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FROM THE CIO

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CREATIVE DESTRUCTION: HERE WE GO AGAIN

There seems to be a widely held view that a recession for next year is a fait accompli, and this has transferred into an almost universally bearish sentiment for risk assets.

In this final piece in 2022, Alpha Leonis Partners' CIO observes signs of what creative destruction as the associated market cleanup periodically discards those players with lofty business models or shady intentions.

Revisiting some of legendary investor Warren Buffett's sayings, David B. Pinkerton reminds us of a well-tested investor rule, which is not to confuse value with price.

David closes by explaining how a focus on knowledge and intellectual capital drives long-term growth and sustainable profits, traits of companies that should be candidates for every private equity portfolio.

IMAGE GENERATED BY ARTIFICIAL INTELLIGENCE

Wrapping up a year-end review and setting the stage for the next is always a complex endeavor, especially when markets have witnessed historic and rarely precedented behavior across all asset classes (whether risk assets or traditionally "safe" ones like bonds). It is times like these where a visit to the "sages" for a perspective is helpful, like, of course, Warren Buffett, one of the GOATs. Reading through some of his annual letters, which span three decades, I came across a quote that seemed especially relevant today.

In late 2008 Buffett said:
"We are certain, for example, that the economy will be in shambles throughout 2009 – and probably well beyond – but that conclusion does not tell us whether the market will rise or fall."

After the 2008 GFC equities were still in the midst of significant declines (~ -40%). At that time, as Buffett's remark suggests, there was a broadly held view that the economy would face difficulty. With 20/20 hindsight, March of 2009 was actually a "bottom" for equities that set the stage for significant advances upwards (4 to 5x) in the S&P 500. The economy avoided a hard landing and rebounded, most likely because of the positive impact of the QE stimulus.

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1 THE STATE OF THE MARKETS: CREATIVE DESTRUCTION

Today may be much different (than in 2009), but one thing is similar. There seems to be a widely held view that a recession for next year is a fait accompli, and this has transferred into an almost universally bearish sentiment for risk assets. Risk assets are off more than 25% YTD and some of last year's high-flying unicorns are down 80-90% from their highs (which were undoubtedly overvalued). These facts correspond to very bearish sentiment and a significant amount of liquidity that is on the sidelines at the moment as almost everyone has "battened down the hatches" in preparation for one of the most widely anticipated recessions ever.

Most market strategists describe the November rally as a short covering rally in a bear market and are cautious to assert that this is a true turning point indicating a bottom in equity prices. Worries persist about next year's recession. What if this consensus viewpoint is wrong, or as Buffett says, the economic outlook does not necessarily correspond to a stock market outlook, and similar to March of 2009 when there was also a widely held bearish view, it actually is the beginning of a pivot point and the initial stages for a new bull market?

On the value of not confusing value with price

Being mostly active in the private capital markets, we philosophically seek to avoid public-market timing, but we are well aware that interest rates affect all financial assets in the near- and long-term, so we would be foolish not to watch the rate environment when allocating long-term capital. Whether one is invested in leveraged buyouts (value tilted) or minority-growth strategies, interest rates affect these valuations significantly. They do not necessarily affect the fundamentals of earnings of many underlying companies, but they do affect the prices. As Benjamin Graham once said, "value" and "price" are not the same thing, but in times when there is significant uncertainty and a broad rush for liquidity, everything that can get sold does, and often great value (companies) can be purchased at very attractive "prices."

Many "babies have been thrown out with the bathwater" over the last 12 months, in our opinion, and conversely, many other companies that were financing artificial, or overly optimistic/unprofitable revenue growth on cheap capital, are now dying slow deaths of "dehydration" due to a lack of capital. The cost of capital has risen substantially, and this is excellent for capital deployment prospectively on many levels, as fewer models can get financed, leaving stronger market dynamics for the survivors and those with strong models. The removal of weak or fraudulent business models with the "flame-thrower of truth" (cost of capital increases) is now underway.

The poster children of excessive speculation get discarded

This is a healthy example of economist Joseph Schumpeter's creative destruction hypothesis. Nowhere is this more obvious than the collapse of the FTX crypto exchange and NFTs, which will be cited as the "poster children" of excessive speculation. Unlike the last crisis, where regulators used the "too big to fail" argument to support systemically relevant actors in the financial system, we do not believe that the "too big to fail" temptation will apply to the private crypto market. Instead, various governments are now stepping in to own and control the crypto market by creating government-sponsored cryptocurrencies to preserve control over the value of their respective currencies and therewith, the stability and soundness of their respective economic and financial systems.

2 OUR VIEWPOINTS

Now, that is probably enough "OpEd" on the state of the markets, and with the appropriate caveats about market timing, let's examine where we think we are in terms of our viewpoints on the economy and markets and interest rates in particular.

Recession or stagflation?

The key question boils down to the following:

1) Will the economy slip into a recession, and would this correspond to a topping of rates (or an actual decline) in a manner that produces an uplift in financial asset valuations to the degree that offsets decline pressure in valuations that comes from earnings erosion and a correspondent recession?

Or 2) What if inflationary forces continue and rates keep moving up and/or correspond to stagflationary conditions?

If this latter scenario is the case, then all bets are off for relief in a financial asset pricing bounce, even though such an environment would be pro-cyclical and one where nominal earnings kept rising.

Market consensus is where the intellectual work actually begins

In an attempt to add insight on these questions we maintain a series of economic and market indicators and use these tools to help ground us in objectivity and mitigate headline-driven cognitive and sentiment biases. If anything, we try to adopt a contrarian viewpoint on the premise that the consensus amongst market strategists is usually fully "priced in" and, therefore, not often good for asset allocation purposes.

