Long Game
Financial

3/3/2020

Dear Clients,

As in every Long Game Financial ("LGF") letter, we will begin by reiterating our investment approach, which remains constant without regard to whether the stock market is stable or volatile:

> *Long Game's continuing mission is to achieve superior risk-adjusted returns across market cycles for our clients through an emphasis on equity ownership. We focus on equities because equity claims on cash-flowing assets, such as companies and real estate, have proven to be the one of the most effective ways to grow wealth in excess of inflation over time. It is difficult to passbook-save one's way to a rate of return meaningfully beyond inflation.*
>
> *Common stocks, in particular, are Long Game's preferred investment option because they have historically outperformed other investments over moderate to longer periods of time, albeit with price volatility year-to-year. This outperformance has been due to a combination of factors that Long Game believes will persist into the future, including (1) the ability of certain companies to reinvest cash uniquely at high rates of return (e.g., only Chipotle can build new Chipotle locations), (2) inflation pass-through, and (3) tax advantages (shareholders pay taxes only when they receive dividends or realize capital gains).*

This year's letter will start with a business update and a recap of 2020. Next, we will share two points on how politics fits into LGF's investment process (spoiler alert: in general, we do not consider politics to be an important driver of the stock market). Lastly, we will conclude with a US-focused macroeconomic overview.

I. Business update:

I would like to thank everyone who supported me after I officially started LGF in 2017; you have made our *collective* success possible. As LGF's updated Form ADV indicates, as of year-end 2020 we managed $48.6MM on behalf of 59 clients. More than anything, I am pleased to report that performance has continued to be favorable relative to the market averages, and a meaningful portion of LGF's assets under management represent net gains for clients.

For a detailed breakdown of LGF's composite results through the end of February 2021 plus important accompanying disclosures, please visit our website here. *Note that individual client results can and will differ from those of LGF's composite for reasons including, but not limited to, client risk profile, timing of contributions and withdrawals, and tax considerations.*

This letter is a bit delayed because the first eight weeks of this year have been so action-packed that they have felt like eight months. Events thus far in 2021: the US Capitol Insurrection, President Biden's inauguration, the GameStop short-selling sideshow that caused volatility in parts of the stock market for a brief time, ongoing fourth-quarter earnings reports, historic freezing temperatures in the Central US, and a rise in the 10-year treasury yield from 0.93% in early January to 1.46% as of 3/1/2021—all during our global COVID-19 vaccination effort.

Action-packed does not mean important, however; nothing that has occurred so far in 2021 has affected LGF's portfolio positioning significantly and it certainly has not affected LGF's operating principles.

More broadly, amidst the market-stirring events of late I feel inclined to reiterate the LGF house view that *reacting to the near-term action* tends to be work counter to long-term investment returns. As one example, while it may

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be tempting to fixate on a shiny object like GameStop shares' recent 20x appreciation in one month, the reality is stocks like GameStop tend to be "greater fool" assets that trade far above their intrinsic worth…and, to state the obvious, predicating one's investment success on the continued presence of incremental buyers willing to transact at prices far in excess of fundamental value is a shaky proposition.

In alignment with our multi-year investment focus, at LGF we set aside short-lived sideshows like GameStop and focus our energies on understanding top-down and bottom-up economic realities that we believe will endure over our multi-year investment horizon—such as population growth, cloud computing adoption, the housing cycle, and, in academic vernacular, the fact that almost every company's value is comprised primarily of its terminal value. (For what it is worth, this latter point has been important over the last year because it means that short-term occurrences—from global pandemics to manias—often mean relatively little to your average stock's true worth.)

Anyway, on a different note I would like to take a moment to recognize the contributions of LGF's most enthusiastic supporter: my son Maxwell. Below is a picture of Max at 14 months, hard at work calculating IRRs on his HP-12C. He tells me that he prefers Reverse Polish Notation to infix notation because it saves him keystrokes and "time is money, dada." [1]

Thank you again for being a client of LGF and allowing me the privilege of doing what I love to do on your behalf. We all must invest our savings to keep pace with inflation and to meet our future goals, and every day at LGF we are mindful of our important responsibility to do so for you. Please reach out at any time by phone (my cell number is 413-725-5010) or email (Charlie@LongGameFinancial.com).

Sincerely,

Charlie Beresford
Founder, CEO, and Portfolio Manager
Long Game Financial, LLC

[1] Possibly a mistranslation.

II. LGF's 2020 chronology:

The year 2020 was extraordinary to say the least. It began with the third presidential impeachment proceeding in US history. The COVID-19 pandemic then started in earnest, which caused: (a) the S&P 500 to fall approximately 33% between late February and late March, (b) the unemployment rate to increase to its highest point since the Great Depression (14.7% in April 2020), and (c) US GDP to decline by 9% (!) sequentially in second quarter 2020.

With respect to the stock market's trading dynamics in 2020, for most of the year COVID-19 more-or-less bifurcated the market into *haves* and *have-nots* by sector and industry. We discussed this in detail in our first-half 2020 commentary on 7/15/2020, and in our COVID-19 update note to clients on 3/5/2020, 3/25/2020, and 5/14/2020.

Most notably for our clients, and as noted in LGF's first-half 2020 commentary, companies in the *have-not* sectors (energy and financial services, for example) generally grade poorly on LGF's CAM Framework. LGF therefore maintained de minimis exposure to these areas prior to the 2020 sell-off, and what exposure we did have we recycled into other holdings as soon we determined that COVID-19 would be a serious problem. Both of these actions benefited LGF clients markedly.

