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Dear Investor,

In the 1940's Alan Jay Lerner penned the musical, *Brigadoon*, in which two American friends get lost in Scotland on a hunting trip and end up in the magical village of Brigadoon, a euphoric village that only rises from the Scottish mist every 100 years. It is our view that the last 12 years have been a *financial Brigadoon*, especially in America. No recession, extremely low inflation and low, even negative, interest rates - it was Shangri-la for capital! Throw in the attendant benefits of the strong US dollar, and you have a period where the average investor experienced a repeating trifecta: 16% returns for the S&P 500, 2% inflation and a dollar which continues to buy more and more of the world's goods and services. A plus 14% real return for over a decade!

A sustained 14% real return sounds too good to be true. So, how did it come to be?

We think two things led to this euphoric period:

1. Free money and low interest rates
2. China's cost and scale advantages leading to low inflation

Free Money and Unrestrained Unicorns

After the 2008 World Financial Crisis (WFC), governments reacted in a distinctly different way than they did after the Crash of '29. Governments had learned that when they stood back and let the system cleanse itself, Wall Street failing led to Main Street failing. This time around governments were extremely active in staving off the collapse of the world's banking and financial systems.

Monetary policy after the WFC is unique in that it was endorsed by both liberal and conservative administrations, even if it was often misdirected and ineffective. In its own way it was a new version of the Reagan years of "trickle down" economic policies. Governments' monetary policies of the post-WFC made money free to do the same, trickle down and jump start the economy.

However, free money didn't make a robust economy, but instead created one on life-support. While goods and services saw little inflation, financial assets inflated dramatically! These free money policies also suppressed interest rates to 5,000-year lows. I think that bears repeating. **A 5,000 year low.** With infinitesimal rates, financial assets began to be mispriced, and we saw plenty of capital "swimming naked!"

One major manifestation of this free money period was the rise of the unicorn – another mythical animal that would feel at home in Brigadoon. These are companies that could grow, receive huge amounts of new capital at little to no cost, without needing to produce cash - just the promise of a "someday" that could conceivably create oodles of cash. This went on for so long that anyone who dared to point out holes in this business model were branded "stuck in the past" with an outdated understanding of economic progression. This belief was hard to fight against as those doing the laughing were laughing their way to the bank.

It seems that today, the horns might be falling off these unicorns- a troubling development as they were trained as unicorns, and now that they can't fly without the free money, they are having trouble walking or working the fields. With no use as horses, and no magic as unicorns, maybe they only have value to the glue factory?

China

In the meantime, on the other end of the globe, China continued to be a juggernaut, little affected by the WFC. Since 2008, China's GDP has nearly tripled as the world continued to flatten. The interconnection of far-off lands through inexpensive transport, relative global peace and mostly open borders helped usher in today's China. The economic integration of 1.4B Chinese people successfully lifted hundreds of millions of people out of poverty and created an engine of consumable goods. This massive generator of low cost, high scale goods successfully devoured any potential for inflation to rise over the last 12 years, as it had for decades prior.

To be clear, "China makes, and the world takes" still holds true. Today China makes 50% of the world's steel, chemicals, aluminum and even cannabis. It seems that when Ross Perot predicted the "giant sucking sound" he was only partly right. It is China, NOT Mexico, hoovering up industries, jobs and, with it, inflation for decades.

In recent years, rising costs, alternative sourcing and changing policies are evolving the 40-year reinvention of China into a more mature economy. Today there is plenty of talk about the possibility of "deglobalization." We are already seeing real policies and investments being made to re-shore production across the globe, and especially in America. The combination of China's rising costs, depleting domestic resources, increasing dependence of inputs from abroad, declining population and aging, and continued growth means rising costs for the world's low-cost producer.

Years ago, Marty Tuckman saw the future and shared it with me. Marty ran Interpool, a container leasing business here in America. The manufacturing of containers had followed the migration of lowest cost. Initially these containers were made in the Midwest, close to American steel production. They migrated to the South, then to Mexico, then to Taiwan, and finally to mainland China, the lowest cost producer of everything on a scale that probably couldn't be replicated. This was all in the hunt for reduced costs, mostly in the form of labor. Today, three worldwide manufacturers control almost the entire market for new containers. They are all based in China (a slight caveat being some start-up competition in Vietnam, but the scale is tiny, and they still import key components from China). Moving away from China will not have the scale efficiencies and therefore additionally sources of supply will cost more.

So how did we get the Brigadoon combo of high returns and low inflation? Free money boosted returns, and China ate inflation.

What Now?

> "In Economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."
>
> -Rudiger Dornbusch, MIT Professor

As Brigadoon once again gets shrouded in the mist for another 100 years, what happens next? The above quote is one I have been using a lot recently, as I am constantly reminded of the difficulty markets have accepting true systemic changes.

That artificial, manipulated world has evaporated, and its return is as likely as that of Brigadoon… not in our lifetimes. In the new world, the winners and losers will be very different. The past patterns of this period will not provide useful tools for identifying future success. The investment world is largely in denial, the first stage of market rollover.

This further sheds light on the need for active managers, specifically those with the skill set and ability to invest differently. In the value investing world this group has been winnowed down through fund migration, style drift and even general despair. The ability to pick the quality companies within sectors is again emerging as crucial today, especially as indexation is still the behemoth in the room, misdirecting capital flows.

