January 25, 2023

Q4 2022 INVESTOR UPDATE

FIXED INCOME

Income+ from Inception: 6.7%
Bloomberg Agg: 0.09%

Muni+ from Inception: 5.9%
SAPIMAIN: 1.29%

Income+ 2022: (7.5%)
Bloomberg Agg: (13%)

Muni+ 2022: (7.6%)
SAPIMAIN: (8%)

Commentary

Happy days are here again! Well- that may be a bit of an exaggeration, but the fixed income playing field has certainly grown more attractive than it's been in decades. Entering 2023, the benchmark yield on the 1-year US T-Bill sat at 4.67%, the highest in over 22 years.

And the story of the great income drought has not just been one of duration; but of magnitude as well. 38 of the 50 calendar quarters preceding Q3 2023, began with the 1-year T-bill yielding less than 1% - averaging a meager 0.66% over those 50 quarters - leaving bank deposits, and uninvested cash across a variety of

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EQUITIES

Equity+ from Inception: 13.5%
S&P500 Index: 11.6%

Equity+ 2022: (11.5%)
S&P500 Index: (18.2%)

Commentary

In this world, nothing may be more certain than death, taxes, and equity market volatility. We'll do our best to put off death and taxes, but market volatility we have no problem meeting head-on.

For perspective though, a little history. Since 1996, the S&P 500 has experienced 11 *intra-year* drawdowns of 16% or more. Over that same 26-year span, however, only 3 of those years *ended* with equities down 16% or more, and in fact, stocks appreciated by *over 700%* in the same period.

Great accumulators of assets get the point intuitively. Baron Rothschild said, "The time to buy is when there's blood in the streets." Warren Buffet has instructed repeatedly that the time to be greedy is when others are fearful. We think

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investment strategies, subject to *negative* real (inflation adjusted) returns.

Yield seekers looking for a living wage in longer bonds didn't find much relief either. The 10-year Treasury note offered a paltry 1.76% a decade ago and averaged only slightly better than 2% over the ensuing 10-year period. Oddly, the total return on a more diversified portfolio of bonds was even worse than that of the "risk free" treasuries. The widely followed Bloomberg US Aggregate Index (formerly the Barclay's Index for those of you who pay attention to such things) delivered an annualized return barely eclipsing 1%. Just about the only place a passive investor found any real returns at all was in a portfolio of exclusively below investment grade bonds - not exactly a comforting thought for those drawn to the bond market for dependable income and peace of mind. Even there, the 10-year annualized return was about 4%, *before fees and trading costs*.

One guiding principle has driven the ability to deliver meaningful income under such difficult circumstances; the willingness to take on difficult – and often distasteful – tasks which others would or could not. It's an axiomatic truth that one cannot invest with the herd *and outperform the herd* at the same time. It should of course be emphasized that *willingness* alone is not enough – it's never advisable for a *slow* water buffalo to cross the river alone – one needs to have the tools and capability as well.

It takes an extraordinary effort to thrive in a difficult market, and successful outperformance often involves "winning ugly" - to borrow the sports aphorism. We've been asked the question more than once: "Is the juice worth the squeeze?" We surely ask ourselves every day whether there's an easier way. But when market conditions are as challenging as those described above, and individuals need fixed income, winning ugly may be the *only* path to winning at all. For us, one defining characteristic of winning ugly is the willingness to search the nooks and crannies of fixed income markets for underappreciated opportunities.

Winning ugly, however, never entails abandoning credit discipline. Credit discipline is the vital ingredient of success, and while we may occasionally get one wrong, it won't be for a lack of thorough and realistic evaluation.

Outlook

Our outlook is seldom based on an opinion of future interest rates. Instead, we seek to curate portfolios which will perform under a variety of potential scenarios. In essence, our focus is on providing investors with a framework to assess *their own* future returns, rather than those of the broader fixed income markets.

The best indicator we can provide of *your* future returns lies in a telling data point: current yield. To be sure, current yield is often a very *poor* indicator of future returns, particularly when bonds are trading at a premium to their face value. Premiums amortize over the life of an investment, ultimately producing a total return of current yield *minus* the premium. In our case, however, our holdings are largely trading at *discounts* to their face value. In the absence of defaults then, returns should be expected to be current yield *plus* the accretion of the discount.