As 2020 approached its conclusion, that *have-and-have-not* dynamic broke down following (i) the US Presidential election (we wrote about the election on 11/4/2020 in a note in which we also shared a constructive top-down market outlook) and (ii) news that two pharmaceutical companies, Pfizer and Moderna, had successfully developed vaccines for COVID-19. The vaccine news in particular helped fuel a sharp market rally across all sectors into year-end, and all-told the S&P 500's total return for 2020 was +18%.

Ex ante, few would have guessed that the stock market would *rise* during the first year of a global pandemic—especially during the market's 3/23/2020 nadir when the S&P 500's 2020 year-to-date total return stood at -31%. But, rise in 2020 the market did, and the plentiful zigs and zags that characterized last year recalled for us the part of our 2019 letter that we wrote for clients who felt shell-shocked by the market's now quaint-seeming sell-off in late 2018. In particular, we believe the following paragraph from that section bears repeating:

> *In fact, we suggest to our clients that the financial media's worry du jour is frequently noise that is best ignored. Without exception, there are always legitimate-sounding worries about the economy and the stock market and the media always has an incentive to amplify discomfort. But particularly in today's world of viral headlines and social media, repetition and perceived urgency are not the same thing as importance. What is important but far less urgent with respect to investing is the following unexciting statement, which should be printed underneath financial headlines as a public service: "stocks tend to generate a positive return over moderate to longer periods of time, but with difficult to anticipate price volatility."*

This gets at a point that we have made many times before and will repeat ad infinitum: our continuing suggestion to clients is to anchor any opinions they may hold about the stock market *not* on transient occurrences like current events, anecdotal experiences, and neighborhood scuttlebutt, but *rather* on what LGF would term durable investing frameworks. For example, two durable frameworks that we follow at LGF in all market conditions include our C.A.M and Four-Step Pattern Frameworks, as summarized in the Investment Process section of the LGF website.

When collective market uncertainty rises to the extent it did in March 2020, durable investing frameworks like C.A.M. and the Four-Step Pattern give us something firm to hold onto…and there will eventually be another March 2020-type event.

III. Analyzing politics is generally a poor use of time for investors:

Due to the large number of politically oriented questions LGF fielded during 2020, we would like to make two important points regarding the relationship between politics and the stock market.

(1) ***In LGF's view, attempting to analyze the effect of politics on the stock market generally represents a poor use of time if you have a multi-year investment horizon (as LGF clients do).***

Because consumption comprises approximately 2/3 of US GDP, it is US consumers (as opposed to US businesses or the US government) that primarily drive the US economy and stock market.

Although federal, state, and local governments perform vital ongoing economic functions like service provision, taxation, and regulation, from an investor perspective the government's most consequential role in the markets is akin to insurance: it tends to act as a shock-absorber when bad things happen. For example, the government (thankfully) bailed out the banking system during the financial crisis.

So, because political change tends to be a diminutive driver of the market relative to the other drivers out there (extreme situations that require governmental intervention aside), LGF maintains firmly that attempting to improve one's returns in the stock market by analyzing politics is a fool's errand.

Furthermore, and perhaps more relevantly, LGF clients need to consider the high opportunity cost of analyzing politics: *more* time analyzing politics naturally means *less* time analyzing the myriad, bottom-up business situations playing out all around us every single day. For LGF, this is a steep opportunity cost because the latter constitutes one of the most important parts of our day-to-day investment process.

To conclude, although LGF will never stop paying attention to what is happening around our nation and world—politics included—political change is not something we will generally think much about. We suggest our clients adopt a similar approach.

(2) ***Another reason to mentally-sideline politics when it comes to investing is our position that the stock market's long-term, consumer cyclical dynamic is inherently apolitical: namely, the housing cycle tends to drive US consumers, US consumers tend to drive the US economy, and US economic expectations tend to drive the US stock market.***

In LGF's view, the single most important driver of the US economy and stock market is *real estate* because (a) a significant minority of US jobs are directly or indirectly related to real estate and (b) real estate is US consumers' biggest store of wealth.

Our simplified framework for how the real estate cycle powers the US economy and stock market is as follows:

STEP #1 - THE UP-CYCLE: home demand exceeds home supply, home prices rise to a level that encourages new home construction, real estate wealth increases, direct and indirect real estate-related employment increases, US consumers generally feel comfortable spending, cash-out refinancing transactions rise, the US economy expands, and the stock market tends to rise (during *most* of the up-cycle).

STEP #2 - THE DOWN-CYCLE: home supply eventually overshoots demand, home prices fall, real estate wealth decreases, direct and indirect real estate-related employment decreases, US consumers generally feel less comfortable spending, cash-out refinancing transactions cease, the economy contracts, and the stock market tends to decline (during *most* of the down-cycle).

STEP #3 - REPEAT STEP #1: eventually, after enough years of under-building relative to household formation, home demand once again exceeds home supply, and a new up-cycle begins.

Observe that the steps to this macroeconomic loop have little to do with the political affiliation of the occupant of the oval office. For example, the housing bubble that caused the Financial Crisis occurred during (R) George W. Bush's tenure, but Bush did not cause that housing bubble. By the same token, the housing rebound that began during (D) Barack Obama's tenure and continues to this day would have happened regardless of who had been president in the 2010s. It would therefore not be right for Obama, or any other politician, to take credit for that housing recovery.

Stated plainly, the US economy—the world's largest, with a Gross Domestic Product of $21 trillion—is too vast for even a president to influence it meaningfully (extreme low probability scenarios aside once again—e.g., single-handedly starting WW3). Our economy's output is the product of time and many trillions of dollars' worth of labor and capital, marshaled and allocated based on the judgment of a decentralized web of millions of corporate managers attempting to anticipate their customers' demand. Although the government has the power to change rules and regulations, nobody controls something that big and decentralized.