Our caution to investors is summed up in a quote often attributed to John Maynard Keynes a century ago: "When the facts change, I change my mind. What do you do Sir?"

Energy is the Driving Force of the Universe

What happens when free money leads to big returns? Capital flows in that direction. However, the flipside is that capital must be pulled from somewhere. One major area where capital has been pulled from is conventional energy. This has always been the case for this cyclical industry, but there are also critical structural changes that have occurred concurrently which provide important differences: climate concerns and the maturation of the world's oil supplies at current prices. The world has entered a period of energy shortages largely due to that underinvestment. I'm not talking about an oil shortage, or even a natural gas shortage like the one that currently exists in Europe. **I'm talking about a comprehensive shortage of energy in all forms.** We not only need more conventional energy for longer than is ideal but also more renewables for both meeting energy needs and mitigating carbon production.

In recent years every part of the world has focused on building out renewable energy production in all its forms: solar, wind, and hydroelectric. Now even further off alternatives are attracting attention and capital. Hydrogen and nuclear fission are garnering attention and investment dollars. We even see the reemergence of nuclear. Simultaneously, the world has focused on becoming more efficient by reducing usage and increasing the ability to store energy to better distribute/use it at periods of peak demand. Success with high double-digit growth has facilitated

reductions in the existing energy generation sources, particularly those causing environmental concerns such as fossil fuels and nuclear.

The problem with these plans is renewables are a small percentage of total energy production. *Even after a period of sustained investment, it is less than 10% of worldwide supply and we seem unable to grow these alternatives fast enough to power the rest of the world's needs.* This problem is exacerbated not just by worldwide growth, but also by the increasing demand from electrification and the shuttering of some of the world's historic energy sources. This metamorphosis is time consuming, capital consuming, resource consuming and, as a result, inflationary. We can and will continue to drive ahead, but at a cost. Our observation is that the drive from climate concerns has caused some unintended consequences and lead us into the middle of the "First Truly Global Energy Crisis." That's not my characterization, or that of a major oil company, but the acknowledgement of Faith Birol, head of the International Energy Agency (IEA), a Paris-based think tank focused on advancing sustainable energy security. This effort will take steel, cement, copper, silicone, rare earth minerals, other basic materials and lots of energy. The world may need to take two steps back before taking a giant and necessary leap to renewables but that can't happen without higher oil prices in the interim.

Not all countries are created equal though. Over the last decade, America has become energy independent. Critically true when it comes to natural gas. Further, we are producing excess supplies which we can, and do, export to the rest of the world. In addition to powering the economy, many industrial companies in America use natural gas as a key raw material: chemicals and all the downstream products, like fertilizers, methanol, ammonia production, and many others. Further, available, plentiful, and affordable natural gas provides cost advantaged electricity which further powers North American industries and moderates costs to consumers. It is not only the cost benefit, but also the robust availability of natural gas which is accelerating American companies to "re-shoring" businesses.

China, You've Changed Man

While China has been the bastion of low-cost goods for decades now, that has shifted. China is more in line with the rest of the world, and because of that, their ability to devour inflation is now limited.

Westlake Corporation (NYSE: WLK) is a critical producer of epoxy, a fundamental element for many lightweight manufactured goods. A good example is blades for wind turbines. Westlake is one of only three western producers of epoxies. In rough numbers, about half of epoxy is made in China, and half by Westlake and its peers. China's quarantine in response to the COVID-19 pandemic has significantly slowed down activity and demand in the epoxy industry. This has led to China dumping epoxy into the world market and dragging down the price. This dumped epoxy is mostly made from coal, and is therefore a high cost, high carbon producing way of making lower quality epoxy. Westlake has identified this and is convinced that the constrained Chinese activity is transitory and that Westlake's cost advantage will grow as it comes back. In the meantime, Westlake continues to be extremely profitable and valued very modestly.

As countries begin to re-shore production and build out new, clean energy infrastructures, meeting the demand for energy is going to be a huge undertaking, especially as we are starting out with limited availability of many of the necessary inputs worldwide.

Conclusion

All these macroeconomic observations are driven by aggregating the grass roots microeconomic observations which come from our bottom-up stock research focused for decades on industrial businesses in both America and around the world. Those industrial businesses are closely interrelated with commodities which are in a period of increasing demand once again after an extended period of being poor return businesses and therefore ignored by most capital market participants. They have also gone through a prolonged period of underinvestment logically due to those poor returns. Over this time most economic participants have formed strong views of this historic disappointment. We identify this investor limitation as the "Myopia of Linear Thinking." They refuse to even think to revisit this area. Investors ignore strong results as transitory or value traps. Past experiences have fixed these views in investors' minds. Investors see no need (and have limited experience and knowledge) to identify and appreciate structural changes that have transformed these businesses and their return generating abilities not only changes in return generating abilities but the sustainability of those earnings. Barriers now exist to new entrants and, combined with limited interest from the remaining participants to add capacity, that profitability should be more sustainable. This is why we believe we are invested in what Warren Buffett characterized as "better businesses" available at Ben Graham cigar butt prices.

All the best,

Bob