Below are the data points which demonstrate this concept:

Income+
Current Yield: >7%
Average discount to Par: ~13%
Weighted Duration: <3 years

Muni+
Current Yield: 4.2%
Average discount to Par: ~7%
Weighted Duration: ~3 years

10-Year Benchmark yields as of 12/31/22
US Treasury: 3.88%
Bloomberg AAA Muni: 2.64%

Year In Review

Across both fixed income strategies, Income+ and Muni+, the most notable activity came in Puerto Rico. During the year, we exited our positions in both PREPA (the electric utility) and PR Rum Tax bonds. Oddly, both investments were profitable ones (one spectacularly so, the other moderately), but contributed negatively to calendar 2022 returns. In the case of PREPA we simply determined that *the juice was no longer worth the squeeze*; in light of the consensual reorganization being terminated, *and* in light of a market which offered very attractive opportunities to redeploy capital elsewhere.

Our default position is always to gravitate to investments which provide tangible cash flow rather than toward more ephemeral opportunities for capital appreciation, so in the end, the decision was an easy one.

The exchange of our Rum Tax bonds marked a milestone in a highly profitable investment that certainly goes in the category of winning ugly. Purchased at an average price of about 16 cents on the dollar, we received an 11 cent cash payment in March 2022, followed by an additional 4 cent cash payment in November. The two transactions together essentially reduced our total cost to a penny on the dollar. But there's more; also received was a new bond which will pay out 73 cents over its estimated 25-year life. Add it all up and the net effect was the purchase of 73 cents of projected cash flow for a single penny. Not a bad deal. The new bonds have traded erratically however, effectively marking down your reported 2022 overall returns to the tune of 150 to 200 basis points. We attribute the price drop at least partially to higher interest rates, but also to a lack of interest in taking on the onerous task of understanding them. We, however, are comfortable with our current outlook for double digit returns on a go-forward basis. Accordingly, we've resumed buying.

Thematically though, the story has always come back to tangible income. While we're delighted to pursue and capture capital appreciation in highly asymmetric situations, 2022 was marked by our usual obsession with sourcing tangible income well in excess of that available in the general market.

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the point may be a bit more subtle.

The truth is, many aren't so lucky to be so instinctive. Some can fight through the pain of paper losses and take action. Still others become paralyzed and unable to capture the moment at all.

For us, it's helpful to examine the cause of the latest downturn as we attempt to put tenets into action. Stock prices are of course set by investors and those investors are largely led by sell side analysts. "Sell side analyst" is the term for those employed in the occupation of recommending stocks to their customers. These analysts form opinions which are heavily influenced by current interest rates. In times of low interest rates, they are willing to accept lower returns on stocks, which they do by willingly accepting higher purchase prices.

Analysts are rewarded for churning out reports, so they have a natural bias toward lowering their standards when markets become pricey. In an earlier memo, we discussed how this acceptance of lower returns is disproportionately reflected in the growthiest of stocks – the stocks which have carried the market forward for the past several decades.

But suddenly, without warning, – Jacques Cousteau's words not mine- interest rates jumped, exposing the risks of a compromised standard, and disproportionately turning yesterday's leaders into today's laggards.

Any broad-based market move creates a liquidity vacuum as well, dragging the market prices of all stocks down concurrently as diversified mutual funds and other investment operations face client redemptions. These moves often bear no relevance to the economic prospects of the businesses being sold.

Higher interest rates then, should be looked upon as the major driver of today's lower stock prices.

It should be stated here of course that we have no doubt that the economy *may* be entering a protracted business cycle - *or maybe just a normal one-* and that inflation and higher interest rates do have a real impact on businesses, especially those heavy in debt.

Rational business valuation, however, should never be based on an irrational view of the world or on the assumption that business cycles can be predicted and timed with accuracy. And especially when one intends to hold assets over long periods, a rational assessment not only values an enterprise on its worth under *normalized conditions,* but also considers its stability under periods of significant stress.

Outlook

As stated above, we see compromising on the discipline of investment returns (lowering your discount rate for the wonks out there) as the surest path to self-delusion and poor performance. Our modus operandi is to take the advice of Rothschild and Buffet every day on an *individual investment by investment basis* rather than applying it to broad markets.

Our discipline has never wavered from measuring an investment's attractiveness based on the long-term returns of US markets rather than measuring against a transitory interest rate environment. Our portfolios therefore are *always* generally underwritten to meaningfully exceed returns of 10%- a close approximation of the past returns of broad-based U.S. market indices. One should be reminded here that an annual return of 10% doubles the value of assets in just over 7 years while a 15% return does so in just 5.

