

Atherean

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Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending December 31, 2022, a summary of your investment objectives and target asset allocation as per our records, and an investment advisory fee statement for the first quarter of 2023. It is important that you review your investment objectives and target asset allocation and let us know if any of it is incorrect or if there are any changes to your financial profile or liquidity needs. For a full report of the holdings in your accounts we encourage you to refer to your statements generated by the custodian.

Economic Review and Outlook

In 2022 we witnessed one of the most intense sell-offs in risk assets since the internet bubble burst in the early 2000s as central banks delivered their most forceful and rapid intervention since the 1980s. The central bank actions have proven to be effective as asset price inflation (both risk asset and real asset), consumer price inflation and producer price inflation have all become more benign in aggregate. Services inflation has remained robust, as it has consistently been over the past few decades, while goods and asset price inflation, which are typically more volatile, have dropped off rapidly over the past year¹. Accordingly the Fed has been striking a less hawkish tone in recent months than it was a year ago, and the Fed dot plot, the short-term treasury yield curve and the Fed Funds futures market imply moderate rate hikes for the upcoming few quarters, followed by rate reductions over a two to three-year time horizon². Such an anticipated rate scenario is in line with what we believe is the market consensus pricing in a moderate probability of a recession, which would in turn result in the Fed cutting rates. However, we do not believe that the probability of a recession is as high as the market consensus seems to believe or accordingly that the Fed will cut rates within the next few years.

The U.S. economy has continued to show resilience with real GDP growing at a 2.9% annualized rate in the fourth quarter of 2022. Long-term treasury yields and credit spreads, although both elevated relative to where

¹ Macro Research Board, *U.S. CPI: Easing Steadily, But Medium-Term Signals Remain Firm*, January 12, 2023

² During the last meeting of 2022 the Fed set the Fed Funds target rate in the 4.25%-4.5% range. As of the writing of this letter the three-month treasury rate stands at 4.7% and the 2-year treasury rate stands at 4.2%. As of December of 2022 the Fed dot plot similarly implies a Fed Funds rate of approximately 5.0% for 2023, 4.0% for 2024 and about 3% for 2025. Source: U.S. Federal Reserve and *MRB Partners, 2023 U.S. Economic Outlook: Sticking To A No-Recession Call*, December 15, 2022

they were a year ago, have come down substantially since October of 2022 when they both peaked³. The labor market remains robust as there are still many more job openings than there are people looking for them and the unemployment rate remains near its lowest level in fifty years.

Regardless of what happens in the global macro economy in the short-term (six months to a year) and medium term (two to three years), we believe that over longer time frames the global economy will be in a high-interest rate, moderate (above 2%) inflation, full employment, high real economic growth rate regime for some time. This does not materially impact our investment philosophy or securities selection process, as we invest in securities of companies which we believe to be long-term durable in any economic environment, and only at purchase prices which reflect a substantial margin of safety. That being said, we do make macroeconomic projections, even though they could be wrong, so that we can better understand what is going on in the world and in the economy at large. We do this so that we can have a solid grasp of the reasons why our portfolio holdings are performing in a given way at any given point in time.

Equity and Fixed Income Markets – Recent Performance and Valuation

In 2022 global equity markets had their worst-performing year since 2008 with the U.S. large-cap (S&P 500) index down 18%, the U.S. mid-cap (S&P 400) index down 13%, the U.S. small-cap (S&P 600) index down 16%, and the Europe, Australasia, and Far East (EAFE) index down 14% on a total-return basis. Bond markets had equally abysmal performance with the Barclays Aggregate Bond index down 13% on a total-return basis for the year. The S&P 500 is currently trading at a forward price-to-earnings multiple of just over 17⁴ and the Shiller CAPE ratio is at a level of just under 28⁵ as of the writing of this letter.

Portfolio Management

We were more active than usual in 2022, and in the fourth quarter we continued to take advantage of the recent market downturn to upgrade our portfolio with new positions in Alphabet, KAR Global, Markel Corp, and Oaktree Specialty Lending Corp⁶. The past year has provided significant opportunities as many high-quality, high-valuation-multiple stocks have become the cheapest they have been in many years⁷. We discussed some of the new portfolio additions we made earlier in the year, including CPRT and ADBE, in our other 2022 quarterly letters. Next we will discuss some new positions which we took in the fourth quarter.

