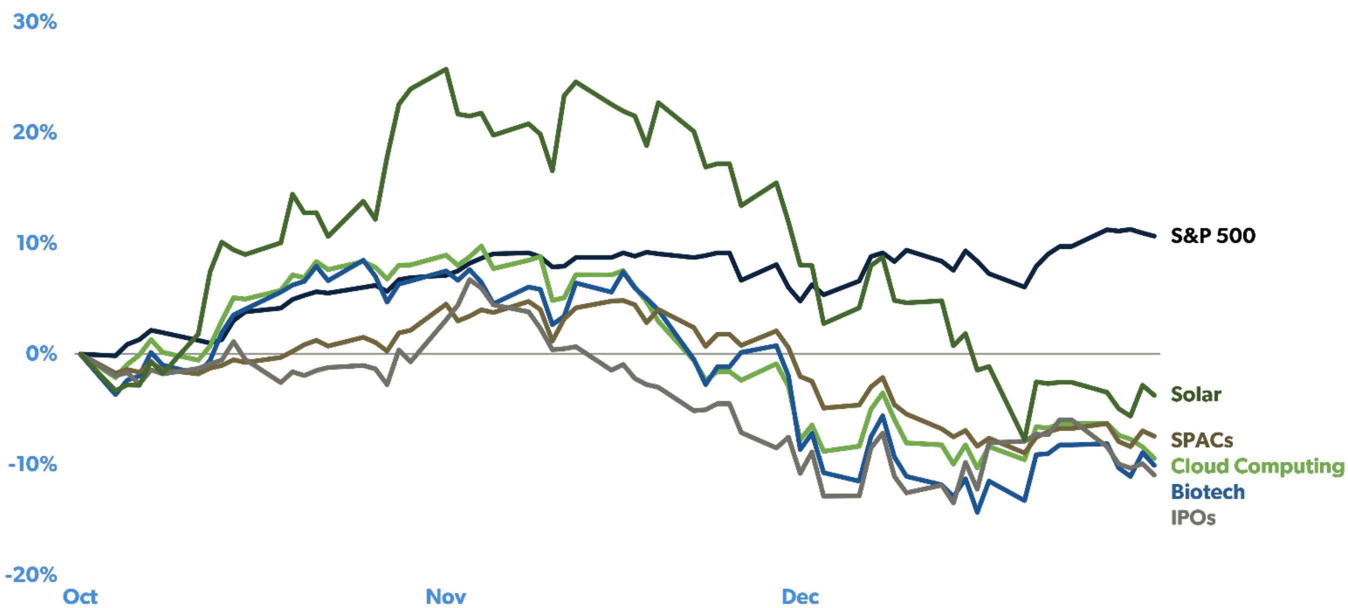
CAZ Investments
Quarterly Letter

4Q 2021 - Perhaps the Last Gasping Breath of the Bull Market?

Creating titles like that is always interesting, as we are writing this letter with the knowledge of what has happened since the end of the quarter, while at the same time no one can ever claim to precisely predict when a bull or bear market will end. What we do know for a fact is that major market indices during the 4th quarter, aside from about two weeks of anxiety around Omicron, were strong as an ox. The S&P 500 rallied by more than 10% to close out a very surprisingly strong year, at least for the indices. Hold that thought, as we will come back to it…

In late November all eyes began to focus on the new strain of Covid, Omicron, and the potential impact on the economy. Large company stocks promptly dropped by roughly 5% and small company stocks fell by nearly 15%, in a matter of days. That is where things got a bit "wonky," as large cap stocks took right off again and jumped markedly before the turn of the New Year. Small stocks did not, as they were only able to muster a feeble rally in the last few days of the year. Behind the indices that most investors tend to focus on there was a very different story being told, and it was a painful tale of what happens when markets decide to punish certain groups of investors. In this case, it seemed the more speculative the company, the more the market took those stocks "behind the woodshed" and it was not a pretty sight. For those of you who attended our Themes for 2022 event, you may remember seeing this chart. It is worth adding it here for everyone to see:



SOURCE: Bloomberg. Cloud Computing = Global X Cloud Computing ETF. IPOs = Renaissance IPO ETF. SPACs = IPOX SPAC Index. Biotech = SPDR S&P Biotech ETF. Solar = Invesco Solar ETF. As of 12/31/21.

We wrote last quarter in our letter about some of the similarities we were feeling to the Tech Bubble of 1999. Let us set the stage by reposting here a few paragraphs from our last letter:

> 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.
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> 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 Rivian is right now valued at $127 Billion!! 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!!

