CAZ Investments
Quarterly Letter

A Pause but not a Pop

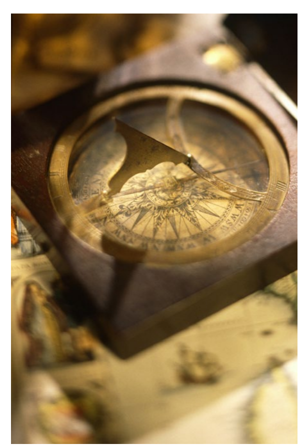
One of the challenges of writing letters like this is to maintain context when looking at past events. In this case we are discussing the 3rd quarter, yet much has transpired in the markets since the end of September. Therefore, we will recap the quarter and some of the way things have occurred through November 13th.

The 3rd quarter was indeed a pause, with a fairly material pull back during the month of September that looked like it might be the start of something substantial, only to have the "buy the dip" crowd, led by the small/retail investors, swarm in to rally the market. Overall, the 3rd quarter was basically unchanged with some material corrections in many stocks and sectors. Concerns about inflation, budget deficits, tax policy changes, labor shortages/wage increases, supply chain disruption, profit margin compression etc. etc., all were front and center with investors during the 5%+ stock market pullback that occurred in September.

Companies reported very solid earnings over the summer and the market seemed to "sell the news," once those results were announced, as they were widely expected to be good. As the earnings reporting season for the 3rd quarter is currently wrapping up it will be interesting to see if that pattern is repeated, or if the "Santa Claus rally" will be a stronger force. What we can say for sure is that expectations for the 4th quarter are high and companies are likely to deliver on those expectations, when they report those results in early 2022. This invariably necessitates talking about the flip side of that coin…

The Flip Side of the Coin

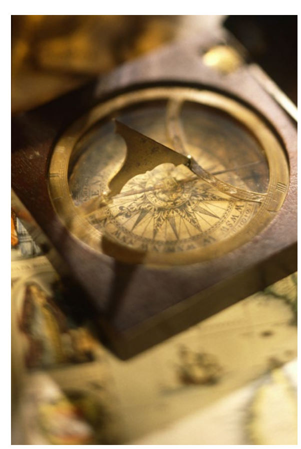
What do we mean the flip side of the very strong earnings results that are expected to be announced in early 2022? Wouldn't strong earnings be a good thing? Most definitely they are, but there is indeed another side of the coin, which is tougher comparables. When the market is fully priced, it is usually because investors have high expectations for the future growth of companies. Stated simply, if you expect a company to grow cash flow by 30% next year, you may be willing to pay a higher valuation because of the near-term visibility to solid results. But, if you felt that the company was going to grow earnings by 5% next year, you are less likely to pay a premium multiple for that business. This is why we frequently remind investors that the market is a "forward looking animal." What happened in the past is important, and what will happen next quarter certainly matters, but the markets are normally focused on the next 6 months to 2 years, as they have the biggest impact on the net present value models that drive most investor decisions.



With that explanation, here is the rub. The economy came roaring back from the Covid recession and company earnings for the last 4 quarters have grown at exceedingly high rates. Likely unsustainable growth rates. The most common metric used by traditional investors related to growth is the year over year change in earnings/cash flow. Thus the 4th quarter of 2021 will be compared to the 4th quarter of 2020 etc. As you would fully expect those comparables ("comps") will be much, much, harder as we enter 2022 because 2021 produced such an extreme earnings recovery because of the fiscal stimulus.

When traditional investors evaluate a company, they are usually focused on top line growth, operating margins, and the bottom-line growth of profits. There are naturally many other factors but for this discussion, we will focus on those three as most investors would agree that they are the "metrics that really matter." When companies report earnings in 2022, they will be compared to how they did in 2021. We all know that the unprecedented fiscal stimulus during Covid caused companies and the consumer to be awash with cash, and that this caused spikes in labor costs, material costs and distribution costs. There are no expectations we have seen that believe that companies will be able to grow their top line/sales at near the rate they did in 2021. Thus, this year companies had "easy comps" and in 2022 they will have harder comps. Further, we know that the vast majority of companies have seen the costs to produce their goods and services rise significantly. This has been both from inflation and supply chain issues, which everyone is likely well aware of. Some of those companies have been able to raise prices and offset those higher costs, but many of them have not been able to do so, and they will make less profit for every dollar of sales that they produce. Thus, they will have lower profit margins and, unless they can offset those lower margins with rapid increases in revenue, they will have lower profits. They may not have negative earnings, but they will be growing slower, and their comps will not look very good. How much would you pay for a company that has squishy results when compared to the previous year? Every company is different but what is likely fair to say is that you would probably not pay all-time high valuations for a company with that profile.

We are regularly asked what the catalyst will be that causes this market to finally correct in a meaningful way. Many pundits believe rising interest rates will be that trigger, and that would absolutely be the case, if it does occur. Others believe that we will have a good ol' fashioned recession. Yes, recessions are still possible…and highly likely to occur in the next few years. We agree that either of those scenarios would be a very big problem for stock investors, but we will focus this discussion on what we believe is the most likely predictable outcome. The leading cause that we would hypothesize is that investors see slowing growth rates, margin pressure and what economists call "Stagflation." This is where the economy begins to slow but there is significant inflation underneath, particularly related to raw material inputs and wages. Sound familiar? That is the scenario that we believe could definitely get investors to start to model much slower growth of earnings and insist on lower valuations, which when combined would create a major correction in the markets. If that is also accompanied by the unwinding of a material portion of the excessive speculation, the meat cleaver could begin to fall at an accelerating rate, which can feed upon itself. Retail options volume is the highest ever, margin debt is the highest ever, household ownership of stocks is as high as ever…and the list goes on. Whenever the correction proves to be sustainable and the "buy the dip" crowd runs out of courage, the unwinding of that speculation could indeed become exceedingly painful. Speaking of excessive speculation…



<u>Déjà vu…Again</u>

With that backdrop, it is hard not to repeat some of the headers when we write these letters, because they simply fit. Why Déjà vu for this letter? Simply because we lived through the Tech Bubble and one simply cannot have that experience and not see the similarities to what is happening today, not just in parts of technology, but in many areas of the markets and human behavior.