Demographics and technological advances as deflationary drivers

Deciphering leading economic and financial indicators is especially difficult at pivot points as there are often false positives, and historical comparisons are rarely a perfect fact pattern match. Common comparisons are being drawn against either the 1970s (when there was oil supply shock inflation) or the 1940s, when there were post-war inflationary demand pressures. Some similarities are relevant to these decades, but in other aspects, there are significant differences. The most significant difference, and in our view, a net-net and significant deflationary contributor, is the state of global demographics, which is almost universally aging/aged and sees zero population growth going forward. This coupled with our view that technological advances are continuing to accelerate on a multitude of fronts, are the two most significant longer-term deflationary forces.

Cyclically pressured interest rates exhibit fading upward pressures

Demographics of an aging population mean shifting and/or slowing consumption as well as less demand for borrowing. The best indication of this shifting of demand characteristics is seen by viewing the velocity of money. This measure has been on a downward trend for over 20 years and, in our view, reflects the demographic conditions of the developed markets. Our view is that the short-term picture of inflationary pressure is cyclical, but the structural aspects of inflationary pressure are weak because of demographics. It is just a matter of time before the reality of demographic demand characteristics coupled with supply chain repairs produces retreating inflation. It does not have to go to zero, and rates do not have to go negative as they were in 2019/20, but the cyclically pressured interest rates are beginning to show fading upward pressure.

Forces cooling the world's economies expected to dampen spiraling inflation

Hence we assess that the scenario of further heating of the global economies is less likely. At the margin, we believe that the economic cooling forces are becoming more pervasive than those that lead to further spiraling inflation.

Critics of the Fed claim that the rate hikes have been too much, too fast and that this portends a hard landing. However, market strategists are almost all quite bearish, and PPIs (purchasing manager indices) are below 50, indicating very reserved CEO confidence. This is also matched with historically high levels of cash on the sidelines for investors and corporates.

Some input prices have abated further increases, whereas others are still persistently high such as food. White-collar labor is a signal of a weak labor market/reduced consumer confidence, but on the other hand, labor shortages in blue-collar jobs and other healthcare service jobs are still in short supply. Supply chain issues are, in some cases, getting fixed (post-COVID economy/China reopening), yet in other areas (German automotive input, energy/gas, etc.), costs are still persistently high.

3 IMPACT ON ASSET ALLOCATION AND A LONGER-TERM PRIVATE EQUITY STRATEGY

Hence, in our view, the key questions we ask ourselves are: How do all of these macroeconomic drivers affect prudent asset allocation and, in particular, define and shape a longer-term private equity strategy?

Focusing on diversified, recession resilient, entrepreneurial-led, owner-operated businesses

We allocate capital and seek to own businesses (following the likes of Buffett), that are diversified and recession resilient, maintain pricing power during inflationary periods and are predominantly "owner-operated." This emphasis on entrepreneurial-led and owner-operated businesses is what has proven time and time again to be the best "moat" for wealth preservation and growth throughout history. This is, in our opinion, the main virtue of private equity strategies as it emphasizes owning control of long-term businesses without the short-term quarterly pressures that lead to the misallocation of capital and aligning with management teams that entrepreneurially led innovative growth across decades. In many respects, Buffett's Berkshire Hathaway is like a diversified private equity portfolio where it owns majority interests and holds long-term assets (railroads, energy, infrastructure, consumer goods companies etc.) and holds minority positions in more growthy companies (such as Apple). Berkshire's insurance businesses can be viewed as a capital-sourcing machine that earns the float on premiums paid upfront for claims that are paid later. The reserves of the insurance assets need to be invested, and it is over time that this surplus capital gets invested in longer-term equity positions, albeit controlled PE assets or minority buy and hold public equities.

Valuations have corrected and, in some cases, overcorrected, pessimism is widespread, and it is in these times that Buffett has said, "be fearful when others are greedy, and greedy when others are fearful."

4 CONCLUSION: LETTING ENTREPRENEURIAL SPIRIT DRIVE THE INVESTMENT PHILOSOPHY

It is so easy to get overwhelmed by a barrage of complex and anxiety-producing headlines such as the rising geopolitical tensions (US-China, Russia, Taiwan), the continuing Ukraine war, political corruption allegations almost everywhere, the FTX crypto bankruptcy and potential contagion risks, the efficacy of Fed tapering, the amazing USD strength and its ramifications on other economies, the start of questions on blunt ESG-rating efficacy, and finally Twitter's release of information about political interferences on that platform, (the Twitter files).

The list can go on and on, but as I have written in the past, bear markets bring about change (almost always healthy), and not only do these harsh markets reveal and correct malinvestment, but they also reveal weaknesses in social structure, political institutions, and lead to needed repairs on many levels. It is the "free market" and the natural corrective process that keeps the vibrancy and health of a market and society. Another quote from Buffett also comes to mind here:

"For 240 years, it's been a terrible mistake to bet against America."

Inherent in this statement is the fundamental tenant of our investment philosophy, and it is not so much a bet on America (although we do), but it is a bet on the entrepreneurial spirit, whether it is in America or elsewhere, one that drives ingenuity, innovation and positive change to deliver value not only for the entrepreneur and shareholders but also to the consumer market and society.

We continue to emphasize knowledge-rich business models, ones that are heavy on intellectual capital, owner-operated, and ones that are likely to have longer-term transformative market share growth and benefit from higher sustainable, profitable margins due to the low marginal cost of replicating code or "IP" of a business.

We wish you all a period of sanguine reflection and time spent with those you love as we round out one of the most challenging and interesting years on record. (Again).

Respectfully,

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