Douglass Winthrop

New York Boston Washington, D.C. West Palm Beach

July 4, 2022

Dear Clients and Friends,

We are pleased to share our Second Quarter Letter with you. First off, we want to offer thanks to our clients. Your trust in our firm and in the plans that we make together is what makes Douglass Winthrop work, especially in uncertain times. As we write this 4th of July letter, we find ourselves focused on the power of partnerships. While independence is something we cherish, it is the partnerships in life that give us the joy, grounding, support and encouragement to push ourselves to pursue fulfilling lives characterized by a sense of purpose.

A Painful But Healthy Correction

Year to date, investors experienced the largest first half decline in the stock market in 52 years, and just the fourth time over that period where both stocks and bonds had negative first half returns.[1] In our January letter we wrote that, "Equity markets have rewarded long-term investors for more than a decade, supported by abundant and cheap savings from years of accommodative monetary policy. Last year the S&P 500 returned 28.7% including dividends despite elevated inflation, a more hawkish Federal Reserve and yet another COVID variant…A consequence of so much capital chasing appreciated assets is that essential products and services such as microprocessors and ocean tankers may suffer from underinvestment. No one can predict the financial markets' twists and turns, but we expect more balance in the months ahead… A sharp sell-off in financial markets could produce a recession…." We noted that high flying assets like shell-company SPACs, Bitcoin and the ARK Innovation Fund ETF looked like leading indicators of liquidity driven excesses in the markets. Year to date through June 30, Bitcoin was down 59%,[2] the ARK Fund is down 58%,[3] and nobody is talking about the latest Special Acquisition Vehicle to raise hundreds of millions to fund a business yet to be identified.

Peak Negativity?

Over the past quarter the worry on Wall Street and Main Street has worsened. Life has become more expensive due to inflation, rising interest rates, reduced access to credit, and supply chain bottlenecks. The pullback in US stocks has eviscerated more than $9 trillion in market value since the end of 2021, according to Bloomberg data on the S&P 1500 index, a broader gauge which tracks small, mid and large-cap groups. The average interest rate for a 30 year mortgage has more than doubled to 5.81% from an average of 2.65% in January of 2021.[4] This change means that the monthly mortgage cost of a million dollar home purchased with a 20% down-payment has risen from $3,224 to $4,699, a 45.8% increase that will price many potential buyers out of the market. Add to these harsh economic realities, the Russian war against Ukraine, fear of Chinese aggression toward Taiwan, and persistent COVID-19 cases, it is easy to see why investors are fearful.

Managing in a Difficult Environment

We think it is possible we are already in a recession. Real GDP decreased 1.6% in the first quarter of 2022 and corporate profitability began to fall.[5] We expect companies to announce mediocre results at best for the second quarter. The always backward looking Wall Street analyst crowd will begin to adjust earnings estimates downward. Even as supply chains

1 https://time.com/6192949/stock-doomsayers-vindicated/

2 Bloomberg

3 Bloomberg

4 Bloomberg

5 Bureau of Economic Affairs (www.bea.gov)

are haphazardly repaired allowing inventories to rebuild, consumer and government demand are in decline as price conscious customers postpone purchases, fiscal deficits shrink and the Fed further reduces liquidity. Two of the largest US retailers shocked the markets in May when they announced large excess inventories. Walmart's share price dropped 20% in 3 days on its announcement and, shortly thereafter, Target's stock price fell 32% following its report.[6] With inventories growing and demand declining, we think the economy could be experiencing the peak of inflation. Economically sensitive commodities oil, copper and lumber have all declined from highs. WTI Crude fell from a recent March 8 high of $129 to a June 30 closing price of $106 from its recent March 3 high,[7] lumber fell 55% by quarter close;[8] and copper, the widely recognized barometer of economic health, is near an 18-month low.[9]

Is it possible that in this moment characterized by profound fear, some long-term opportunities are being overlooked? In keeping with Warren Buffett's admonition that it is wise for investors to be "fearful when others are greedy, and greedy when others are fearful," we have been active in response to what could be a hard landing for the economy. The broad equity markets have been quick to adjust, in some instances already pricing in a recession. Equity markets tend to anticipate the economy. They will begin to price in a recovery well before the bottom in the economy.

