January 4, 2023

Dear Clients and Friends,

One can discuss investments; or, one can discuss investing. One can speak of a particular stock or asset allocation stance. Or about *how* to think about a security or asset class, or even what an asset class is.

Investors now face questions they haven't had to consider for decades. Until this past year, the entrenched basket-of-securities approach to investing meant one didn't have to think, one just bought the recommended asset classes. That approach is now in disarray. It depended on a simplistic presumption that the prior 20 or 40 years of daily price data represented normality. It couldn't contemplate a change in those presumptions. History is a lot messier. That data, it turns out, described an anomalous period, not a normative one.

It should now be clear that indexation and asset allocation models – at least as practiced – can no longer be relied upon as having predictive value. Bonds, for instance. Over the past 20 years[1], after taxes, they returned only about 2%, annualized. Even accepting the government's CPI calculation that inflation averaged only 2.5%, that means bonds had a negative real return, a two-decade loss of purchasing power. That was not supposed to happen (on the reasoning that it hadn't happened before). And that was during a period of relatively benign inflation. 'Benign' is not the likely caption for the next 20 years. Rationally, one must rethink one's approach to bond investing. One must rethink other presumptions about the standardized approach to investing.

A place to start is to recognize group-think and how institutional thinking can be blind to important information. A well-studied area of behavioral finance, ever a topic of academic studies, is how to design compensation formulas that align the interests of senior executives with those of shareholders – an ailment seemingly immune to cure. The same misalignment of benefits and risks, or of short- vs. long-term interests, can exist between purveyors of investment advice or news, and consumers of those products. It's why, despite a daily parade of news about passing events, we rarely receive substantive information about developments that will have long-term consequences not yet in evidence. 'Not yet in evidence,' meaning two years or three years away, is not news, it's not marketable. At best, it's a moment's entertainment, a short interview with an outlier tagged as a fringe theorist or fabulist. Real news is the noise you often hear when consequences finally arrive.

There's a sense, among many, that we've partially regained our footing from the last two years' confusion about inflation and interest rates (even if not about mega-cap IT companies and future stock valuations). The new focus is on when the central bank will succeed in stifling inflation, at which precise level of interest rates, and whether and when a recession will ensue (with "when" still revolving around the next 12 months, give or take). It is even believed that the 'inflation scare' might be over, because the CPI figures have subsided for a few months.

But we haven't really regained our footing. One can know this, because there is no serious mention of: 1) the record level of government debt, and the necessary inference that the Federal Reserve might already be trapped into a long-term strategy of inflationary money printing; nor, 2) any mention of some basic (inflationary) geological realities. Our ancestors, as of about 200 years ago, began making dramatic use of fossil fuels, for the simple reasons

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[1] *Inception through 11/30/22, less federal taxes, for iShares 7-10 Year Treasury Bond ETF (7/22/02), iShares Core U.S. Aggregate Bond ETF (9/22/03), iShares iBoxx $ High Yield Corporate Bond ETF (4/4/07), and iShares TIPS Bond ETF (12/4/03): 2.57%, 1.80%, 1.86%, 2.37% (annualized pre-liquidation returns after taxes on distributions).*

that they were plentiful and extraordinarily effective power sources. In 1850, coal accounted for only 7% of all fuel energy in North America and Europe; almost all the balance of applied kinetic energy came from direct human labor and draft animals. By 1900, coal and oil accounted for half of all global primary energy[2]; and that was only 1900. From 1850 onward, almost the entire edifice of global technological and population advancement has depended on the use and improvements in the use of fossil fuels. If, after two centuries of fossil fuel use, we wish to change to different energy sources, alternative substances are required. This is the practical, physical science challenge in the transition to solar, wind and battery power: that the enabling substances, such as lithium, silver, cobalt and neodymium, are neither as plentiful nor as accessible. As to better substitutes, there are only 118 elements in the Periodic Table, and most are not suitable as energy sources. Therefore, the energy transition becomes a more complex and challenging objective to solve than might be thought. The structural supply insufficiencies of such essential hard commodities (including oil) is another example of evidence not yet in full public view.

After this prelude, it might strain credulity to hear how unusually enthused we are about the investing future. Yet, we are. In the same way that observable, quantifiable trends previously pointed (and still do) to a long period of much higher oil prices, recently developing events and data now point the way to new significant return opportunities. Even, new asset classes (and that's saying a lot).

Much as we wrote last year at this time, portfolios have been positioned in companies with business models uniquely structured to benefit from extended inflation, whether commodity-scarcity based or monetary-debasement based. This year, additional royalty companies were added, bringing exposure to iron ore, copper, a range of electrification and battery metals, and even fertilizer. Why, do this, aside from diversifying into a broader array of inflation vectors? Because they're too cheap. Why too cheap? Because, A) as above, investors generally remain unaware of the true inflation risks, so they don't yet value such companies, and B) most such companies are decidedly not to be found in the world of indexed securities – call them index-unavailable. In thinking about the process of investing, both of those are positive factors for future salutary returns.

Another, almost unavoidable, opportunity on the horizon is a disruption in the bond market. Yes, another disruption not yet in evidence. In the past 12 months, the marginal cost of corporate borrowing has doubled. There hasn't been time for these interest cost increases to filter into companies' income statements. But, they will. And it doesn't take much to tip many a BBB-credit into the BB non-investment grade category. Meanwhile, during the zero-interest rate years, investment grade bond funds came to rely heavily on that lowest rung of corporate credits, the BBBs, for extra yield. When those downgrades ultimately occur, those index funds will be, at one and the same time, both price-insensitive and time-sensitive sellers. If history is a guide, there may be bargains aplenty, both for income-oriented and, possibly, equity accounts.

We would be remiss to not mention our exposure to fixed-supply cryptocurrencies (bitcoin, which we introduced in 2016, as a then-border-of-de minimis holding, in a variety of strategies). Though currently (and maladroitly) maligned, it remains a strategic allocation for the looming stretch of structurally high inflation. The prospects for such technologies and assets are abundantly clear to most who dedicate the proper time and attention to objective analysis. However, the worst actors in a nascent industry can temporarily obscure its value proposition. Regardless of your predilection for fixed-supply cryptocurrency, it remains an emerging asset class and should be sized as such.

[2] *Smil, Vaclav. How the World Really Works. Penguin Random House UK, 2022.*

We introduced some new funds this year to address the pressing need for true return diversification. Among them is the Diamond Standard Fund, launched in partnership with Diamond Standard Ltd. Enabled by patented computer technology, Diamond Standard transforms algorithmically selected packets of diamonds into a tradeable, fungible commodity, each of precisely the same value, 500x more value-dense than gold bars. That was previously impossible, each single diamond being unique. But, with such transparency, there is now trading a new, global scale and well-known asset class, uncorrelated or negatively correlated with gold and other asset classes, and accessible to individuals and institutions. As to price development, as in all human economic endeavors, supply relative to demand is the determining factor. The addressable demand for portfolio-allocable commoditized diamond 'coins' and 'bars' is immense, and, moreover, with an asset manifesting declining long-term production supply.

With those and other pathways that can appear when one is open to and free to think about investing, not just making investments, today's and tomorrow's economic stresses may be seen a bit more clearly as the basis for opportunity, not worry.

Wishing you health and success in the year to come,

Horizon Kinetics LLC