimations (at best!), the difficulties in forecasting inflation are evident.

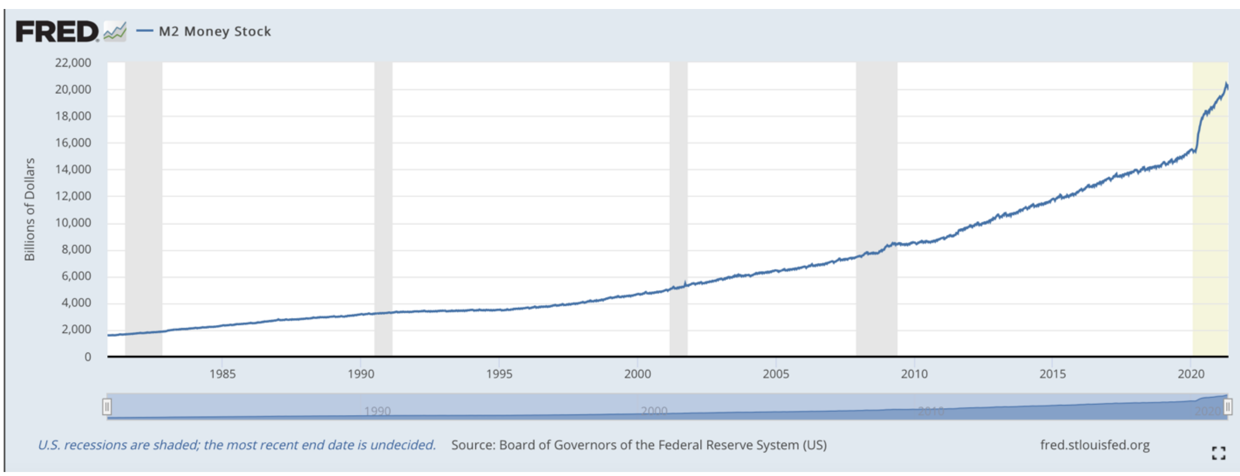
Most of the time, the inputs in our price level equation above stay pretty well in balance. However, a government may sometimes intervene and alter the money supply to achieve specific economic aims. As long as there is a corresponding movement in the supply of real goods/services, price levels will maintain a pretty fair balance. If the supply of real goods and services does not keep up with the increase in money supply, we may see upward pressure on price levels due to more dollars in circulation chasing a smaller quantity of goods and vice versa.

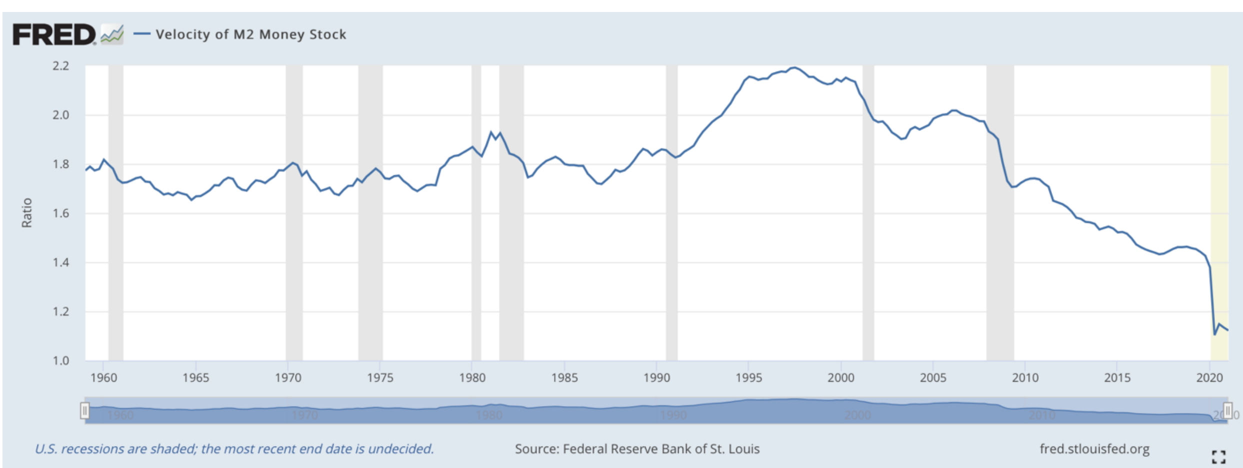
So, where are we today?