Nonetheless, politicians in both parties and at all levels will always have the incentive to *attempt* to take credit for the positive economic developments that occur on their watch, regardless of whether that credit is deserved. Just remember, once again, that politicians do not run the immense US private sector that comprises the majority of US GDP, politicians cannot make Americans buy homes, and politicians cannot force American companies to create jobs. Therefore, if the private sector or stock market happens to grow or shrink, chances are it had little to do with a politician.

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IV. LGF's macroeconomic outlook:

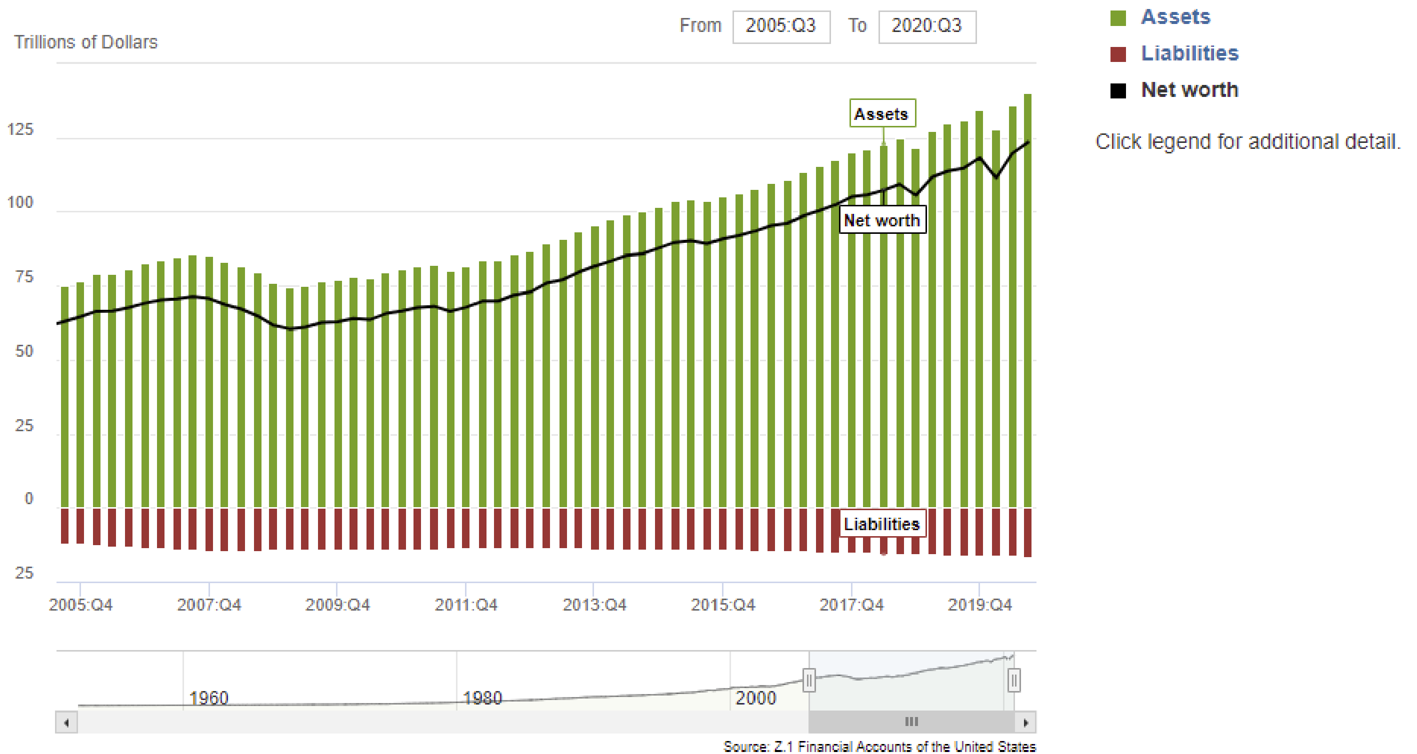
LGF remains constructive on the economy currently due to historically high levels of consumer wealth, low interest rates, the accelerating housing cycle, and the COVID-19 vaccines.

We also remain constructive on the stock market overall despite its recent strength, although there are areas of it that we consider frothy right now (SPACs and anything having to do with electric vehicles, for example).

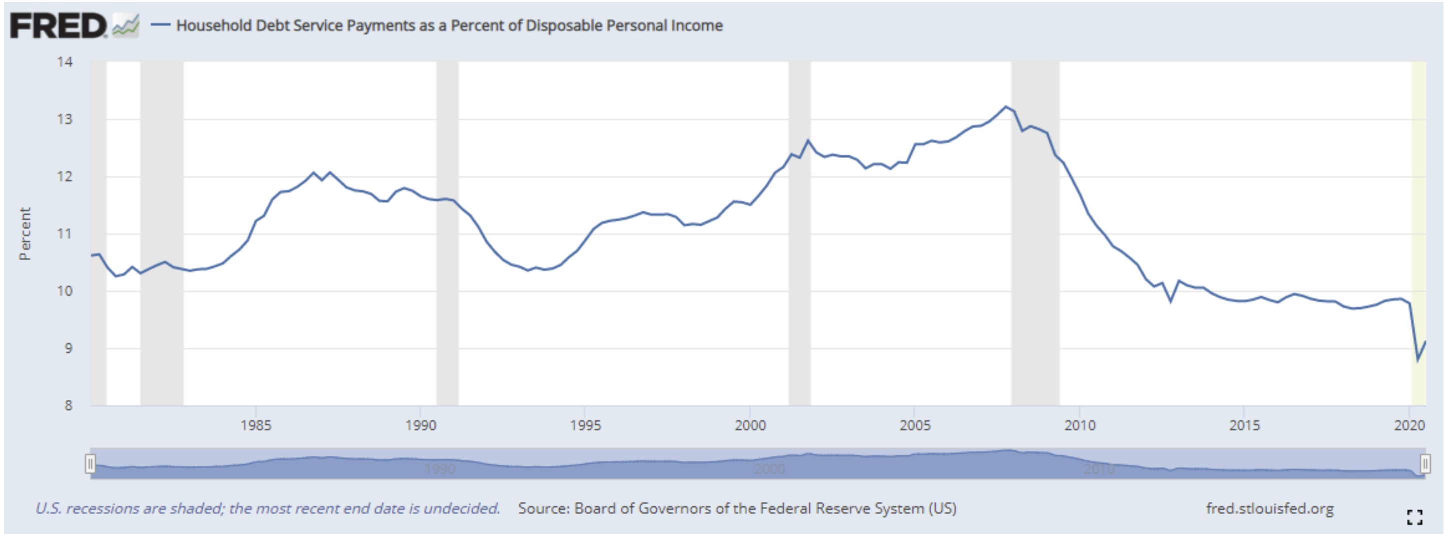
The remainder of this letter contains various macroeconomic charts that we think provide helpful context vis-à-vis the US economy.

