April 8, 2022

Dear Clients and Friends,

It has been two years since the onset of the COVID-19 pandemic unleashed shock waves that continue to reverberate around the globe. At least in the U.S., case counts and hospitalization rates are down significantly after the Omicron wave retested our healthcare system at the beginning of the year. Just when it seemed okay to breathe a sigh of relief, though, the world turned its collective attention to Russia's shocking invasion of Ukraine. Images of suffering and destruction are overwhelming. The spillover effects, including disruptions to global food supplies, are of grave humanitarian concern. At such times of turmoil, it is even more important to sift through the many voices to analyze the impact events may have on global markets as well as our portfolio companies. Short-term noise will eventually surrender to long-term signals, and we believe our clients' portfolios are well-positioned to deliver satisfactory returns over the next several years.

Adapting to a shrinking world

The trend of greater global economic integration has been a deflationary force for much of the last 50 years. Until recently, companies had been free to roam the globe in search of new markets for their goods and services and the locations where they could produce them most cheaply. That trend began to reverse in recent years with the rise of protectionist sentiment around the world, related economic sanctions, and then widespread lockdowns to contain COVID-19. Now, Russia and China have made it abundantly clear that there are hard limits on how far they are willing to tolerate Western democratic thinking, even at the expense of severe consequences for their domestic economies. Companies are increasingly limited to operating within trading blocs comprised of countries with likeminded political systems. Those that learned to adapt to the rapidly changing circumstances wrought by COVID-19 have demonstrated that innovation and determination can overcome undreamed of challenges. These outstanding companies are likely to lead the world on a path to growing prosperity -- and reward shareholders while doing so.

Of course, there are always bumps in the road and near-term there are plenty. A year ago we wrote that all the fiscal and monetary stimuli aimed at countering the impacts of lockdowns could cause prices to rise if production capacity was not restored quickly enough. By the end of 2021, companies were still struggling to meet swelling demand and central banks and governments were slow to throttle back stimulus. As a result, inflation accelerated to the highest rates in four decades. The war in Ukraine and subsequent sanctions against Russia further stifle the flow of global commerce and exacerbate the upward pressure on prices. Central banks, including the U.S. Federal Reserve, are attempting to ease demand by increasing short-term borrowing costs but there is little they can do to lift production and improve supply in the short term, and uncomfortably high inflation is more likely to persist. Wages have not kept pace with prices, and if consumers pull back on spending, economic growth could sputter. Indeed the recent inversion of the Treasury yield curve (2-year rates are higher than 5-, 10- and 30-year rates as of this writing) suggests that bond investors anticipate a recession within the next year or two.

Beware of crowded trades

Asset valuations were stretched coming into 2022 after two years of well above average gains. Given the headlines, financial markets were understandably volatile in the first quarter: The **S&P 500** ended down 4.6% (including dividends) after being down almost 14% from its year-end close at one point. The **NASDAQ 100**, which includes many faster growing companies that rely on access to cheap capital to fuel their growth, dipped 20% before recovering to end the quarter down 8.9%. Bonds were no safe haven: during the quarter, the yield on the **10-year Treasury note** rose from 1.6% to 2.3%. Bond prices move in the opposite direction of yields, and the total return on bonds (as measured by the Barclays Aggregate Bond Index) was negative 5.9% during the period. Of the 185 quarters since 1976, a negative

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quarterly return for both stocks and bonds has occurred just 19 times including the first quarter of 2022. Furthermore, over the same period, there are just four instances where both stocks and bonds are negative for two consecutive quarters with three of those four instances associated with a recession.[1] With long-term interest rates likely to rise further as the Federal Reserve tries to tame inflation, we maintain our view that investors should avoid large allocations to bonds.