On an ongoing basis we re-underwrite our portfolio and enter the year confident that our portfolio is positioned to meet our target returns. Our Equity portfolios also begin 2023 with 16% in cash, a figure which we would very much like to bring down, but which positions us in the ready when the next opportunity arises.

We'll be patient though, as everywhere and always, the key to performance is the accumulation of assets *at the right price.*

Year In Review

In a tough year for most investors, Seabird's Equity+ strategy fared quite a bit better than the herd.

Three long-time holdings left our portfolio, but not all by choice; Allegheny was acquired by Berkshire Hathaway while Athene was acquired by Apollo. The irony should not be lost on you that both acquisitions were made *by* companies currently in our portfolio - run by management teams we highly respect - at purchase prices well above our original cost.

We opted out of our highly profitable position in PRIFA bonds as future returns were projected well below our underwriting standard. It was good while it lasted. All of this was a bit of a good news/bad news situation. The good news is that each of these investments crystallized with large gains – well exceeding our targets. The bad news is that this large influx of cash ultimately needs to be redeployed.

To that end, we added three new holdings to our portfolio: (1) Bath & Body Works; (2) Salesforce; and (3) Activision.

Bath & Body Works (BBWI) is a business we have long admired. Our familiarity with the business reaches back to 2017 when we purchased bonds in our Income+ strategy. Bath & Body is a market leader with great brand equity in their core business of home fragrance and body care; a business that has virtually no risk of obsolescence. We acted quickly when the business was spun out of Victoria's Secret and the stock declined from $80 to $50 and we added to our position at prices below $30. At a recent price of ~$45 per share, we own a share of a long-lived asset with an 8% normalized earnings yield and a clear path to long-term growth.

Salesforce (CRM) has long been a darling of the tech and growth-stock crowd, but largely shunned by value-oriented investors. That changed quickly when the company lost more than half its market value following what was perceived to be an overpriced acquisition (we agree) and the aforementioned interest rate-based re-underwriting by analysts. Still, the business is a durable one with a market leading position in its core focus: customer relationship management software. They benefit from long-term trends in demand for digital automation of sales and marketing functions, rapid creation of customer data, and the need to make sense of it with advanced analytics and artificial intelligence. Of most interest to us, we think the business is misunderstood, and one with earnings power that is largely obfuscated by GAAP accounting rules. Today, we see the current earnings power of CRM at close to $11 per share with ongoing growth prospects of 10-15% per year.

Activision is in the process of gaining regulatory approval to be acquired by Microsoft. While it's unusual for us to pursue an opportunity with an eye to shorter term returns, we won't ignore opportunities we understand well when the odds are stacked in our favor. While the deal is pending regulatory scrutiny, we think opposing parties have a weak case. If the deal goes through, we stand to gain 25% over the next year from the current price of $75. If it fails, we still hold a dominant market player in the gaming space with attractive future returns.

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One final note: For broker/dealers – TD Ameritrade, Schwab, Fidelity, and the like – 12b-1 fees have long been an opaque source of revenue and profitability. What is a 12b-1 fee? A 12b-1 fee is a fee paid by a mutual fund to a broker/dealer.

Over time these fees have generally ranged from 0.25% to 0.75% and are ultimately paid by the mutual fund investor (you). While we own no mutual funds as they are typically understood, it may surprise you to learn that money market funds – where investors have typically held uninvested cash- are special mutual funds which have paid generous 12b-1 fees in the past.

Historically, in normal interest rate environments, these money market funds were an important contributor to your returns. Unlike most mutual funds, money markets swept up excess cash seamlessly and automatically each time a dividend was received or securities bought or sold. Money market sweeps keep your cash working for you constantly and efficiently, without most of us ever noticing.

When interest rates dropped to near zero however, this source of revenue for broker/dealers essentially dried up, while at the same time investors paid little attention to money markets due to their de minimis returns funds.

Shockingly, with the return of higher rates, broker/dealers – Schwab and TDA in particular – have opted to restrict investors from using a sweep vehicle. This restriction, left unaddressed, produces a transfer of wealth from your account to the broker/dealer of close to *0.5% per year*. While unsustainable, for the time being we have undertaken the onerous task of placing uninvested cash into higher-yielding money markets *by hand*. In the meantime, we are investigating other options to right this situation.

-Arch Peregoff
-Joseph Di Scala