1) **Per the Federal Reserve, US consumers in aggregate remain wealthier than ever.**

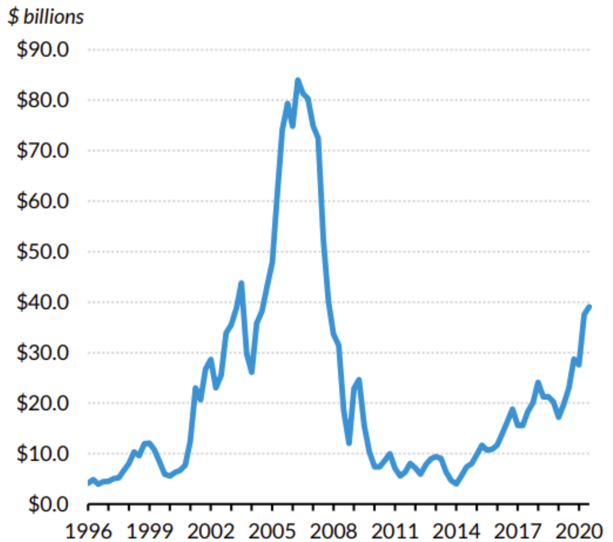
- US household and non-profit net worth in third quarter 2020 reached an all-time high of $124 trillion. This is a nearly $54.5 trillion increase (+78%, approximately) from the third quarter 2007 aggregate net worth peak of $69.5 trillion.



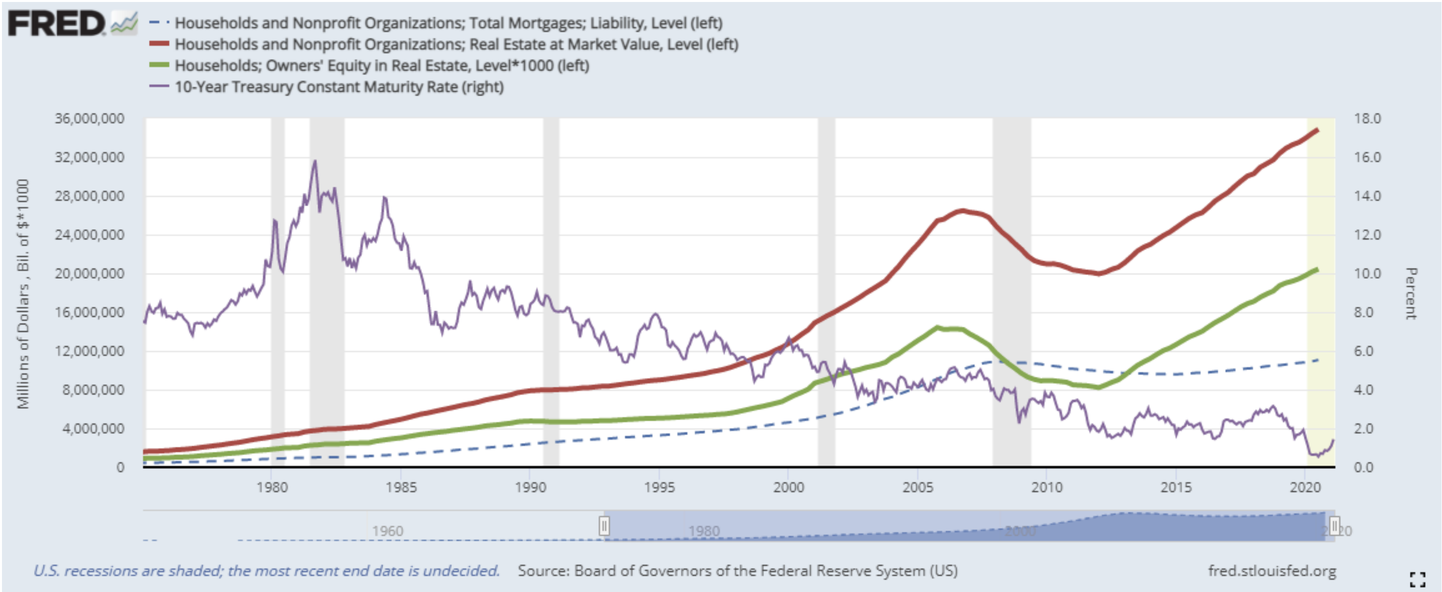
- US household debt service relative to disposable income was 9.1% as of 2020Q3. This is the second lowest reading for this metric since at least 1980 (the beginning of the St. Louis Federal Reserve's data) and represents a marked decline from the >13% high that occurred prior to the 2007 recession.