Responding to inflation and various supply shocks, investors have piled into inflation-protected assets, with commodities and the shares of commodity producers attracting significant attention. **West Texas Intermediate Crude Oil** recently traded as high as $130.50 per barrel and energy stocks have significantly outperformed the broader markets over the last year. While these trades have enjoyed impressive short-term gains and may continue to run, we do not view them as attractive long-term investments. Fortunes can (and often do) reverse quickly in commodity markets. Remember that just two years ago, when lockdowns reduced demand, oil futures traded at negative rates, meaning producers were willing to pay for someone to take oil off their hands because storage capacity had been exceeded. We believe the long-term secular trends that have caused the energy sector to underperform over the last five years are still in place. Other commodities are similarly unappealing due to their capital intensity and unpredictability. Real estate may be an attractive inflation-resistant asset class, but carrying costs are high and many investors already have significant capital invested in their homes. Moreover, since September the interest rate on the average 30-year fixed rate mortgage has jumped by more than 60% from 3.0% to 4.9%. That increase in borrowing costs could cool the red-hot housing market.

Focus on quality

Rather than betting on the future of hard asset prices, we prefer to focus on identifying enduring businesses run by managers who are adept at navigating through turbulent waters. We are constantly evaluating our holdings to ensure that they still meet our standards. During the last two years, we have made more changes to our client portfolios than usual in our pursuit of quality. Volatile markets have presented opportunities to buy stocks of exceptional companies that we have long admired but that tend to trade at higher valuations reflecting their better than average management teams, financial profiles, and competitive positions within their industries.

If “quality” sounds like an objective term, rest assured that we are not comfortable with “you know it when you see it” explanations. Our determination of quality involves empirical measures such as a company’s ability to exercise its pricing power and its leverage with suppliers by growing profit margins consistently. Capital efficiency, as measured by the percentage returned on invested capital (ROIC), provides insight into what degree investments are required to remain competitive. Consider **S&P Global,** which has one of the highest 5-year average ROIC percentages in our portfolio, reflecting the company’s dominant market position in the financial data sector.

Strategic consistency and earnings predictability are also important factors in our assessment of quality. We became increasingly concerned with **PayPal** last fall when it signaled a shift in its business model by making a bid to acquire the e-commerce platform company **Pinterest** without much explanation. This quarter, we decided to exit the position when PayPal abandoned the active user growth targets that it had only recently set. Similar changes in course precipitated our decision to remove **Spotify** from our buy list late last year. Both are innovative companies that met our Five Filters[2] criteria when we bought them. They may eventually prove to be good investments, but until they can stick to their plans and produce more consistent results, we feel our clients are better served elsewhere. We used the proceeds from these sales to initiate positions in **Texas Instruments** and **United Healthcare.** Both companies are long-time leaders of their respective fields, and we believe their shares are attractively valued relative to their long-term growth potential.

A good time for insurance

Without the ability to share or transfer certain risks, many economically beneficial activities -- from launching a communications satellite to sending a teen driver to the store -- might be perilous. The concept of risk sharing is ancient

but the modern insurance industry emerged from the ashes of the Great Fire of London in 1666 when economist and doctor, Nicholas Barbon, started insurance companies to indemnify property owners in the event of another catastrophe. Not long after, businessmen selling insurance started meeting with ship owners at a coffee shop owned by Edward Lloyd.[3,4] The Lloyds insurance market still thrives today as a testament to the enduring role insurance has in enabling economic activity. Given all the uncertainly these days, we have never been happier to have significant holdings in the insurance sector, including **Aon, Berkshire Hathaway** and **Markel.**

Aon helps businesses identify and manage risk, yet as the consultant and insurance broker, it takes on zero underwriting risk itself. Its 90% customer retention rate is proof of its strong position in a relationship-driven business. Aon's breadth and array of expertise allow it to gain share in established markets and to compete within largely untapped markets such as cyber risk, intellectual property theft, climate change, and other natural disasters. Unlike smaller competitors, Aon operates in over 120 countries which allows it to scale with its multi-national customers and to capture new growth in less developed nations. Maximizing ROIC drives all management decisions and CEO Greg Case has built an impressive track record of improving margins. Stable free cash flow generation has allowed Aon to maintain its dividend and repurchase around 3.5% of its shares per year on average for the last five years. Customers need to prepare for unknown risks, and Aon's investors can be confident that its shareholder-oriented management is working hard on behalf of all of its stakeholders.

