January 10, 2022

2021 Annual Letter

"In economics, you always want to ask, 'And then what?'" —Warren Buffett

If on January 1, 2020, someone had told you that the world was about to experience a global pandemic that would close borders and businesses—and continue to periodically close them at various stages during the next two years—no one would have blamed you for not wanting to own too many stocks in your investment portfolio. And yet, over the last two years, $1 invested in the S&P 500 has grown to more than $1.50.

The "And then what?" question often plays out in unexpected and unpredictable ways in economics and markets. Governments and central banks have been more eager to jump in to try and keep things afloat since the financial crisis that culminated in 2008-2009, and their pandemic support reached never-before-seen heights of experimentation. What the long-term effects of this support will eventually be is yet to be seen, but if current trends continue, higher inflation may be one of them.

The 13-year market performance during 2009–2021 has been one of the best of all time. The S&P 500 has averaged a total return of nearly 16% per year during that timeframe and has only had one down year. Interest rates have also drifted lower, allowing for some gain on bond portfolios, even as proceeds from those bonds have been reinvested at lower and lower rates.

It's said that one of the keys to happiness is low expectations. While we expect clients to have high expectations for the service we provide and the efforts we make to do our jobs well, we want to stress that for clients with diversified portfolios, the returns from stocks and bonds during the next 13 years are likely to be much lower than during the last 13 years. With interest rates close to zero and stock valuations near all-time highs at year-end, the odds favor much lower returns going forward.

How do we manage diversified portfolios in a lower-return world? Many of our clients have all or a substantial portion of their net worth invested with us in our **Diversified Strategy**. For those clients, we look to apply the first rule of auto racing to the investment process: *To finish first, you must first finish*. In this case, finishing first isn't about having higher returns than

anyone else—that would likely require taking unnecessary risks. Instead, finishing first is helping clients reach their goals. Whether those goals entail retirement, taking care of one's family, or the peace of mind that comes from being able to live one's life by hiring us to manage the ups and downs of the markets over time, we take great joy in seeing clients get to the finish line and in doing our part in helping them get there. As such, we focus on diversification and survival, and we don't aim to swing for the fences by taking undue risks.

For clients in our **Absolute Return Strategy**, we continue to look for mispriced bets and some occasional special situations as they arise. There was some progress in a couple of our micro-cap holdings during the year, and we've found some larger companies in which we've opened smaller position sizes. We generally ease our way into new positions, and many of these names are ones we hope to size up when the price is cheaper, or when we gain further insights as we follow the companies over time. As a reminder, this strategy is a concentrated equity strategy and is likely to experience much higher volatility than more diversified portfolios over time.

No matter how diversified one is, or where one falls on the spectrum for risk tolerance, taking advantage of volatility when it inevitably pops up from time to time will be a vital component to both improve returns and manage taxes. The rise of passive investment products and competition has been a boon for lowering trading costs to almost nothing. And the range of available products has made it both easier and more rewarding for even long-term investors like us to actively manage taxable portfolios when volatility arises—all while continuing to stay invested according to one's investment plan. Volatility doesn't always feel good when it arrives. But arrive it will. When it does, it's our job to keep a cool head and keep a disciplined process to see things through.

"I can live with doubt, and uncertainty, and not knowing. I think it's much more interesting to live not knowing than to have answers which might be wrong." —Richard Feynman

Dividend yields on stocks began to yield less than bonds for the first time in September 1958. Before then, stocks were seen as being riskier and less predictable than bonds, and the income stream from stocks was viewed as being less attractive, so stocks thus required a higher dividend yield to justify the risk. But then things changed. People suddenly realized that companies could reinvest, and dividends could grow—oftentimes substantially—during one's holding period. In a 2004 interview with author and personal finance columnist Jason Zweig, financial historian Peter L. Bernstein described the lesson he learned from that episode:

"All my older associates told me that it was an anomaly, and it could not last. To understand why that happened and what that meant — and to recognize that what was accepted wisdom for a couple hundred years could turn out to be wrong — was very important. It really showed me that you don't know. That anything can happen. There really is such a thing as a 'paradigm shift,' when people's view of the future can change very dramatically and very suddenly. That means that there's never a time when you can be sure that today's market is going to be a replay of a familiar past."

As we enter 2022, those who look to the distant past will say that interest rates this low, valuations and government debt levels this high, and monetary and fiscal support as friendly as they have been cannot last. But those who look to the recent past will say that low rates are here to stay, valuations are high because rates are low, and technological growth in all areas of the economy will allow us to grow our way out of our debt burdens. I tend to side mostly with the former. I feel that nearly free money leads to misallocation, and that most major booms lay the foundation for that misallocation to eventually lead to bust. But I also keep in mind some of the wisest investing words that I think exist, which come from investor Howard Marks: "It's one thing to have an opinion, but something very different to assume it's right and bet heavily on it."

So, we continue moving forward. We remain open to the fact that anything can happen—some of which we'll expect, and some of which will be surprising. Like the wisdom in Carl Sagan's quote below, we look to find the balance between being skeptical that old rules no longer apply and being open to the possibility that, sometimes, things really do change in a meaningful and lasting way.

"It seems to me what is called for is an exquisite balance between two conflicting needs: the most skeptical scrutiny of all hypotheses that are served up to us and at the same time a great openness to new ideas. Obviously those two modes of thought are in some tension. But if you are able to exercise only one of these modes, whichever one it is, you're in deep trouble."

We met new clients and, more importantly, made new friends in 2021. Many of you also had a chance to speak and interact with Theresa, whom we welcomed to the Sorfis team in April. She and I plan on traveling more in 2022, so we hope to see and meet everyone in person throughout the year.

Our contact information is included below for easy reference. As always, feel free to call or email us if you have any questions. And thank you for your support.

All the best,

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