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FFG Market Pulse Newsletter, Q4 2021

The S&P 500 had a phenomenal year in 2021, achieving 70 record closes, and ending a three-year run where it averaged an almost 24% annualized return. The last time consecutive annual returns were this strong was during the late 1990s. After periods, especially extended ones, of very strong performance, it is usually wise to lower one's expectations coming into the new year. It is unnatural to sustain such high levels of investment returns without periodic and healthy pullbacks. Progress in all aspects of life does not occur in an upward sloping straight line, and no one should expect investing to be any different.

Part of the reason for these spectacular returns was the unprecedented influx of capital into the economy and markets we experienced during the past few years. This additional money and ensuing momentum chased returns which led to a rising market and high valuations. This was evidenced by the tremendous activity experienced in IPOs, SPACs, cryptocurrencies, and meme stocks. This behavior, usually present during the late stages of a bull market, occurs when investors shed their regard for risk and focus exclusively on the upside. This momentum is unlikely to continue indefinitely as the markets need to eventually correct themselves to function properly. I am saying this with some reluctance and no timing estimate because of how difficult it is to make macroeconomic ("macro") predictions and the ability for markets to become untethered from reality for long periods of time.

This provides a good backdrop to explain our approach to portfolio management. As tactical risk managers, our intended primary goal is to protect against downside risk before considering any upside potential. In other words, we are willing to forgo possible upside if it means having to take on an undue amount of risk. As stewards of your savings, we prefer not to take on any excess risk simply to increase our performance scorecard even a little.

As we enter the new year, two factors that will be at the top of investors' minds will be interest rates and inflation. However, focusing exclusively on these factors as the two main determinants for a successful investing strategy is misleading and improper. This is true because although they are important, they are virtually impossible to know with any level of certainty. Yes, you may have a good idea as to whether they will go up or down, but that is not sufficient to make an informed investment decision. There are two crucial elements that are missing: 1) what the actual rate of change will be, and 2) how the other market participants will react to those changes. In other words, markets are second-order systems. In such systems, not only does your forecast have to be accurate, but you also need to correctly predict how the rest of the market will react to each event to have a chance at a successful outcome. This is quite a daunting undertaking, making it difficult, if not impossible, to rely on economic forecasts alone. If what I am saying is true, you may ask why everyone seems to be discussing them with such fervor? Some of the reasons are because they provide a lot of content to debate, they make investing seem more complicated than it is, and they elicit unnecessary action. These are all factors that benefit the media and Wall Street investment banks, but not you, the investor, and should therefore be considered with some skepticism.

This is not meant to suggest that macro factors are unimportant or that we ignore them completely. Margaux, Scott, and I do spend time trying to determine different scenarios of how these macro factors will affect the economy and the companies within the strategy. However, it is only a factor, and not the main determinant in our ultimate investment decisions. Our main strategy is to invest in high quality companies that are dominant in their respective industries. We refer to these companies as the pillars and cores of our strategy. These positions are our bedrocks, and we are unlikely to sell them merely because the macro backdrop seems unpromising or bleak in any given year. These are dominant franchises that are likely to continue strengthening their economic positions well into the future. As such, these companies are likely to outperform the market, over a multi-year period, as they have in the past. The analysis we do is more focused on the competitive position and prospects of each company and less on the macro factors that are currently prevailing in the market. Does that mean macro factors will not influence these companies at all? Absolutely not, but we just do not think that they should be the primary factors to consider for these types of long-term investment decision.

In addition to our pillars and cores, we have smaller portions of the strategy we refer to as the macro-focused and speculative positions. These positions are meant to supplement the pillars and cores and hopefully provide additional upside by taking advantage of shorter-term, momentum-driven trends. The positions are small enough where if we are wrong the impact will be muted, but if we are right, it should add some outsized performance to the rest of the strategy. As mentioned above, our goal is always to minimize the downside before focusing on the upside, which results in this part of the strategy being limited in size and usually the first to be sold when raising cash. This is the portion of the strategy where we are most tactical, and you are likely to see more activity throughout the year.

This past year, the market returns were driven by many poor-quality companies that happened to have their day in the sun. Many investors took big bets on cyclical industries hoping that an economic recovery would benefit those companies and cause them to significantly outperform the broader market. This is unlikely to be a successful strategy over longer periods of time and one which we are happy to have a limited exposure to. We were unwilling to reduce the quality and increase the risk of your portfolios to try and earn a couple of extra percentage points. We are entering the new year with muted expectations for the broader market, but optimistic that there will be continued prosperity throughout the economy.

Wishing everyone a happy and healthy New Year!

Warm Regards,

Gabriel Levy, CFA
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