Douglass Winthrop clients have counted the U.S. insurance titan **Berkshire Hathaway** among their holdings since our firm's founding, and we have written about the company and its iconic leader, Warren Buffet, many times. Berkshire has been putting more of its large cash reserves to work recently, repurchasing stock last year when the share price was relatively low and then by announcing the planned $11.6 billion acquisition of Alleghany Corp, a similar but far smaller insurer. We are encouraged to see Berkshire being more aggressive with its large cash balances and are confident that the predictability and efficiency of its insurance businesses will provide more capital to build on its long track record of making successful investments.

Markel Corporation models itself as a mini-Berkshire Hathaway. So far, it has proven worthy of that comparison. The company aims to grow earnings and book value through three divisions: insurance, investments, and Ventures. In its insurance business, the quality of its underwriting and reputation for paying claims swiftly differentiate the company within niche markets such as equine, marine and catastrophe insurance. These markets are less regulated and see fewer competitors, allowing Markel to exert pricing power. Co-CEO Tom Gayner heads the investment division, which has returned roughly two percentage points more than the S&P 500 under his tenure. As a vote of confidence in his abilities, about 25% of Markel's "float" is invested in equities, above insurance industry averages. Ventures is a relatively new piece of the business, where Markel fully acquires niche companies. This line is still in its early stages of development, but meaningful shareholder value can be created if the company applies the same discipline which guides the insurance and investment arms.

Firm updates

We constantly endeavor to hold ourselves to the same or higher standards of quality as we do for the companies in our portfolios. This starts with making investments in our most valuable asset: our team. We are excited to welcome Vilas Satkalmi as Information Technology Manager. Vilas is an IT veteran who will help us leverage our investment in technology to improve our customer experience and keep our systems running smoothly and safely. We also added depth to our Wealth Management team by welcoming new Associate Zelle Richardson, and to our remarkable Client Relations team with the addition of CR Associates Michelle Vassallo and Laura McCaffrey.

It has been five years since Robert Douglass opened our Florida office in West Palm Beach, and as many of our clients are spending more time in the Sunshine State, you can expect to see a greater DWA presence there. Managing Principal Lea Highet is making frequent trips to the area and portfolio manager Oak Strawbridge is splitting time between our Washington and West Palm Beach offices. With more relaxed COVID-19 protocols we are excited to return to more frequent face-to-face interactions with our clients and friends in all geographies. Each of our four offices is welcoming visitors; when in New York, be sure to visit our Fifth Avenue headquarters where guests can enjoy a meeting on our outdoor patio overlooking the New York Public Library.

In closing, we are grateful to our clients for the privilege of serving as trusted advisors as we navigate these complex times together. We hope we will continue to earn your trust through whatever challenges may lay ahead, and we wish you a healthy and happy spring.

Sincerely,

Douglass Winthrop Advisors LLC

Note: All market data is from Bloomberg, L.P.

[1] Strategas Research Partners, Daily Macro Brief, April 7, 2022.
[2] We subject all new purchase recommendations to our Five Filter analysis: 1) Does the company have a sustainable competitive advantage, or moat? 2) Are there ample reinvestment opportunities to grow the business? 3) Does it have the financial strength and flexibility to take advantage of those opportunities? 4) Is its management shareholder-oriented? 5) And is the stock attractively valued, offering a favorable ratio of potential reward to risk?
[3] https://www.iii.org/publications/insurance-handbook/brief-history
[4] http://wsrinsurance.com/how-insurance-began-3000-years-of-history/
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