

Atherean

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July 29, 2021

Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending June 30, 2021, a summary of your investment objectives and target asset allocation as per our records, and an investment advisory fee statement for the third quarter of 2021. 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 overall 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.

Equity Markets – Valuations and Sentiment at Highs

Global equity markets continued their ascent in the second quarter with the S&P 500 index up 15%, the S&P 1000 index up 19%, and the Europe, Australasia and Far East (EAFE) index up 9% year-to-date as of June 30. Based upon forward earnings estimates¹ the S&P 500 is now trading at just over 23 times projected 2021 earnings. While this year has thus far been excellent for earnings growth, we remain vigilant of the possibility that much of the substantial earnings spike which we are seeing for many companies is due to pent-up demand related to the economy reopening. We would not be surprised if earnings for many companies were to revert back to their long-term trend level within the next few quarters. Based upon the longer-term earnings trend equity market valuations remain historically high, and as we have stated in the past we believe that these valuation levels are primarily the result of low interest rates and high market sentiment, i.e. optimism. As one well-known value investor² put it: bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria, and in our opinion the current market sentiment lies somewhere along the optimism – euphoria spectrum.

Inflation – Review, Breakdown and Outlook

On a fundamental level, the market is currently vulnerable to higher interest rates, which are related to the anticipation of how the Fed and the bond market will react to inflationary data. While the amount and intensity of inflation will be difficult to predict and difficult even to define (see later discussion), we believe that the probability of rate increases is higher than it was a quarter ago due to the U.S. economy and employment picking up steam faster than anticipated. That being said, our view is that the Fed will tolerate multiple

¹ Source: S&P Dow Jones Indices via YCharts, S&P 500 Earnings and Estimate Report, July 15, 2021

² John Templeton, founder of Templeton Investments

quarters of inflation before raising rates for several reasons. The first reason is that we expect that the Fed will adhere to its stated mandate; specifically, that it will seek to maintain its 2% target rate for inflation in the long run. Given that inflation ran well below this level for many years prior to the pandemic (see Q3 2020 letter for a detailed discussion), it is highly likely that the Fed will be comfortable keeping rates low for an extended period even if inflation runs above the 2% level for quite some time. The second reason has to do with the long-term economic growth outlook and relatedly the current term structure of interest rates, i.e., the yield curve. The Fed is in a difficult position because the U.S. economy arguably remains in a secular low-growth phase (see Q3 2020 letter for a detailed discussion). The long end of the U.S. treasury yield curve remains low, with the ten-year treasury settling in at 1.3% as of the writing of this letter. Raising the Fed funds rate above or even close to this level would run the risk of an inverted yield curve, which would result in a substantial probability of running the economy into recessionary territory. Furthermore, we believe that the longer end of the treasury curve is for the most part driven by factors such as economic growth expectations down the line. The low interest rate levels currently reflected in the prices of long-dated treasuries are implying low economic growth and, perhaps ironically, low inflation. Many argue that these long-term interest rates are being significantly influenced by the asset-buying activities of the Fed (which the Fed is currently discussing the possibility of tapering), however our view is that the Fed's ability to have a material impact on interest rates in this segment of the bond market is limited.

We see other forces exerting downward pressure on short-term rates, including the excess amount of liquidity currently in the banking system. Due to the monetary and fiscal stimulus programs which have been in place since the pandemic began many U.S. banks currently have more liquidity than they need. Anecdotally, on one second quarter bank earnings call a few weeks back³ we heard management indicate their intention to burn off excess liquidity from their balance sheet. More broadly, loan-to-deposit ratios at U.S. banks are currently at their lowest levels since the 1960's⁴, as deposits have increased at the same time that loan books have been shrinking⁵. While it remains to be seen exactly how the banking sector will react to this excess liquidity in aggregate or if it will even react at all, there remains a chance that, in order to reduce their cost of funding, many banks will lower rates paid on deposits. This could add to downward pressure on short-term rates.

All this being said, we want to reiterate that we believe that there are two definitions of inflation which have the potential to impact your portfolio and financial well-being. The first, as discussed in prior sections, is consumption-based, and is related to day-to-day basic consumer spending. This is the measure of inflation which the Fed appears to be most concerned about, as we believe that the Fed's goal is to control inflation as it relates to a household's basic spending needs. The second type of inflation, which we believe that the Fed is less concerned about, has to do with the price levels of assets, goods and services which are not essential (e.g. luxury goods and capital assets). The Fed is most concerned with price levels of basic, essential consumption items (defined by the Fed as the Personal Consumption Expenditures Price Index, or PCEPI, the largest components of which are food, housing, and transportation). Put another way, the Fed is more likely to raise its policy rate in response to the price of oatmeal, rice, wheat, peanut butter, gasoline, and/or rent going up, but less likely to respond to higher price levels of Aston Martins, luxury apartments on Central Park South, 100-price-to-sales ratio stocks, SPACs, "meme" stocks being discussed in Reddit chatrooms, or high-end watches.