M2 Growth Surge/Velocity Plunge



Source: Charles Schwab, Bloomberg, Federal Reserve Bank of St. Louis, as of 3/31/2021. The velocity of money is the number of times one dollar is spent to buy goods and services per unit of time. If the velocity is increasing, then more transactions are occurring between individuals in an economy.





Not surprisingly, the money velocity has slowed to a crawl due to government-mandated closures. I believe it reasonable to assume that as the economy reopens, we will see the money velocity return close to the average historic range.

The shocking portion of the story is the money supply. Regardless of the aims or achievements of the stimulus, the sure size is something extraordinary.

The unprecedented ongoing stimulus by the government saved many industries and families, and I do not doubt they achieved their aim of keeping the economy and millions of Americans afloat during the pandemic. However, the current stimulus is unlike 2008, in my opinion. In 2008 much of the stimulus funds ended up in the stock market through the bank capital infusions. Unlike 2008, the current stimulus is broadly held by a wider swath of the population where it is more likely to be spent in the "real economy" of goods and services.

Without a subsequent rise in the supply of real goods, our equation above becomes imbalanced. Currently, the supply of real goods is lagging behind the money supply. Forced closures and unexpected demand are the leading causes for the current lag. Supply issues may resolve relatively quickly once the economy is reopened and is running efficiently. In this case, the inflationary pressure will be transitory and will pass like a seasonal storm as the supply of goods catches up with the money supply.

My concern is that even as supply rises, any price increases will not be rapidly and readily pulled back. Inflation is like a train barreling down the tracks, and once it picks up steam, it is damn hard to stop without bold actions. In the absence of subsequent rises in the supply of goods and services, more and more stimulus will need to be allowed to continue the subsequent level of prosperity. It compounds itself. And it is essential to remember what this stimulus is, a loan on future prosperity. It is a debt we are levying on ourselves and future generations. And like all debts, it must be repaid. Everything has a cost, and that cost must be paid in one way or another. The result of continual monetary stimulus is that we are building larger and larger debts owed. Any nation's deficit which exceeds the practical limit must somehow reduce the debt to come within limit. The only three ways to reduce the debt are to repudiate it, to assess capital levies and pay it, or to inflate and dilute it. Inflation is the way which is invariably used.[11]

One of the necessities to curb any inflation is to stop pumping money into the system. To give the supply a chance to keep pace and allow prices to rise to regain equilibrium. As this happens, it is given that interest rates generally rise to help curb spending and inflationary pressure.

[11] Parsson, J. (2011). *Dying of Money*. Dog Ear Publishing.

Interest rates and inflation tend to have an inverse relationship. Increasing inflationary pressure raises the chance of interest rates rising to help slow inflation. Interest rates are said to be the gravity in the financial system. In a negative or near-zero interest rate environment, valuations for outstanding companies can be essentially infinite. As interest rates rise, the value of future cash flows falls. The future cash flows are discounted back to a lesser sum with higher rates. Future earnings become worth less, and the perceived value of enterprises begins to fall, leading to a contraction of the multiple that investors are willing to pay.

Inflation and interest rates do not move in lockstep. Inflation is felt earlier than it is shown in the data. This means that inflation can continue unabated by higher interest rates for a considerable amount of time. Additionally, officials do not like to be the ones that throw a wet blanket over the easy money party. It doesn't garner you any party invites when you're the one that calls the adults. But eventually, the easy money policies will need to be ended. Everything has a cost, and those costs must eventually be paid.

Predicting inflation or interest rates is a fool's errand. However, with the money supply at unprecedented levels, the money velocity at unusually low levels due to government intervention, and a struggling supply of goods and services, it appears that we have all of the ingredients needed. Whether or not it occurs, is simply transitory, or should be a serious concern will be seen. But it is one more data point that needs to be examined and carefully considered when evaluating business prospects and valuations.

So What?

I do not intend this to be overly pessimistic. I am simply highlighting what I consider a few warning signs that I feel should be heeded. My job is to protect your savings from permanent loss from inflation, taxation, and bad decisions. I must consider a wide range of factors when making investment decisions, and the list above is far from exhaustive.

This does not mean that the market cycle will turn today, tomorrow, next week, next month, or even next year. There are opposing views and counterfactuals to what I have chosen to discuss in this letter. I could be wrong in my assessment altogether or for long enough to negatively impact your returns over the long run. Being too conservative is indistinguishable from being wrong.