We have been active in our response to this challenging environment. We have redoubled our focus on research and analysis as we believe the market is offering opportunities we have not seen in some time. We have been harvesting tax losses. More than ever, we are focused on investing in companies with agile and visionary management teams with clear goals, easily understood plans and track records of successful execution. We have been concentrating capital behind our best ideas, particularly those companies that have suffered most in this market relative to our estimate of long-term intrinsic value: **Alphabet**, **Berkshire Hathaway**, **Amazon**, and **Charter Communications**. Berkshire is trading at about 1.2 times book value, a discount to its long-term median and at a level Buffett has in the past indicated he would buy back the stock. Investors have treated technology stocks with particular disdain thus far in 2022, selling the entire sector without regard to quality. As of late May, Alphabet had declined 27% year to date.[10] Adjusted for cash on hand, Alphabet is trading at 16.5 times expected 2022 earnings, a multiple that appears comparable to the S&P 500 as whole despite Alphabet's long history of growing revenue and earnings more rapidly than the market. It strikes us that investor pessimism has discounted Alphabet's opportunities too aggressively. As a result, Alphabet has earned a spot as the co-largest holding for Douglass Winthrop clients alongside stalwart Berkshire Hathaway.

Alphabet has become an integral piece of the digital economy. Its Android operating system drives 2.5 billion mobile devices globally. Google handles ⅔ of all internet search traffic. YouTube reaches 2.0 billion monthly viewers watching an hour a day.[11] The immensity of Alphabet's scale, ubiquity, and data archive, and its relentless pursuit of technical improvement create a formidable economic moat. Management is still refining novel ways to monetize these vast advantages. As the world continues to digitize, Alphabet should benefit, be it from online advertising, mobile operating systems, cloud infrastructure, or its innovation-centric "Other Bets," which include artificial intelligence, quantum

6 Bloomberg

7 Bloomberg

8 https://tradingeconomics.com/commodity/lumber

9 https://tradingeconomics.com/commodity/copper

10 Bloomberg

11 Alphabet Q1 2021 Earnings Call; Douglass Winthrop Advisors

computing and self-driving cars. Whatever the market might think of the company's prospects over the next few quarters, we believe Alphabet's advantages will reward investors handsomely in the years ahead.

Our Clients, Our Partners

Our approach to navigating the uncertainties inherent in long-term investing is to combine a clear mission, strategy, and process with a deep commitment to being present and capable partners for our clients. Our partnership approach with clients and teammates means that we set goals together, invest together and course correct together. In difficult markets like those we have recently experienced, mutual trust and a clear understanding of the plan allows us to stay the course. While past is no prologue, history does suggest that the right thing for investors to do during difficult periods is to stay the course and remain invested. According to research by Vanguard, from 1926 to 2019, the average annual return on equities has been 10.27%. This period of history includes the Crash of 1929, the Great Depression, World War II, the Korean and Vietnam Wars, the inflationary period of the late 1970s, the Crash of 1987, the Dot Com Bubble, the Great Recession, and other deeply disturbing, even existential, events. Investors who avoided the instinct to sell at the moment things seemed most dire were amply rewarded for their fortitude.

If you have any questions about your portfolios or feel like now would be a good time to reconfirm the plans that we have put in place with you, please reach out or stop in for a visit. If you are not a client and find yourself attracted to our investment strategy and partnership approach, we would love to talk with you further about becoming a client. There is no better time than right now to get a smart long-term plan in place.

DWA Updates

Please join us in welcoming Laura McCaffrey and Michelle Vassallo to our Client Relations team and bidding farewell to Chars Crane who is leaving after more than a dozen years to pursue other interests. Chars has served our firm in a variety of roles, always willing to take on whatever challenge we asked of him. Whether drawing upon his nearly four decades of investment experience, learning operations and compliance from the ground up, or his steady and consistent editorial hand, our clients and our firm have benefited from his work. We are grateful for his service and wish him well.

Sincerely yours,

The DWA Team

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

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