Remember these names; Webvan, The Globe.com, Buy.com, and so many others? If not, they were some of the darlings of the IPO craze during the Tech Bubble. Where are they now, you ask… Gone. They no longer exist as businesses and simply serve to remind us of the dangers of buying something because it is going up, without understanding why it should be going up, and what the actual business model or economic return is likely to be from the investment. This famous quote from Winston Churchill holds true today, “Those that fail to learn from history are doomed to repeat it.”

Investor behavior today is simply shocking, and those who have studied/experienced history recognize that for the vast majority who choose to ignore economic realities, their experiment will end badly. We could list pages and pages of examples and charts to illustrate this point, but two examples from just this past week will likely send shivers down your spine.

There was a Wall Street Journal article on November 9th that contained the following statements:

"It’s easy to manage $500,000, $1 million yourself," said Mr. Martocci, who says he spends less than an hour a week monitoring his investments. He said that at this point in life, he prefers risky investments that could potentially double or triple his money over those promising "market type returns." He funnels 90% of his money into cryptocurrency.

"Most young people don’t really care about the downside," Mr. Martocci said. "They care about the upside and it being this fun thing."

Hmmm… It is fun when things go up, not as much when they go down.

The other amazing example to provide is the IPO this week of Rivian. Only time will tell if this is the ultimate illustration of the excess of this bull market that started last spring, but it certainly feels like it could be… The odds are good that you heard about this electric vehicle company and its first day IPO pop, but you may not have heard, to quote Paul Harvey, “the rest of the story.”

Rivian explained to investors that they will generate somewhere between $0 and $1 million in Revenue this Year and expect to lose approximately $1.2 billion dollars…this Quarter…and they hope to deliver automobiles to customers by…the end of 2023.

Now, there are lots of startup companies that go public with large prospects, and that is a great thing for capitalism. However, what you may not realize is that <u>Rivian is right now valued at $127 Billion!!</u> Note above we said they hope to do somewhere between ZERO and $1mm in revenue this year. And yes, it is currently worth more than Daimler (Mercedes/Chrysler), General Motors, Ford, BMW, and countless others. As a matter of fact, it is right now worth more than Hyundai, Kia, Honda, Volvo, and Nissan…combined!!

For those of us who lived through the Tech Bubble of 1999, this is frighteningly familiar, and what makes it even more shocking is that Rivian is a car manufacturing company!! Try to extrapolate the market share, sales, profit margins and cash flow this company will need to produce in order to justify a $127 Billion valuation. If you can build that model, we would love to see it, as we cannot come close to a forecast that would accomplish that, unless they sold an exceedingly vast majority of the vehicles purchased on the entire planet. Something tells us that all the other manufacturers are not going to just roll over and let this start up take over the market. Time will always tell, but if there was ever an example of extreme disregard for risk, this could very well turn out to be the poster child.

Based on the data and tone provided above, it will not surprise you to learn that we remain exceedingly cautious. All investors should be fully aware of the amount of euphoria that is rampant in markets and not get swept away by complacency. Be on guard, know where your risks are and be sure you have adjusted your asset allocations to protect yourself against the "what if" factor. **We remain a 1 on the CAZ Scale and believe that the risk/reward from these valuation levels remains heavily tilted to the risk side of the equation.** No one knows when the music will stop in this dangerous game of musical chairs, but when it does people will be unpleasantly surprised by the speed and ferocity of the decline.

It is for this very reason that we have placed such an emphasis on protecting the downside, which is now harder than ever for investors to accomplish. Every investor should have a Risk Mitigation plan in place for their portfolio, just like they do for their cars, homes, lives, health etc. You should already be aware of what we are doing to provide that for our ecosystem. If you do not already have a plan in place, please let us help you develop a strategy. No one knows when the music will stop and once it happens, it will be too late to put protection in place.

The Next Generation of Investor Reporting

As many of you know, we have been working for more than a year and a half to build a custom solution that will allow you to experience an extremely unique and valuable investor reporting portal. Our business, with both liquid and illiquid private funds, makes this exceedingly difficult, but our Team has spent hundreds and hundreds of hours building what we believe to be a world class solution. The developers are working with our Team to beta test the portal internally and we expect to enroll a small group of current investors and investment advisors in the beta test group during December, with a rollout to all investors in the 1st quarter. If you would like to be part of the beta test group and will commit to help us work out the kinks, we would love to have you involved. Please let us know if you are willing to serve in that capacity.

Our Team continues to grow rapidly, and our access to unique alternatives is expanding exponentially. The magnitude of both will be on full display at our

Themes for 2022 event, which will be held in person, on January 20th, 2022. We will have breakout sessions during the afternoon with some of our partners in our largest themes, and then the dinner with the keynote fireside chat that evening. Please save the date and be certain that you confirm your attendance as soon as the registration window opens, as we do not want anyone to be left out if we get above the capacity of the room. Current investors will have priority for a short period of time, so please look for emails from the general firm email address in the next few weeks. We hope that you will make the event a priority, as we expect it to be extremely valuable.

Thank you for your partnership and we look forward to seeing each of you very soon.

All our very best!

The CAZ Investments Team