Some or all the factors discussed above could be inconsequential or produce positive outcomes. If there are no significant changes and interest rates remain low, then the valuations of many companies today may not only be justified and fair but perhaps even undervalued. With foreknowledge of interest rates, my job of allocating savings would become easy and possibly obsolete. A significant question is then, where will interest rates be in the future? Can low-interest rates be maintained for a very long time? If Japan holds any clue to our future, the answer is yes, where interest rates have averaged 2.41% since 1972. In that case, my conservative stance will prove to be unwarranted, and I will have failed at my endeavors.

Perhaps we have reached a new golden age of unabated economic prosperity via continual government stimulus and artificially low-interest rates. I simply don't believe this to be true. I think our contemporary Modern Monetary Theorists are just the New Economics Theorists of the 1960s. Both Keynesians that have taken his economic view a few steps too far.

Time will tell.

"They don't sell glasses for your ass." – Unattributed

I loved this quote since the first time I heard it, and it's a heck of a lot catchier than hindsight is 20/20. It is easy to look back as events transpire and view yourself acting more swiftly, adeptly, bravely as they unfold. We can always rewrite the narratives in our heads. If I'd only done this, known this thing a little sooner, or had the courage to act more decisively… I find it far more important not to lie to myself. When reflecting on my performance, I try to leave out the what-ifs and focus on the information I had at the time and the decision I made. How can I improve? What else should I be considering in the decision-making process? What did I not understand, and how can I best learn about it?

The alternative histories view is fun. I can learn a lot by going back and adding in this or that piece of information and seeing how events could have played out. But this doesn't tell me how I performed as a decision-maker and how I can improve. Looking back, there are things I should have seen or known, but this is just hindsight bias. In reality, it takes living through the experience to internalize some lessons.

There are many things I wish I would've done differently throughout the last year or so. Some errors were simply wrong decisions made with the correct information, and others were an opportunity to learn and improve my process. This past year-plus was humbling in many regards. It was also very rewarding. I have learned many lessons since beginning this practice. Most critically, I learned that I could keep my composure and stick to my investment philosophy.

I was and continue to be conservative concerning the investment of your savings. Over the last year and a half, we experienced unprecedented uncertainty. This uncertainty provided opportunities early but partly due to the central bank and government intervention, this window of what I consider good deals was short. Since that time, there has been a great deal of what Mohnish Pabrai calls "navel-gazing," or quiet contemplation without much action.

This navel-gazing is much harder than it sounds at first blush. Fear of missing out is genuine. Maintaining conviction and patience while markets scream to all-time highs requires a great deal of belief. I did not believe that there were abundant opportunities to invest your savings at the start of 2020 (pre-pandemic), and I believe there are even fewer opportunities today. Opportunities to invest your savings will come, but they cannot be forced. For this reason, I believe that continued patience and strictly adhering to my investment philosophy are critical if I am to protect your savings from permanent loss.

Please reach out to me directly to discuss specific positions in the managed accounts, current account positioning, or any other topics you would like. I am always available. For now, I will leave you with a couple more serious quotes.

"Given how hard it is to accumulate capital and how easy it can be to lose it, it is astonishing how many investors almost single-mindedly focus on return, with a nary of thought about risk. Lured into their slumber by the 'Greenspan-now Bernake-put', an investment mandate of relative and not absolute returns, as well as a four-year period of generally favorable market conditions, investors seem to be largely oblivious to off the radar events and worst-case scenarios. History suggests that a reordering of priorities lies in the not too distant future." - Seth Klarman, 2006 Baupost Holdings, Letter to Investors

"Because of the quirks of our human eagerness for the immediate reward, we are forewarned that what seems easy and straightforward is deceptively so; the roundabout is in practice a counterintuitive path—of acquiring later stage advantage through an earlier stage disadvantage—nearly impossible to follow." - Mark Spitznagel, The Dao of Capital: Austrian Investing in a Distorted World

"The strongest of all warriors are these two – Time and Patience." - Leo Tolstoy, War and Peace

Thank you sincerely for your trust and confidence,

Beau Fruechtenicht

Important Disclosures and Information

Please contact me if there have been any changes in your financial situation or individual requirements you feel warrants a change to your portfolio strategy, if you have any questions about your statements or an account, or if you wish to add or modify any reasonable restrictions to the management of your portfolio. Camston Asset Management's current Form ADV Part 2: Firm Disclosure Brochure is available for your review upon request.

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