- Record *high* net worth and record *low* debt service relative to disposable income indicate Americans have the *ability* to increase their borrowing and spending.
- Cash-out refi activity accelerated in 2020: the Urban Institute reports that cash-out mortgage refi volume grew last year to nearly $40 billion in third quarter 2020, per below. Yet, there remains trillions of dollars of latent cash-out refi capacity (i.e., latent GDP) system-wide.

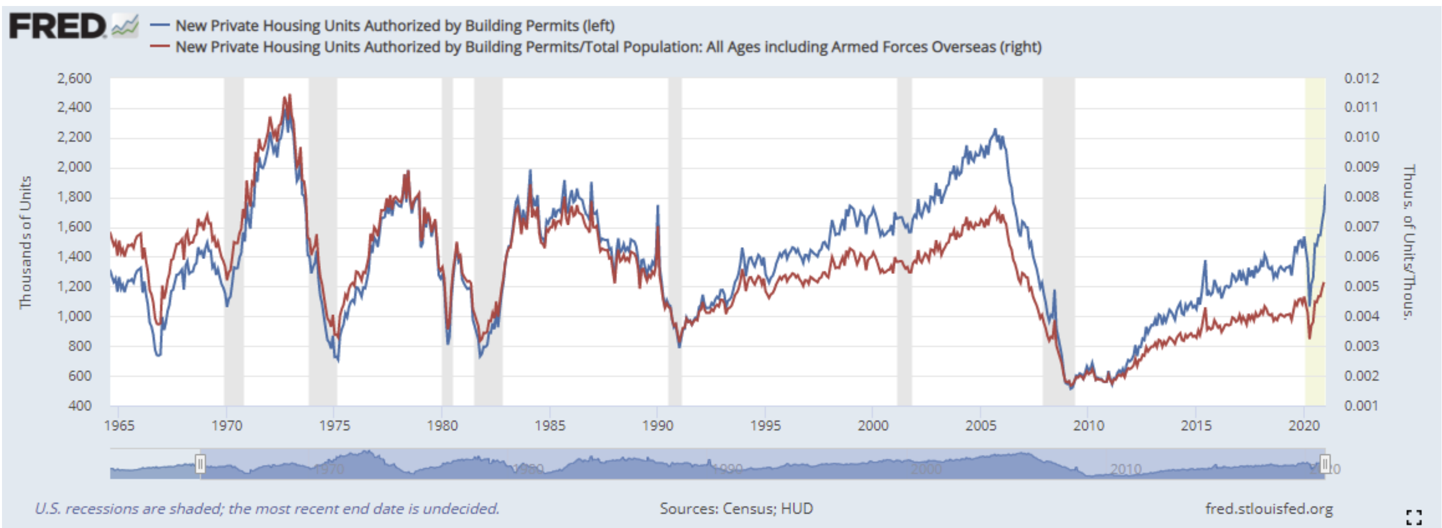


2) **Home prices are currently at an all-time high and aggregate mortgage debt has not grown in more than a decade. Therefore, aggregate home equity is also at an all-time high right now. Interest rates remain near all-time lows. (source: St. Louis Federal Reserve)**



3) **High real estate prices, increasing demand for homes, and low rates are encouraging homebuilding, but per capita home construction nevertheless remains below pre-financial crisis levels.**

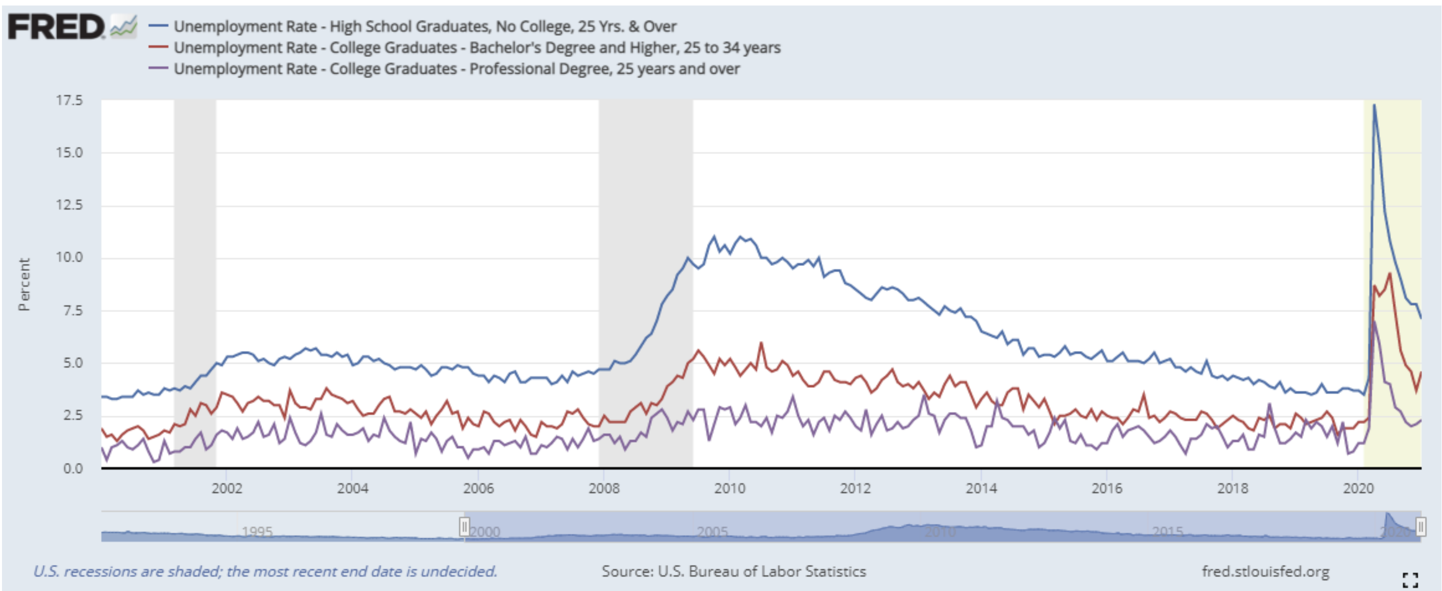
- Home permits per capita, despite recovering from their post-financial crisis nadir, remain below their 1993-2008 level per the red line below.
- In our view, these data suggest medium-term upside for the current housing up-cycle.



