> *I've had a lot of worries in my life, most of which never happened.*
>
> *–Mark Twain*

Lorne Steinberg,
MBA CFA
PRESIDENT

Climbing the Wall of Worry

Dear Investor,

For investors, the start of 2023 has been notable for ongoing geopolitical issues, continued supply chain bottlenecks, the impact of higher interest rates, and distress in the banking sector. However, despite all of this, markets have experienced positive returns across most asset classes.

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Silicon Valley Bank and Credit Suisse: Another Financial Crisis?

For the first time since 2008-2009, there were two major bank failures. While this may be reminiscent of the financial crisis, the current situation relates more to bad management than systemic issues.

SVB's issues stemmed from lax internal risk controls and a business model that was overly dependent on the technology sector. When interest rates rose sharply over the past year, financing for the technology sector dried up, forcing many of these businesses to draw down their deposits, leaving the bank short of funds. The problem was that SVB did not maintain adequate liquidity to cover the withdrawals, as it had invested too aggressively in longer-dated treasury bonds, which had lost value due to rising rates. When these problems became public, more depositors demanded their money back, leading to a classic run on the bank and the forced closure of the 16th largest bank in the United States.

For Credit Suisse, a 175-year-old major global financial institution, weak management oversight resulted in a series of financial scandals, compliance failures, fines, and losses over the past fifteen years, eroding investor and client trust. These ongoing problems resulted in a collapsing share price, the inability to raise capital, and the loss of client and shareholder confidence. The Swiss authorities forced the bank to merge with UBS in order to maintain the stability of the Swiss banking system.

In the cases of both SVB and Credit Suisse, depositors were protected, while shareholders and bondholders suffered the losses.

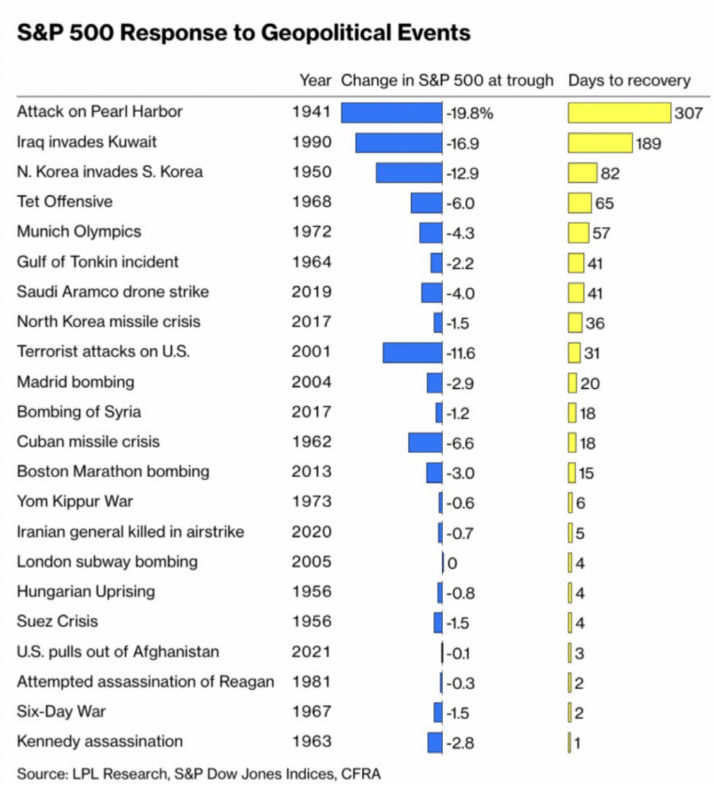
Following the financial crisis, capital requirements were greatly increased for banks, resulting in far less leverage and risk-taking, while oversight in the U.S. became much stricter for the large banks (those with assets greater than $250 billion). With lower leverage ratios, the risk of bank failures has been greatly reduced, especially for those deemed "too big to fail." Regulators have also learned from past mistakes, acting promptly to stem the risk of contagion. That being said, the smaller regional banks will always carry more risk, which is why we have avoided them.

