Global Markets
January 2022 Outlook

An opportunity to build exposure for long-term gains

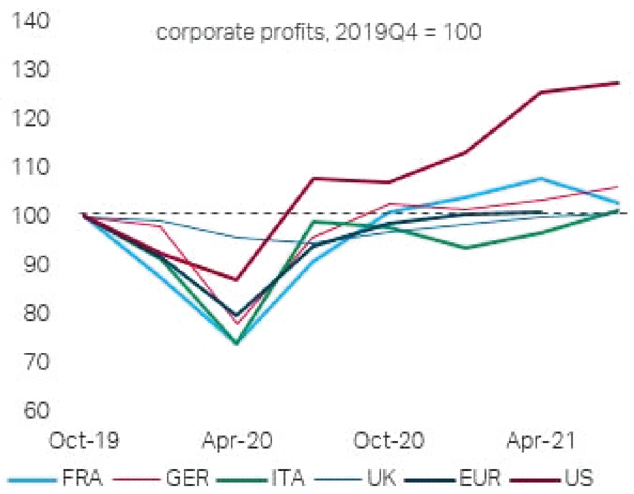
In Physics, Black Holes are popularly considered a destructive force, attracting, and consuming anything that comes too close. Therefore, it was considered a surprise when NASA's Hubble telescope recently captured images that suggested a smaller Black Hole was contributing to the formation of new stars. Scientists theorize that the outflow (there is always some outflow) from the smaller Black Hole was gentler and the escaping gas was compressed enough to aid denser interstellar clouds in star formation. In a similar manner, sharp market drawdowns after long run-ups, can appear to be a destructive force to investors, erasing months of portfolio gains. However, for well-managed, antifragile[1] portfolios, they can be an opportunity to build exposure for long-term gains. In July 2021, we had said the following:

"As we stated at the start of the year, we remain constructive on Equity Markets for the year. We expect US Treasury 10-year bond yields to remain below 2%, despite higher (but transitory in our view) inflation prints this year. Earnings and cash flow are supportive of US Equity Markets- share buy backs and cash dividends are expected to total $1.45 Trillion[2] which translates to a shareholder yield of 3.9% vs current 10-year yield of 1.2%. Earnings expectation for 2021 and 2022 are higher now than at the start of the year, and over 85% of companies have beat both revenue and earnings expectation. While, the United States economy and its corporates continue to outperform its developed market peers, there is an element of risk with the entrenched political divide and the attempt by certain state politicians to create scenarios where the legislatures could override election results. We believe, these efforts would be thwarted by the Judiciary. Supreme Court Chief Justice Roberts may well turn out to be the most important figure of this fraught period in our history. Europe presents a lot of value opportunities and could perform well as they catch up on vaccinations. We like select opportunities in Emerging Markets where there are higher long-term growth opportunities. As we wrote in the last letter, there are elements of speculation in some risk assets (chart 10), particularly ones that are not anchored by cash flow. These include stocks trading on expectations of extremely high future growth, certain SPACs, "meme-stocks" like GameStop and AMC, and crypto assets. The broader market has seen rolling corrections across sectors that have been supportive of the continuing bull market. New variants of COVID, especially if they are vaccine-resistant could be a risk to the Markets if they result in a return to economic shutdowns."