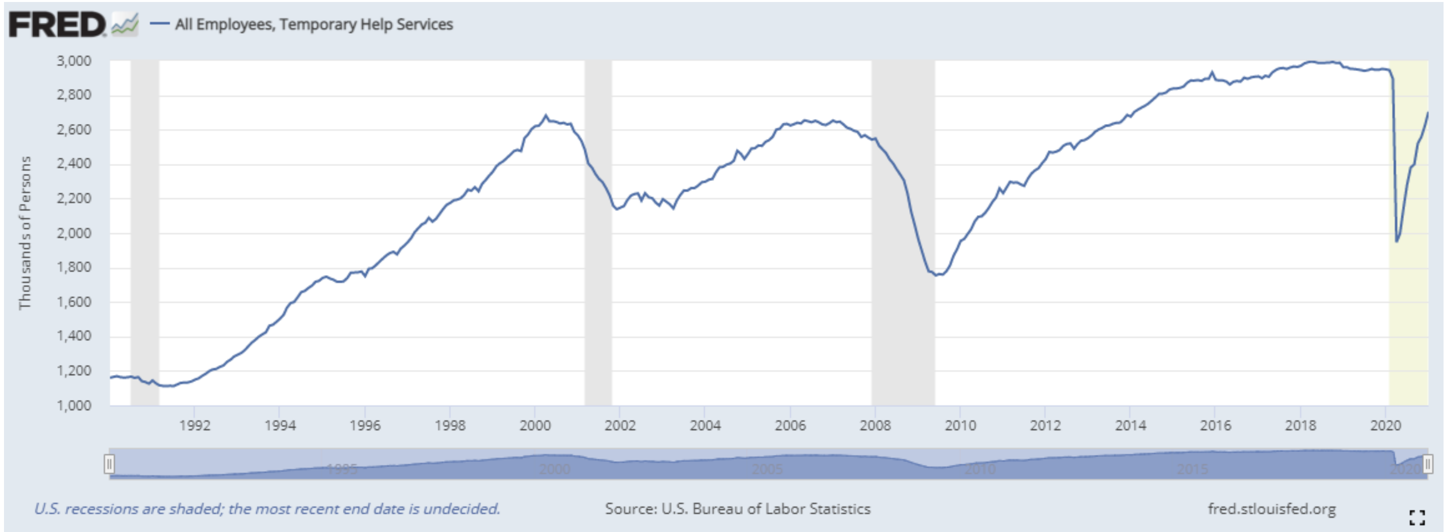
4) Unemployment has declined from its spring 2020 apex but remains elevated.

- Unemployment remains elevated despite its sharp reduction since spring 2020.

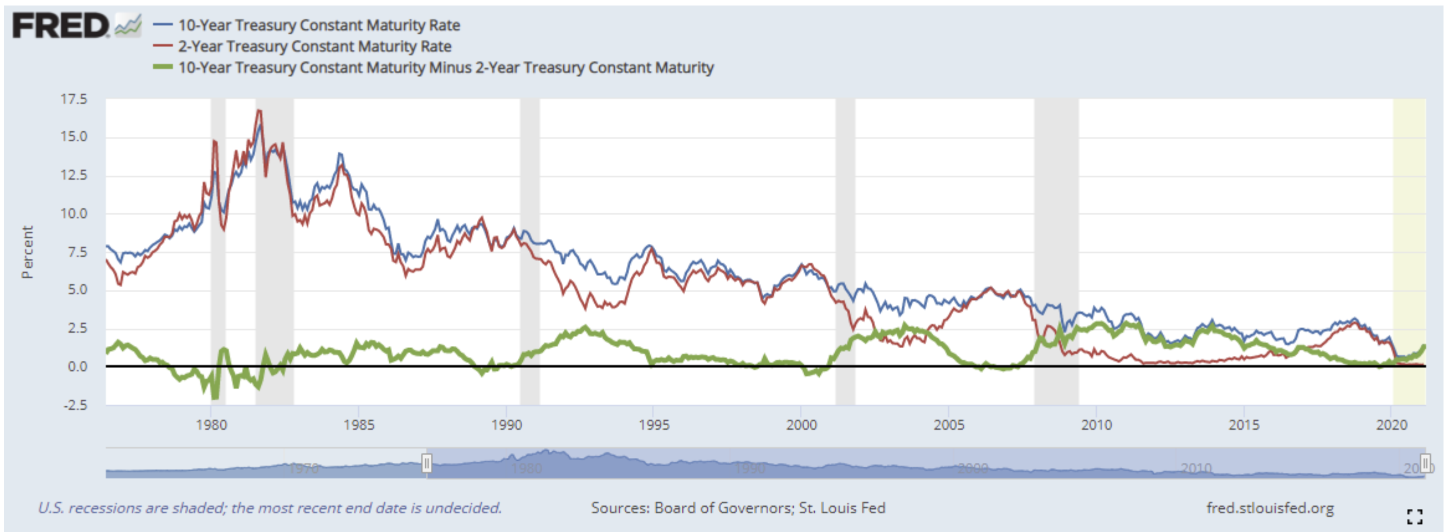
- COVID-19 hit low-income workers the hardest: unemployment is significantly higher for non-college graduates than it is for college graduates at present.