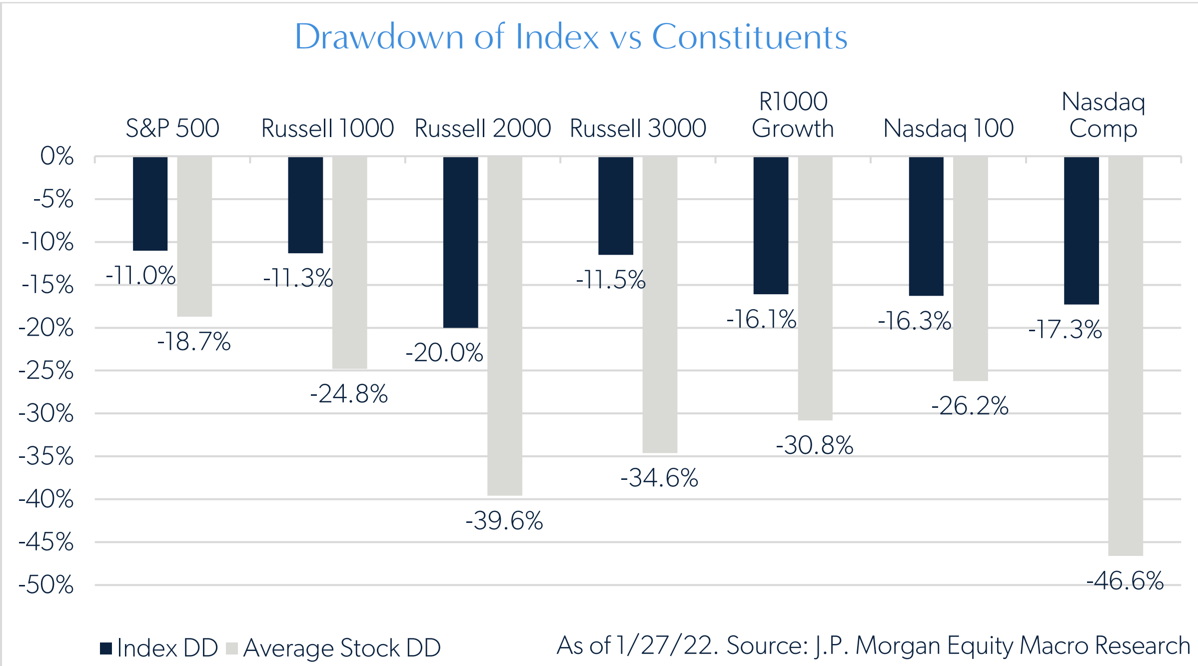
For those of us who lived through the Tech Bubble of 1999, this is frighteningly familiar, and what makes it even more shocking is that Rivian is a car manufacturing company!! Try to extrapolate the market share, sales, profit margins and cash flow this company will need to produce in order to justify 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.

Well, that bubble was materially deflated beginning in early November, and the pain accelerated into the start of 2022. Here are a few details that will drive that home:

- First let us look at the car company we spoke about in our last letter, Rivian. The stock plummeted by ~72% in just over 60 days.
- Next, we can point to the ARK Innovation ETF, which declined by more than 48% from early November to mid-January.
- Then, we can look at cryptocurrencies, which have been a clear signal of risk on/risk off moods of the market, where Bitcoin dropped by ~50%.
- Even the Reddit board favorites were overwhelmed by this unwinding of speculative excess, with GameStop and AMC Theaters dropping by ~64% and ~70% respectively.

As a matter of fact, while the major indices seemed immune to the sell-off, there was a stealth bear market that was punishing investors who had gotten caught up in the "easy money" strategies that just seemed to be "foolproof." As is normally the case, the market will find a way to punish those that believe they have found the holy grail of investing, and the bear left a trail of carnage in its wake. To provide specifics, the chart below shows the peak to trough decline of the Average Stock in each of the indices, compared to the index itself.



One would likely immediately ask, "how is it possible that the Nasdaq was down -17.3%, when the average stock was down -46.6%?" What most people forget is that several of the major indices are Capitalization Weighted, meaning the bigger a company is, the more weight it gets in the calculation of the value of the index. Yes, for all the academics reading this, it does mean that the index providers have built survivorship bias into their design… That is a story for a different day. For the non-academics reading this, what it means is that when you look at the Index, it is only telling you a part of the real story. Investors who owned the Nasdaq Index did not like the -17% drop, but for all those investors who owned the average stock in the Nasdaq, that declined by -47%, it certainly felt like a bludgeoning!

