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Dear Clients:

During periods of volatility, it's helpful to communicate the investment principles that guide our approach. We're humans and thankfully we were created with emotions and the desire to flee from risk and pain. These qualities have served humankind well over the years in many capacities. However, there are some areas where emotions and the "flee from risk" instincts do not serve us well. One of them is investing! I was watching Russia invade Ukraine last night and thinking about the situation, how it might unfold, whether China would consider doing the same to Taiwan, and wondering what NATO and the US in particular might do about it. I don't know the answers to these questions, but it doesn't stop my mind from wondering and wanting to know. Events like these and the uncertainty surrounding them create opportunities to get back to the basics of investing.

This short memo will focus on the following:

- Asset Allocation
- Time Horizon
- Ownership Mindset

Asset Allocation: You hear me talk about asset allocation continuously but one cannot overestimate its importance. There are only five assets: equity, fixed income, real estate, commodities, and cash. How your capital is divided between these assets matters because different assets react differently under various circumstances. Diversification between asset classes (and within asset classes) reduces risk and can also increase return, depending on the types of assets you own. Over the long-term, asset classes will perform differently, and the benefit of allocating your capital to distinct asset classes lessens the volatility and drawdown.

Additionally, holding cash reduces risks, and we are holding significant amounts of cash in our portfolios today. This decision is based entirely upon asset class valuations. This cash serves two purposes: it reduces risk when asset prices fall and, more importantly, allows us to purchase new investments should asset prices fall enough to make them more attractive.

Time Horizon: In addition to asset allocation, time is critical to investment decisions. One of the biggest investment mistakes is time horizon mismatch/confusion. If you plan to spend all or most of your assets in the next five years, you have a short-time horizon. If you're a hedge fund, quantitative investor, day-trader, margin-based investor, or trying to "get rich quick", you have a short time horizon. If you're a family with wealth that needs to be invested and stewarded for your life and possibly the benefit of the next generation, you have a long time horizon. 100% of our investors fall into the long time horizon camp. The mistake happens when investors who actually have long time horizons act like they have short time horizons. Time is the most important advantage in investing and many investors turn this advantage into a disadvantage. For long-term investors, assuming your asset allocation plan is customized and structured for your unique situation (for ECM clients this is true!), you have two options when panic-selling by short-term investors takes place: 1.) do nothing – this is the right move most of the time; 2.) buy – this is the right move if valuations fall far enough.

Ownership Mindset: Many of our clients own businesses. None of these business owners will attempt to sell their business because of the Russia invasion. I don't think any of them sold their business because of Covid or even the Global Financial Crisis of 2008. Generally, people don't sell long-term assets because of short-term problems and most problems turn out to be short-term in the long-run. Why then, would investors desire to sell businesses that are publicly-traded? I have a few guesses:

- Liquidity & Marketability: Owning Berkshire Hathaway, Nestle, or Starbucks comes with the embedded advantage of liquidity (you can sell anytime you want) and marketability (you know the price). These are great advantages, but like the time advantage, most investors turn liquidity and marketability into significant disadvantages. Benjamin Graham discussed this example in his 1949 book called *The Intelligent Investor.* Graham describes a fictitious business partnership between himself and a partner called Mr. Market. Mr. Market is a manic-depressive gentleman with wild mood swings. One day he offers to buy Graham's 50% interest at incredibly high valuations, while the next day, because he is concerned with the economy and depressed, he offers to sell his interest at 50% less. Here Warren Buffett, Graham's most famous student says, "Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence." See link for more: Buffett on Mr. Market
- Incentives: We all know incentives drive behavior. Below are a few examples of businesses with incentives that could cause you irreparable investment damage:
  - The media: The investment news media makes money in two ways: viewership and advertising. These two are certainly correlated and determined by eyeballs. They need you to be interested and nothing is more interesting than breaking news, calls for action, and alarming stories. Never will you hear an analyst on CNBC say, "this is a short-term issue that won't matter in six months, please turn off your television!" No, you will be told the world is out of control and you should act now, before it's too late.
  - Wall Street: Wall Street used to make nearly all of its money based on transactions – buying and selling securities. Now, they are much more sophisticated, but if you peel back the onion, you'll notice the money is still made by exploiting greed and/or fear. They simply cater to your desire to take action, regain "control," reduce risk, or move money around.
- Herd Mentality: As I mentioned earlier, humans are hard-wired to run from danger. This makes sense, but when it comes to investing, it's important to think about fear versus danger. In the jungle, if you think a lion is approaching, you don't sit down and think about risk/reward or juxtapose fear versus danger! No, you just run! But investing is different and reacting to fear is costly. When we see others reacting to fear, it causes us to want to join the herd but for long-term investors, we don't want to join the short-term herd and run off the cliff. No, like Mr. Market, we're best off just ignoring them.

In closing, when your asset allocation plan is dialed in, you have a long time horizon, and you operate with the appropriate ownership mindset you can resist the temptation to join the herd and simply ignore Mr. Market or take advantage of him should he become overly generous.

Sincerely Yours,

John Barker

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