- Temp employment, a historically useful leading indicator, troughed in spring 2020 and is now back at 2014 levels.



- The spread between the yield on 10-year treasuries and 2-year treasuries, respectively, remains historically low but has increased notably so far this year. The slope of the yield curve is a widely discussed leading indicator because recessions have historically followed yield curve inversions.



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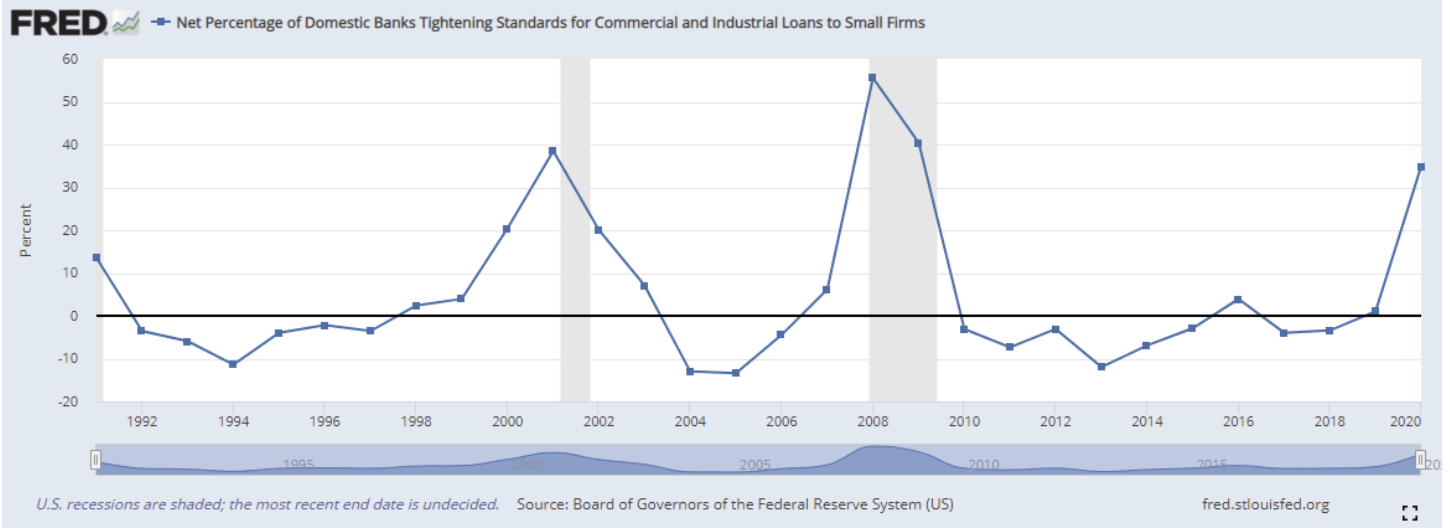
5) **<u>Bank lending standards tightened significantly in 2020 but debt raised via the capital markets remains historically cheap.</u>**

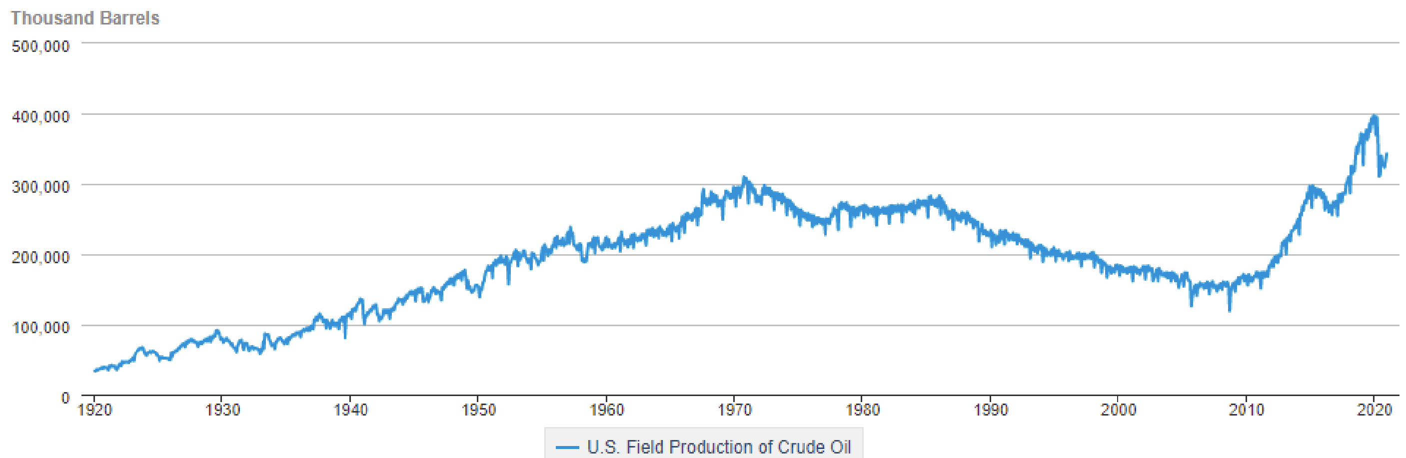
- [Bank commercial & industrial lending standards tightened significantly in 2020] due to COVID-19. This is negative for small- and medium-sized business borrowers.



- The riskiest subset of below-investment grade corporate bonds [now trades at the low end of its post-2009 trading range]. The capital markets are open for business for riskier borrowers.

