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New York Washington, D.C. West Palm Beach

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Dear Clients and Friends,

In *Red Notice*, Bill Browder's account of starting the first western investment fund in post-Soviet Russia, the author describes the moment he grasped the scale of the investment opportunity unearthed by the fall of Soviet communism. Working on Salomon Brothers' Eastern European desk, Browder was asked to advise a fishing company in Murmansk, Russia on whether to exercise an option to acquire 51% of the company for $2.5 million. Quick math indicated the value of the company's trawlers alone exceeded $1 billion, meaning the vouchers that represented ownership interests in the company were severely undervalued – and suggesting that vouchers in other formerly state-owned enterprises must be similarly mispriced. For intrepid investors, privatization in Russia and other emerging markets represented an enticing new opportunity.[1]

Attracted by huge markets and rock bottom valuations, western capital poured into emerging markets in the decades following the collapse of Soviet communism in Russia and the advent of market reforms in China championed by Deng Xiaoping. From 1999 – 2009 the MSCI World Index, including stock markets in India, China and Russia, returned 10.0% annually vs. -1.0% for the S&P500.[2] In the wake of this surge in investor interest, Alibaba and Saudi Aramco sold shares to the public in the two largest initial public offerings in history, eclipsing amounts raised in IPOs by Visa and Facebook in their public debuts. To many, investing in emerging markets was seen as a win / win with private capital accelerating development of civil institutions and political freedoms, thereby improving integration with the West and further enhancing conditions for investment.

This virtuous cycle seems naïve today with few countries embodying its collapse more than Russia itself, prosecuting a barbaric war in Ukraine and hobbled by the avarice and narcissism of its leaders. Despite spanning 12% of the Earth's land area, Russia today occupies an ever-shrinking footprint on the world's economic map, producing little of what the world needs beyond oil and gas and facing a declining population due to high mortality rates, low birth rates and migration.[3] China, with a GDP 10x the size of Russia's, is turning away from the model of economic partnership with the West promoted by Xi Jinping's predecessors, launching its Belt and Road initiative, projecting military power in East Asia and suppressing dissent internally.[4] A loose coalition of nations including China, Russia, India, South Africa and Brazil, motivated by the perception that the post-War economic system mainly benefited the U.S. and its allies, imagines an economic future untethered to the West.

A turning point for global trade and investment

Investors face the hard truth that private investment in developing markets has thus far failed to produce a more peaceful world tied closer together by free market principles. Business leaders and policy makers are re-evaluating trade and investment, weighing the economic logic of efficient global supply chains against national security and moral issues inherent in an interconnected world. A more protectionist and less efficient trading system is likely to emerge as companies diversify supply chains, vertically integrate operations and "re-shore" manufacturing. A bleak winter for global trade looms.

Legislation is accelerating these trends in the U.S. Last year's bipartisan Infrastructure Investment and Jobs Act, seeking to encourage investment in transportation, energy and communications, authorizes $185 billion for new bridges, ports, broadband internet, public transit and electric vehicle charging stations.[5] The 2022 Chips and Science Act authorizes more than $52 billion to develop advanced semiconductor

[1] Browder, Bill. Red Notice: How I Became Putin's No. 1 Enemy. Corgi, 2021.
[2] Bloomberg, L.P
[3] https://www.msci.com/research-and-insights/russia-ukraine-war/russias-diminished-role-in-emerging-markets
[4] Bloomberg, L.P
[5] https://www.congress.gov/bill/117th-congress/house-bill/3684/text

manufacturing.[6] Global chip maker Taiwan Semiconductor plans to invest $40 billion in its second Arizona plant in one of the largest-ever foreign investments in the U.S. Apple, which invested heavily to establish a China-centric supply chain, plans to shift MacBook and iPad production to Vietnam and iPhones to India.[7] Amazon, Alphabet and Microsoft are similarly moving production away from China.[8] A recent McKinsey study noted that 93% of companies surveyed intend to make supply chains more "flexible, agile and resilient." With many companies re-shoring production, just 3.6% of U.S. warehouse space was vacant in the third quarter, a historically low industrial vacancy rate.[9]

This retreat from global supply chains and ensuing investment in domestic infrastructure will require time, skilled labor and investment capital. Consistent with this view, in 2022 we initiated investments in Transdigm (aerospace supplies), Martin Marietta Materials (construction aggregates), IQVIA Holdings (outsourced drug trials) and Texas Instruments (analog semiconductors), adding exposure to the reshoring and broad based capital spending we expect many companies to implement. These exceptional businesses complement our long-standing investments in industrial companies such as Deere, Berkshire Hathaway, Fastenal and Canadian National Railway – all market leaders with large addressable markets, wide economic moats and high returns on invested capital. Each of these companies possesses a high degree of pricing power and abundant reinvestment opportunity to fuel growth as the economy rebuilds in the years ahead.