Naturally, there is no definitive explanation as to why the market got spooked. One can try to blame it on Omicron, but that clearly was a blip that was ignored by markets as something that would be short lived. While there are obvious exceptions like March 2020, September of 2001 etc., it is usually very, very difficult to point to a single cause of a particular market effect. The most common "culprit" as to a reason for the recent sell-off is the Federal Reserve telling us that they were actually going to begin raising short-term interest rates, and that speculative stocks are just not worth as much in a rising rate environment. There is some definitive support for that position as rising interest rates impact the discount rate on a very long-dated stream of expected cash flows, but there was no shocking surprise from the Fed. Quite the contrary, the Fed clearly advertised their stance and went out of their way to manage expectations. Inevitably, there is no definitive/single reason why stocks began to drop, but that decline began to accelerate and it then turned into a full-fledged route. We have mentioned multiple times over the last several quarters that stocks always go down faster than they go up, because fear is a more powerful motivator than greed, and that is why investors must "sell when they can, not when they have to." The declines illustrated in the chart above will be yet another reminder as to the truth of this adage.

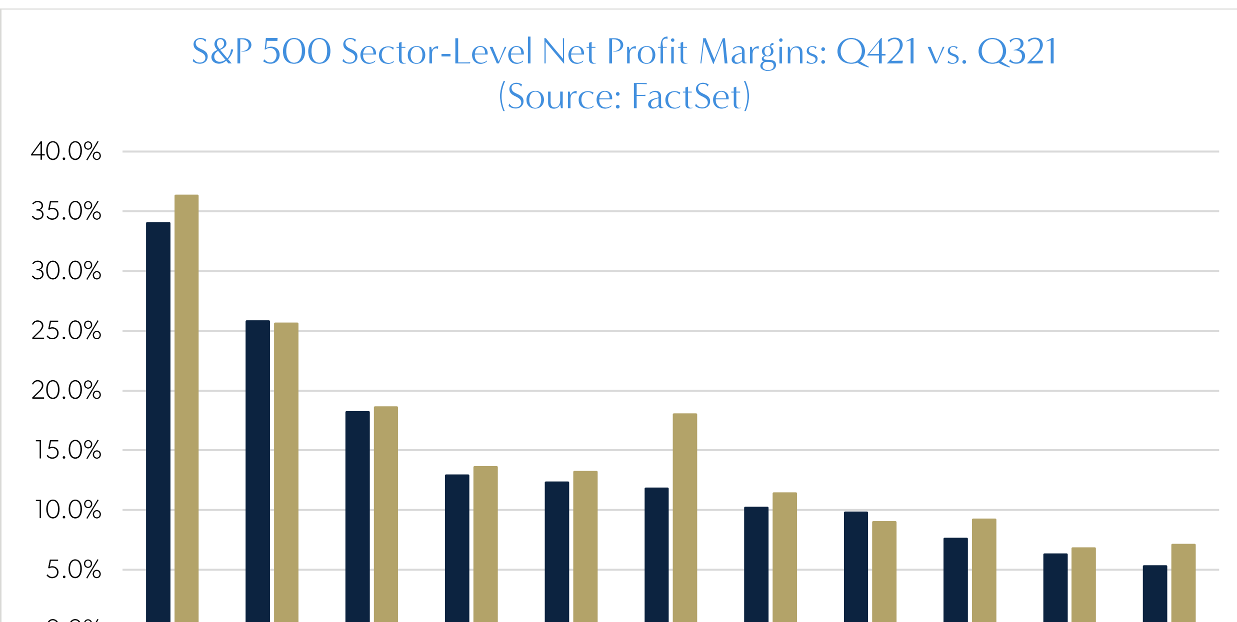
That Did Not Feel Good, So Now What

If the reader is expecting us to say that the worst is over and that we have nothing but blue skies to look forward to, we are sorry to disappoint. We think the real reason the market has begun to punish risk takers is longer lived than just a few days. Time does not permit us to provide all the background on historical valuations and how unlikely it is that stocks can perform well from the elevated levels that are prevalent today. You can go back and read the last few letters, or you can watch the recording from our Themes from 2022 event, which gives some additional context. Click [HERE](#) to watch that video.