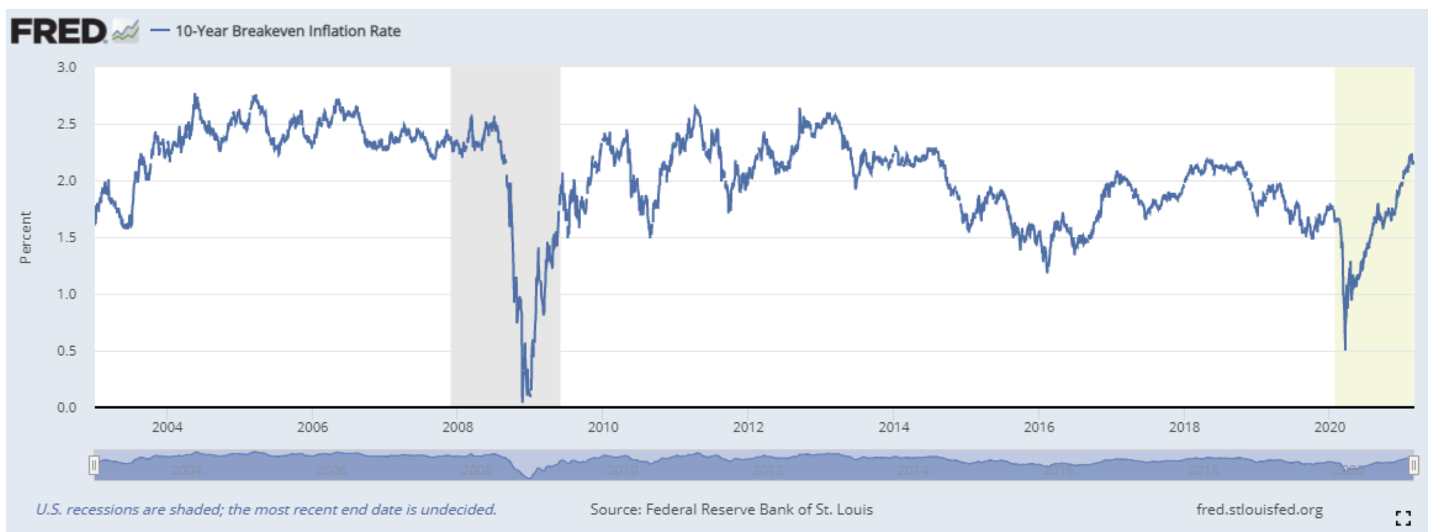
6) **US oil production remains above the high it reached in the 1970s.**

- US crude oil production, though below its 2019 high, remains elevated versus history. This is important because high crude oil production typically leads to lower gasoline prices and, therefore, increased disposable income for consumers.
  - Increased disposable income is important because consumption constitutes over 2/3 of US GDP (that is, it is difficult for the US economy and the US consumer to decouple).



7) **Market-based measures of forward inflation expectations remain within their historical range despite their recent rise.**

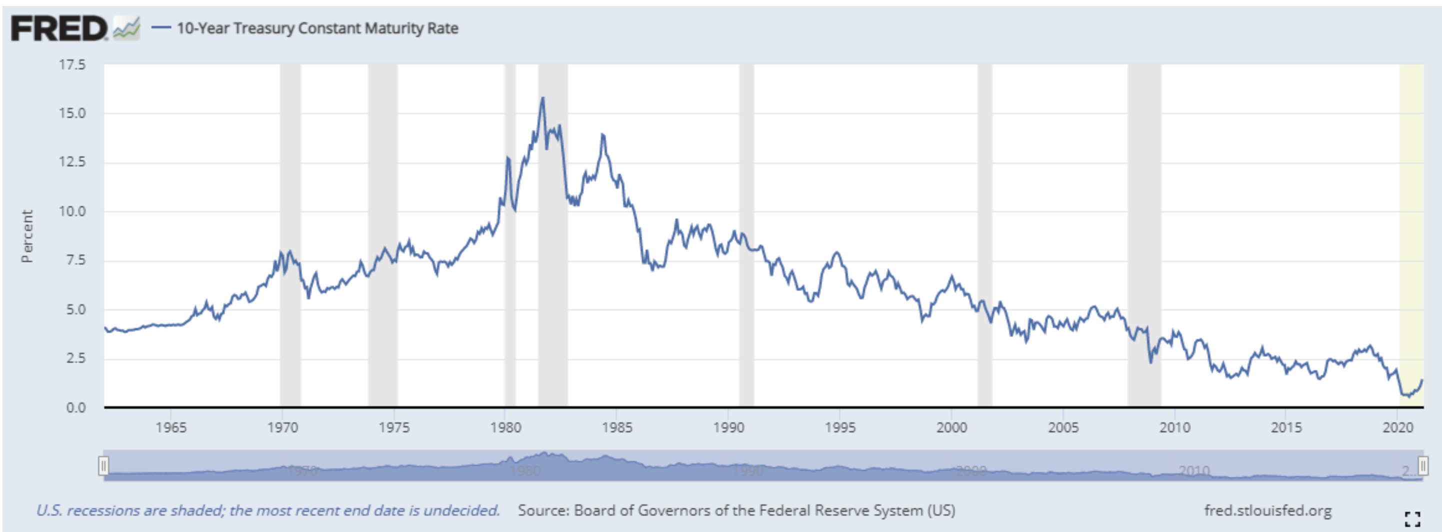
- Ten-year breakeven inflation—a forward-looking, market-based measure of inflation expectations—has risen sharply from its 2020 lows but remains rangebound. This is important because muted inflation is ideal for most investments.



8) **Although there are parts of the stock market that we consider richly valued today we remain constructive on the market in aggregate, especially in light of continued historically low long-term interest rates.**

- Ten-year US treasury bonds currently yield approximately 1.5%. Although this is up from the <1% yields we saw in 2020, in the grand scheme of things (see below) interest rates remain at all-time lows.

  A historically low 10-year yield is notable because all else equal, lower long-term interest rates reduce discount rates and therefore increase asset prices.



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