In the fourth quarter of 2022 we took a position in Alphabet inc (NASDAQ: GOOG; GOOGL)⁶. With substantial cash flow margins provided by an exceptionally wide economic moat, we believe that the company offers a solid opportunity for long-term growth. We are confident that the company has the ability to grow its free cash flow per share in the years and decades ahead through its highly advantageous market position, superior capital allocation and culture of entrepreneurship and innovation.

In general, the larger the company, the more complex the investment thesis. At one end of the spectrum are global macro bets and on the other end would be an investment in a microcap stock or the small business down the street. The former requires more in-depth, comprehensive research than the latter. Alphabet, currently

³ Between October of 2022 and the writing of this letter the US Corporate BBB Option-Adjusted Spread has declined from 2.1% to 1.6% and the ten-year treasury rate has declined from 4.1% to 3.5%. Prior to the Fed pivot in November of 2021 the BBB OAS was at 1.1% and the ten-year treasury rate was at 1.5%. Source: Federal Reserve and Bank of America Merrill Lynch via YCharts

⁴ Source: Yardeni Research, Inc, "Stock Market Briefing: Selected P/E Ratios", January 11, 2023

⁵ For January 2023. Source: Robert Shiller via YCharts

⁶ The securities which we discuss in this letter are not necessarily allocated to all of our client accounts. Whether or not we choose to allocate a particular security to your account will depend on your risk tolerance, investment objectives, tax situation and objectives, and liquidity needs. Nothing printed in this letter should be construed as a solicitation or an attempt to effect transactions in securities.

⁷ These are not to be confused with low-quality, high-valuation stocks, which needless to say deserve to be cheap

sitting at a market cap of almost \$1.3T, is one of the most complex ideas in our investment portfolio. We will sketch out some of the rationale behind this investment but needless to say it will only scratch the surface of our investment thesis. We will break this analysis into several bullet points which we consider to be the main drivers of the stock. These are (1) historical context and market position (2) corporate culture and capital allocation

First for historical context. In the late 1960s and early 1970s there was a group of stocks known as the “Nifty Fifty”, many of which had persistently-high valuation multiples and, at the time, seemingly persistently high growth rates. These stocks were highly recommended by many financial professionals as buy-and-hold-forever stocks. While some of these businesses, such as Texas Instruments, Coca Cola, and American Express did have the durability and timelessness to survive, prosper and continue to grow many others performed poorly over the subsequent decades and/or went bankrupt (Polaroid, Xerox, Eastman Kodak, Revlon, etc). As has been noted by many other market practitioners, the Nifty Fifty period of the 1960s and early 1970s has many similarities to the FAANG stock era of the 2010s, when S&P 500 market returns were dominated by Facebook (now Meta), Apple, Amazon, Netflix, and Google (now Alphabet). Indeed, the low interest rate environment of the 1960s eventually begat an era of Fed hiking and rising interest rates in the 1970s, similar to what has happened with the recent Fed pivot to higher rates over the past year or so. Similar to what transpired subsequent to the Nifty Fifty market dominance, we believe that some of the FAANG stocks of the low-interest-rate, technology-driven era will prove to be durable and survive and continue to grow, prosper, and generate wealth for shareholders while many others will be disrupted and fail.

Of all of the FAANG stocks we have believed for many years that Alphabet is a durable business with a strong market position and solid culture of entrepreneurship which will endure for a long time, however until the past year the stock has been too expensive for us to purchase with a sufficient margin of safety⁸. The company’s various business units consist of a monopolistic position in one business line, an oligopolistic position in several other business lines, and potential future moonshot upside through its R&D and venture capital arm.

