April 12, 2022

Q1 2022 INVESTOR UPDATE

There's no shortage of topics to discuss in our quarterly memo and we'll attempt to give them the scrutiny they deserve. We'll start with the war in Europe, provide an update on the Puerto Rico settlements, move on to interest rates, and end with a recap of our portfolio performance.

You haven't heard us say much about the war in Europe to date. Our view is that an investment memo is not the appropriate venue for moralizing or expressing our views on international politics. Suffice it to say that we agree with General Sherman's view that all war is hell.

Fear and uncertainty, however, are paralyzing rather than productive conditions. While our brains may have evolved to act first and think later under extreme conditions, this relic of evolution is unlikely to be a helpful trait in making thoughtful investment decisions.

We don't see ourselves as able to handicap either the likelihood or severity of a truly extreme event; suffice it to say that we doubt that the last inhabitant of the planet, wandering through the ashes and rubble, will be muttering to himself "Thank goodness I got out of the market...."

What we have learned so far is that apparently the Russian military does not seem to have the wherewithal to expand this war into Europe – if they even have the capacity to "win" this one. At the end of the day, this war, like all others, will end and be followed by a period of rebuilding and (dare we say) maybe even economic prosperity. And although we don't subscribe to the "broken windows" school of economics, these events are an undeniable part of an ongoing rhythm of economic destruction and rebuilding that result from a predictably recurring string of unpredictable events, such as the recapitalizing of the banks after the financial meltdown, or the rebuilding of infrastructure after a natural catastrophe like the hurricanes in....

...The Commonwealth of Puerto Rico has done a great job selling the public on the idea that their problems have been the result of unavoidable, natural disasters. Our take is that a general culture of corruption and unaccountability have been the root cause.

To recap, Puerto Rico made their last debt payment on January 1, 2017 (on all but a handful of bonds which remained current). Due primarily to the strength of municipal bond insurers AMBAC, NatRe, and Assured Guaranty, the bonds which we owned then have remained current on all debt payments.

In 2019, the Commonwealth completed their first major debt restructuring – new "Cofina" bonds backed by sales taxes with excellent security and legal protections. Over time, clarity began to emerge on the ultimate settlement of other obligations, such as bonds backed by rum taxes (PRIFA) and those backed by the electric utility (PREPA). We subsequently took the opportunity to leverage our insight to buy these two non-paying bonds, at deep discounts, with two objectives in mind. The first was simply to profit off the arbitrage between current prices and the likely range of settlements. Our second and less obvious objective was to "reserve" the right to own the new soon-to-be issued bonds at yields unavailable in the market today. And like Cofina, the newly proposed bonds offered excellent security and legal protections.

In late Q1, PRIFA indeed exchanged their old bonds for cash and new bonds, much on the terms we expected. PREPA will likely reach final terms on their deal before year end.

I mentioned "excellent security" above, so you may be wondering how this can be in the wake of such enormous natural catastrophes. The (intentionally obscured) reality is that post-hurricane Puerto Rico has been a bonanza of government aid and subsequent economic activity. Personal bank balances have grown to all-time highs, Commonwealth coffers have grown fat with federal aid, and annual tax collections have far exceeded the rosiest estimates – not that you've read much about in in the papers.

So, to our earlier point, the cycle of natural or unnatural destruction which has remained in the headlines, has once again been followed by a less noticed economic boom.

As to addressing corruption – which one should assume is ongoing - negotiators struck these new bond deals with eyes wide open, adding statutory language and securitized structures which provide significant legal protection for investors.

The upward march in interest rates which has begun in Q1 is getting noticed, but it certainly shouldn't have come by surprise. We've been well prepared – focusing on shorter maturities and floating coupon bonds which move with prevailing rates. Our strategy of simply collecting interest – rather than attempting to achieve performance through active trading – should serve us well in this environment. It's everyday blocking and tackling for us.

In our Equity+ portfolios we came out of two positions in Q1. We took our chips off the table in PRIFA – an investment which fell squarely in the "win" column for us. We love the potential yield moving forward for fixed income strategies, but the double digit returns we seek for Equity+ are almost certainly not to be found in these bonds moving forward. And we don't mind holding cash opportunistically.

In last year's Berkshire annual letter, Warren Buffet praised the value of being able to wring profits out of future tax liabilities – essentially investing the money you will owe the IRS for unrealized capital gains. In other words, deferring capital gains for as long as possible can result in great economic value. We of course intended to heed his advice - until he promptly stabbed us in the back by buying Alleghany Corp (Y) out from under us. We've been consoling ourselves with the 70% premium he's paying to our purchase price in July 2020.

Of course, these sales have produced a significant pile of new cash, and we've taken advantage of lower equity prices to deploy it judiciously. Still, we ended the quarter with cash at about seventeen and a half percent vs. fourteen and a half at 12/31/21. As always, we're on the lookout for new opportunities and adding as the market obliges.

Below is a table of our quarterly results along with relevant benchmarks. We don't think there's much importance in short-term performance (see the attached composite performance for a more complete picture) with the significant exception of how our fixed income portfolios are performing relative to the broader market's sensitivity to interest rates.

Equity+	-4.52 %
Income+	-2.37 %
Muni+	-1.63 %
S&P 500	-4.61 %
Bloomberg Agg Bond	-5.93 %
S&P Muni Bond	-5.53 %

We would make one last comment about the fixed income performance numbers above. In absolute terms those numbers are not indicative of performance. Our returns are pre-determined; as long as our debtors remain "money good." And there's no success in losing less than your peers – that's a lot like being a little less sick than the patient in the next hospital bed. Rather, our outperformance can be looked at as an indication of our ability to take advantage of higher yields *sooner* than others who are less well positioned – which is why we generally continue to view a higher interest rate environment favorably.

Finally, it's April again - that wonderful season when we are compelled by regulators to include our privacy policy (attached) and make an annual offering of our Form ADV Part 2. Please feel free to reach out to Barbie at the number below if you would like a copy.

-Arch Peregoff
-Joseph Di Scala