A world of risks

While geopolitical problems have always been present, it feels as if the level of aggression and polarization is greater today than in a long time. During the Cold War era, the struggle was between two so-called superpowers, the U.S. and the Soviet Union. However, today, with the rise of China, the proliferation of nuclear weapons, and the sense that the U.S. has pulled back from its policy of Pax Americana, the geopolitical risks seem elevated.

In the short-term, markets could be derailed by any number of disaster scenarios. That is why history is always a valuable reminder that, despite world wars, financial crises, pandemics, and the like, humanity has been resilient, and investors who stayed the course through difficult times have always come out ahead. The quote at the beginning of this letter speaks to this. There is something in human nature that causes us to worry about things that have not yet happened. Investors who focus on the ever-present risks that exist often sell based on emotion and end up missing the long-term returns.

The chart below presents the short-term performance of the market following numerous geopolitical incidents, demonstrating how rapidly it recovered from these events.



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Investments

With a portfolio of strong businesses that is diversified across a number of sectors, we are well positioned. For example, here is a brief look at three of our core holdings.

AMERICAN EXPRESS

Founded in 1850, American Express today is known principally for its charge cards but also extends credit to its customers and provides a suite of related services to businesses and merchants. Commissions and fees from card usage account for about 75% of revenues. Given the prestige associated with being an American Express cardholder, the group continues to attract a high-end client base, most of whom pay annual card fees for the various privileges and rewards.

AMEX offers a suite of services for commercial customers and has a very strong following among small and medium-sized enterprises. One of the key attributes of their business model is that a significant portion of their costs are cardholder rewards, which means that if revenues decline, that portion of their costs declines as well. As a result, even during the depths of the global financial crisis, the company remained profitable, as it did during the onset of the pandemic, despite the travel business being almost entirely shut down. The company has used its free cash flow over the past many years to buy back shares and raise its dividend, and it continues to offer the prospect of double-digit earnings growth.

Reckitt Benckiser

While far from a household name on this side of the Atlantic, Reckitt owns some of the most recognized global brands in hygiene, health care, and nutrition. These include Lysol and Dettol disinfectants, Finish dishwasher tablets, Air Wick air fresheners, detergents such as Woolite and Vanish, as well as Strepsils, Gaviscon, and Durex. These products have commanding market positions - typically first or second in terms of market share - reinforced by significant marketing spending as well as product innovation (they spend over 2% of sales annually on R&D). With such an enviable portfolio, the company is well positioned to deliver superior organic sales growth as well as incremental improvements in profitability. In addition, we are likely to see ongoing portfolio enhancement through selective M&A, as the group has shown itself to be both a willing buyer and an opportunistic seller of businesses over time.

TSC TRACTOR SUPPLY CO

Tractor Supply is the largest rural lifestyle retailer in the United States, albeit with only an estimated 7% market share of a near $200 billion total addressable market. Through a network of over 2,000 stores in 49 states as well as an e-commerce website, they sell an extensive mix of products for the home, land, pets, and farm. They also own Petsense, a chain of almost 200 pet care stores in 25 states. The company has seen revenue growth every year for the past 20 years.

This is very much a rural retailer, with a loyal customer base of close to 20 million "Neighbor's Club" members. The company has used its growing free cash flow to buy back shares and raise its dividend, while doubling its revenues over the past five years.

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High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

"Climbing the Wall of Worry" speaks to the market's ability to rise in the face of seemingly insurmountable obstacles. History has shown that such problems are usually temporary and are eventually resolved.

Investors who focus on what "might happen" fall prey to bad decision-making, which can lead to missed opportunities and reduced returns. Making decisions based on emotion has never been a winning strategy. Successful investing requires patience, discipline, and time.

Sincerely,

Lorne Steinberg
President

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