Since its founding, the company has had a strong history of entrepreneurship, innovation, and careful and effective capital allocation. While the dual-share class structure prevalent in the technology sector has been widely criticized as disenfranchising to the majority of shareholders, we believe that in the exceptional case of Alphabet the ownership structure provides management with a healthy insulation from the short-term mindset which public companies are frequently under pressure from. Due to what we believe to be a culture of entrepreneurship, innovation, and focus, Alphabet has been extremely selective and careful in how it has approached its capital allocation and evidence of this can be found in its remarkable success with respect to making acquisitions. In general we shy away from highly acquisitive companies as statistically acquisitions destroy shareholder value and oftentimes are reflective of a shareholder unfriendly empire-building mentality. However, unlike most of its technology peers, many who have a history of making acquisitions involving substantial purchase prices for small amounts of revenue and earnings (in some cases no earnings)⁹, Alphabet company has a spectacular track record. Some of these include Android, purchased in 2005 for \$50M, Maps, purchased in 2004 for \$70M, YouTube, purchased in 2006 for \$1.65B, and DoubleClick, purchased in 2007 for \$3.1B. All of these businesses have achieved returns many times their initial investment since their purchase and integration into the Alphabet ecosystem.

While we are on the topic of our new position in Alphabet, we want to take a moment to discuss an important aspect of our investment philosophy. In general, we are believers in absolute valuation, rather than relative

⁸ When we took the position in Alphabet in the fourth quarter of 2022 it had a P/E ratio of under 20, the lowest that this multiple has been since 2013

⁹ For example Facebook purchased WhatsApp, a company which generated only \$10.2M in revenue in 2013 for \$22B in 2014. Source: Bloomberg, *Facebook \$22 Billion WhatsApp Deal Buys \$10 Million in Sales*, October 28, 2014, and late last year ADBE announced that it was acquiring Figma for \$20B, a company expected to have \$400M in annual recurring revenue for 2022. Source: Adobe press release, *Adobe to Acquire Figma*, September 15, 2022

valuation. In most cases relative valuation is used when comparing companies within a given industry with one another. We find this version of relative valuation to be watered-down and not very useful, because valuation multiples tend to change over time in response to sentiment, interest rates, and expected growth. We do, however, believe in relative valuation on a time basis for a single company, such as comparing the earnings multiple of Alphabet currently to where it has been historically. In this case, more easily defined discounted cash flow model input variables such as interest rates and growth rate can be easily modified so that the less well-defined sentiment contribution to the discounted cash flow valuation model can be backed out. In the case of Alphabet, we believe that the current market sentiment has caused the stock to become irrationally undervalued as the (much deserved) popping of the recent speculative bubble has caused any and every stock associated with technology and growth to become oversold (some of them deservedly but others, such as Alphabet, not so much).

In the fourth quarter of 2022 we also took a position in KAR Global (NYSE: KAR)¹⁰. The current version of KAR is the remaining company in the 2019 spinoff of the salvage auction business Insurance Auto Auctions (NYSE: IAA), where the old KAR Auction Services Inc separated its auto salvage business from its wholesale auto auction business. As we discussed in our Q1 2022 letter, we believe that the auto salvage business is extremely attractive and participate in the ownership of this business through our position in Copart (NASDAQ: CPRT)¹⁰. KAR Global's primary asset is its used-car wholesale vehicle auction platform, Adesa. Recently KAR sold the physical, brick and mortar component of Adesa to Carvana (NYSE: CVNA) for an amount exceeding KAR Global's market value at the time (the deal closed on May 10, 2022 for \$2.2B in cash, an amount exceeding the \$1.523B market cap of KAR at the time¹¹), leaving only digital wholesale auto auction platforms to remain. KAR Global used the proceeds from the sale to retire a substantial portion of its debt, and accordingly the company now has a leverage ratio significantly lower than it was prior. When we took the position in KAR Global in the fourth quarter of 2022 the company was a fully-digital, asset-light, high-margin business which was still trading at the valuation multiple associated with its old, asset-heavy, highly-leveraged former self. We believe that in time there is a solid chance that the market will recognize the company's new incarnation and that the stock will re-rate accordingly.

As always, we are available to discuss your investment portfolio, discuss your financial plan, or address any other questions or concerns which you may have. Please feel free to reach out via phone or email if you would like to speak with us.

Sincerely,



Atherean Wealth Management, LLC

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¹¹ *KAR Global Completes Sale of ADESA US Physical Auction Business to Carvana*, KAR Global press release dated May 10, 2022.