The Fed brings markets back to Earth

As investors grasp the scale of capital investment required to restructure supply chains, they are exiting speculative assets. In our January 2022 letter, we predicted mediocre returns for investors in mega cap technology stocks and carnage for the prices of speculative assets. According to Bloomberg L.P., popular video-conferencing company Zoom Video Communications returned -63% last year, only slightly better than widely-owned Tesla (-65%) and Shopify (-75%). Special Purpose Acquisition Company issuance fell off a cliff to $13 billion in 2022, down 94% from the prior year when 957 SPACs raised $212 billion. Bitcoin fell 64% in 2022.[10] The bankruptcy of crypto exchange FTX and its sister company, Alameda Research, was a dramatic coda to an era of ebullience that rivalled the "dot-com" craze of 1999 and real estate bubble of 2008.[11]

Last year's market declines were not limited to speculative assets of course. The S&P 500 fell 19.4% (-18.1% including dividends) in its worst year since 2008, and was down -25.4% at its trough in early October. The technology-heavy NASDAQ returned -33.1% with many widely owned stocks falling by 50% or more. Painful as the decline in prices was, the duration of the bear market took its toll on investors long accustomed to "buying the dip" in stock prices. As stocks fell, bonds suffered their worst year ever with the Bloomberg U.S. Aggregate Bond Index falling 13.0% in 2022. According to Bloomberg, the index has had a negative return in only five calendar years since 1976 with its worst previous year recorded in 1994 when the index returned -2.9%. Commodities from gold to lumber fell too, suggesting that traditional inflation hedges were largely ineffective against a sharp rise in prices in the economy.[12]

The Fed is struggling to contain an inflation brushfire, caused on the *supply* side by broken supply chains, China's zero-COVID policy and Russia's invasion of Ukraine – and on the *demand* side by years of low interest rates following the 2008-09 recession and massive pandemic-driven fiscal stimulus. Starting in March, the Fed launched an aggressive tightening program that drove short term rates from just over 0% to 4.3% at year-end over the course of seven rate hikes – the steepest such program since the Volker Fed in 1980. Sales of long term bonds by the Fed ("quantitative tightening") kept bond prices under pressure all year, with the 10-year Treasury yield rising from 1.5% in January

[6] https://www.congress.gov/117/bills/hr4346/BILLS-117hr4346enr.pdf
[7] https://www.ft.com/content/575009cf-450b-4dfd-ad41-ea913dfaa23e
[8] https://www.ft.com/content/7a4e07e0-deb3-4ba9-b6ae-f75f961ad001
[9] https://www.mckinsey.com/capabilities/operations/our-insights/how-covid-19-is-reshaping-supply-chains
[10] Bloomberg, L.P
[11] Bloomberg, L.P
[12] Bloomberg, L.P

to 3.9% at year end, driving mortgages and commercial borrowing costs skyward. An inverted yield curve and a steady stream of hawkish commentary from Fed officials kept markets on edge all year.[13]

An optimistic look ahead

Grim as the data seems, a brighter future beckons. December consumer price inflation (as measured by the CPI) is expected to be 6.5%, down from the June reading of 9.1%, and some economists believe actual inflation is lower when adjusted for backward-looking indicators such as housing costs. Sentiment in the stock market is almost universally negative – paradoxically, a positive sign suggesting many traders have already sold – and valuations have declined from 22x forward earnings a year ago to 17x currently. Consecutive down years in stocks are rare: the S&P500 has been down two years in a row only four times since 1928, all occurring around severe economic shocks.[14] Remember too that the chance exists for unexpected positive surprises such as peace talks in Ukraine, an early end to the Fed rate hikes or a shallower recession than many are now expecting. Whatever the future holds, our focus remains entirely on identifying and owning securities of high quality companies that control their own destiny and can increase intrinsic value per share for years ahead.

Our optimism for our portfolio is grounded in confidence in the terrific team here at Douglass Winthrop Advisors. The ranks of our partnership increased last year as Dan Abbasi and Christina Zhang joined the partnership. Dan leads our Sustainable Equity strategy with longtime DWA partners, Bowdy Train and Josh Huffard, and Christina is the strategy's lead analyst. Including Dan and Christina, DWA now has 17 working partners, representing over half our staff and defining a flat organizational model that distinguishes DWA from other investment advisory firms that are owned and led by founders. While our biased view is that our partners are uniquely great, we believe our culture of partnership enhances our clients' experience in the form of heightened fiduciary mindsets, sound investment judgement and professional ethics.

Our excitement in welcoming new partners and team members is second only to our gratitude to you, our clients, for the confidence and support you give to our firm. Your year-end financial reports are enclosed with this letter. Meanwhile, all of us at DWA wish you and your families a peaceful and prosperous 2023.

Sincerely,

Douglass Winthrop Advisors LLC

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PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS. INVESTMENTS BEAR RISK INCLUDING THE POSSIBLE LOSS OF INVESTED PRINCIPAL.

[13] Bloomberg, L.P

[14] Bloomberg, L.P