What we can tell you is that for a few hours on January 24th, we officially changed our rating from a "1" to a "2" on the CAZ Scale (1 = worst risk/reward, 5 = best risk/reward). The market displayed definitive signs of panic that morning and, in the portfolios that we manage in the liquid markets, we became slightly more constructive. After the significant rally that afternoon, and the continued increase through month end, we reverted to a "1." As of this writing we would consider ourselves a borderline "1 to 2". That means that in some areas there is a better risk/reward but overall, the market is still heavily tilted to the risk side of the equation. We encourage investors to still be thinking more about protecting their capital than trying to maximize gains, in the public markets.

If one listens to the general market commentary, the primary culprits for the concern in the market usually revolve around persistent inflation, rising interest rates and geo-political concerns with Russia and China. All of those are very logical reasons for markets to take a breather, but we think they are not actually the real underlying drivers. What has us most concerned at this point in the cycle is much more basic fundamental analysis 101, earnings growth and profit margins. It is well documented that earnings growth is slowing, so we will not spend a lot of time in this letter, as we mentioned that in some detail last quarter. It is also very logical that the rate of increase is going to naturally slow after such a dramatic rise from the Covid lows.

Therefore, let's explore profit margins. Here is a chart that shows the quarter over quarter change in profit margins for each sector of the S&P 500, from the 3rd quarter of 2021 to the 4th quarter of 2021:



	Real Estate	Info. Tech	Financials	Materials	Comm. Services	Utilities	Health Care	Energy	Industrials	Cons. Staples	Cons. Disc.
Q421	34.0%	25.8%	18.2%	12.9%	12.3%	11.8%	10.2%	9.8%	7.6%	6.3%	5.3%
Q321	36.3%	25.6%	18.6%	13.6%	13.2%	18.0%	11.4%	9.0%	9.2%	6.8%	7.1%

What becomes quite apparent, with just a quick glance, is that profit margins are already contracting in nearly every sector. In some cases, the drops are very meaningful. This is a disturbing trend for a market that is priced to "perfection." If we see revenue growth slow, which is very likely, and margins contract further, also likely, then earnings growth could slow quite rapidly. That is very bad for a market that has made over half of its returns the last decade from P/E multiple expansion. Valuation multiples can contract faster than then people expect, as valuations are driven much more by emotion than actual changes in fundamentals. If multiples contract and earnings begin to slow/drop then that is the "double punch to the gut," we refer to in the Themes video. We have not seen that market event occur since March 2020, and we all know what that felt like….

Will that happen this time? It is hard to make a case that it will NOT happen at this point in the economic cycle, with a Federal Reserve that does not appear to be ready to drop helicopter money again, or a Congress that does not appear to be willing to provide unlimited fiscal stimulus. Sometimes economics is really hard, other times it is fairly straightforward. In this case, it appears to be more the latter, as we are unlikely to see any monetary or fiscal chariots come to the rescue.

Obviously, anything can and sometimes does happen to change politicians' minds, including simply pending elections… so we must always be prepared to pivot and adapt. For now, we remain much more comfortable being cautious and generating returns from things that do not have much correlation to the broad stock market. We continue to believe that the recipe for success in 2022 consists of the following ingredients:

- We continue to believe that The Growth of Private Equity as an Asset Class is a theme from which we can benefit for the next decade or more. Demand for private market capital has increased substantially in recent years, fueled by several market dynamics that we believe are likely to persist.
- In an expensive world, we believe that focusing on non-correlated assets with durable and growing revenue models, resilient through cycles, will position us for success regardless of broader economic and market trends.
- As the world evolves more and more quickly, the opportunity to invest in game-changing disruptive technology companies remains a core source of potential return generation.
- We see private credit markets as significantly more attractive for fixed income investors, with lower risk and substantially higher yields.

The good news is that we have the flexibility to access unique alternatives to find ways to capitalize on these major themes. We will continue to identify those opportunities for our personal capital and will let you know when we find attractive solutions.

By way of an update, our long-awaited Investor Portal is almost finished. For anyone that has ever launched a major technology initiative, they just never seem to go as smoothly as we design it in our heads. We are literally at the finish line and are in beta testing. Once we are comfortable that we have worked out all the kinks, we will proceed with the formal rollout.

In closing, please let us know how we can be helpful as you navigate what will likely be a very different investment environment than what has been experienced for the duration of the accommodative Fed easing cycle. We are happy to be helpful in any way we can be.

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

All our very best!

The CAZ Investments Team