Inflation could potentially impact equity prices in three ways – (1) directly through its impact on price levels of U.S. companies' outputs (revenue from its products and services) relative to their inputs (costs of their raw

³ Source: Synchrony Financial (SYF) earnings call

⁴ Source: Federal Deposit Insurance Corp data obtained from Grant's Interest Rate Observer, July 23, 2021

⁵ Discover Financial Services' (DFS) revolving loan book contracted by 2% year-over-year in Q2, and Synchrony Financial's (SYF) revolving loan book was flat year-over-year in Q2. This is despite total purchase volume increasing by 46% for DFS and 35% for SYF, which indicates that consumers were paying off their balances at a faster rate than they were spending on their cards. In the second quarter of 2021 payment rates on consumer revolving lines at Discover Financial Services were at their highest level since the company began reporting their results just prior to going public in 2007 (source: DFS Q2 2021 earnings call and SYF Q2 2021 earnings call).

materials, capital expenditures, labor, etc), (2) through the Fed's reaction to inflation via higher policy rates (as discussed previously), and (3) via the increased amount of liquidity, i.e. money, in the economy. We believe that the third is the most pernicious and dangerous as relates to your investment portfolio as it has the potential to result in asset bubbles. Indeed we believe that much of the market irrationality over the past year (meme stock craze, rapid rise in real estate prices etc.) is related to the increased amount of liquidity in the system due to the strong pandemic-related stimulus measures put into place both by the Fed and by Congress in 2020 and 2021. Of the first and second impacts we believe that the second one, namely the Fed's reaction to inflation, is a more serious risk to equity markets than the actual inflation itself, due to the fact that higher interest rates would make the future earnings of U.S. companies worth less in present value terms. Put another way, interest rates have a material and substantial effect on equity prices due to the fact that they represent the opportunity cost of capital for an equity investor.

As far as this relates to the investment landscape we believe that stocks of companies having strong moats (barriers to entry) and pricing power will fare the best in the event that we continue to experience high inflation. All else being equal companies that are in competitive industries will have a more difficult time raising their prices than companies which are part of monopolies or oligopolies. One of the most important things that a company can do is to grow its nominal revenue, earnings and cash flow at a rate faster than that of the economy as a whole. In an inflationary scenario where we have high nominal GDP growth and low real GDP growth, companies which can grow at a rate faster than the nominal GDP rate will do well. However, companies' ability to raise prices faster than the aggregate amount of inflation is only one part of the equation. For example, a given company will be able to do well in an inflationary environment even if it is unable to raise its prices if it has minimal fixed and labor costs and is able to sell more products due to increased demand.

Economic Review and Outlook

Just prior to the writing of this letter the U.S. Bureau of Economic Analysis released their preliminary estimate of second quarter real GDP growth of 6.5% annualized. This represents a level of economic growth well above the long-term trend level, and the first batch of earnings results which have been released over the past few weeks confirm that we seem to be in a bumper earnings and economic growth year due to pent-up demand. We expect growth to revert back to long-term trend levels as long as government stimulus continues to be withdrawn over the next few months and quarters as anticipated. When valuing companies we remain very vigilant of the possibility of 2021 earnings clocking in significantly above trend and rely more on more reasonable and conservative trend-based models using 2019 earnings results as a jumping-off point.

Portfolio Management

As discussed in previous quarterly letters, the manner in which we construct portfolios tends to involve an overweighting of small-cap stocks and value stocks with respect to the global market portfolio. While this is not entirely by design as the individual stocks which we invest in are selected using bottom-up analysis, we believe that from a portfolio construction perspective these factors (size and valuation multiple) represent systematic risks for which we will be appropriately compensated. Besides being favorable for these reasons, small-cap stocks represent good active portfolio management opportunities given the organizational structure of Atherean Wealth Management and our involvement in bottom-up stock selection. Large company stocks typically have large amounts of analyst coverage, are held by large asset owners, and consequently tend to be difficult areas in which to uncover market inefficiencies. Small-capitalization stocks are typically neglected by the sell-side analyst community due to the fact that they are too small to be held by most institutional investors. For these reasons we believe that they represent solid opportunities for the relatively small and enterprising investor. In the next section we will discuss the two investments which we made in the second

quarter⁶, both of which are small-capitalization stocks whose market caps were less than \$1B when we made the purchases.

In the second quarter of 2021 we initiated holdings in Investors Title Company (ITIC)⁶ and FutureFuel Corp (FF)⁶. Investors Title Company is a regional title insurer based in North Carolina. Founded in 1972, the family-controlled company has steadily grown its market share of the commercial and residential title insurance market in the southeastern United States through disciplined underwriting and steady organic premium growth. We were attracted to the company's consistently high profit margins and high return on invested capital. Through share repurchases and special dividends the company has returned over 70 percent of its operating cash flow to shareholders over the past five years. The company has no long-term debt, and we believe that its equity is reasonably priced, trading at approximately five times 2020 earnings and 1.5 times tangible book value.

FutureFuel Corp is a St Louis-based chemical manufacturer with the three business lines of custom chemicals, specialty chemicals, and biofuels. We initially saw a potential buying opportunity in the first quarter of 2021 when the price of natural gas spiked, forcing the company to temporarily shut down its manufacturing plant in Arkansas. This shutdown resulted in FutureFuel's first quarterly loss in the past 15 years of operation, resulting in the price of the company's equity dropping to a level just exceeding its tangible book value. On a free cash flow basis, making very conservative assumptions, we believe that FutureFuel equity remains very attractively priced. The company management has significant skin in the game, with the current CEO directly and beneficially through controlled entities owning over 40% of the common equity outstanding. The company has almost zero long-term debt, a significant amount of liquidity, and net-current assets of about three quarters of its current market capitalization. We believe that this situation represents an investment in a solid enterprise with a factor of safety provided in the form of a strong balance sheet and whose shareholders' equity, i.e. book value, is close to the proportionate price paid for the equity securities mentioned.

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

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.