1. From the book Antifragile by Nassim Nicholas Taleb

2. JP Morgan/Barron's July 26, 2021

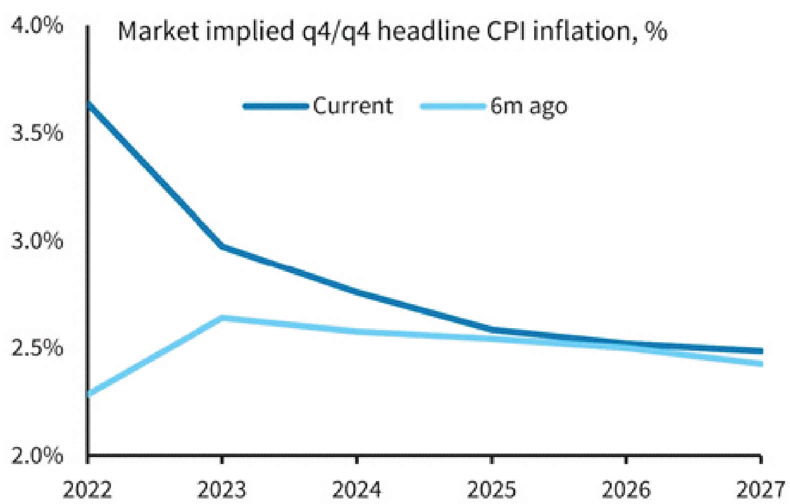
For the full year 2021, MSCI ACWI Index was +18.54%, EAFE Index +11.26% and the MSCI EM Index lagged at -2.54%. The United States continues to lead performance among the major markets (Chart 1) with the MSCI US Index +26.45%. As the chart below suggests, the earnings rebound among US companies have been the strongest.



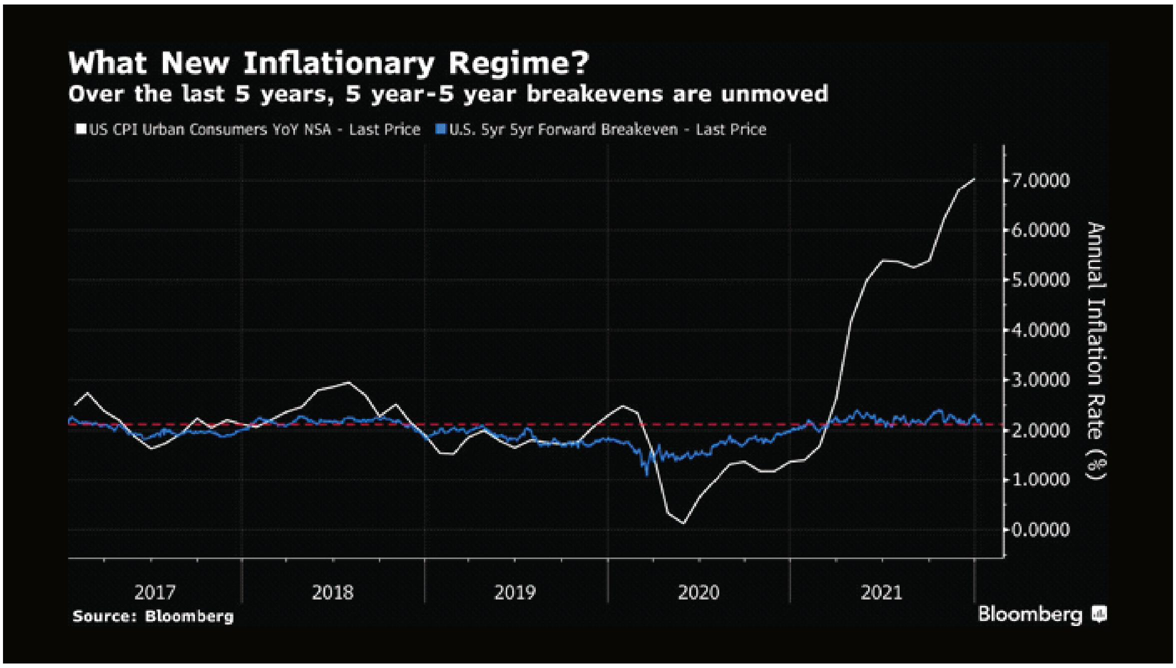
MSCI Europe did well at +16.30%, Japan was a laggard among developed markets with the MSCI Japan Index +1.71%. Among major Emerging Markets, India +26.23% and Taiwan +26.13% were leading performers and China -21.72% and South Korea - 8.39% lagged.

The scenario we had projected for 2021 in our two investor letters last year, appears to have been reasonably accurate. The environment for risk assets appears to have changed since the start of 2022. The key change in our view is the market perception that the Federal Reserve is more hawkish than the prior consensus.

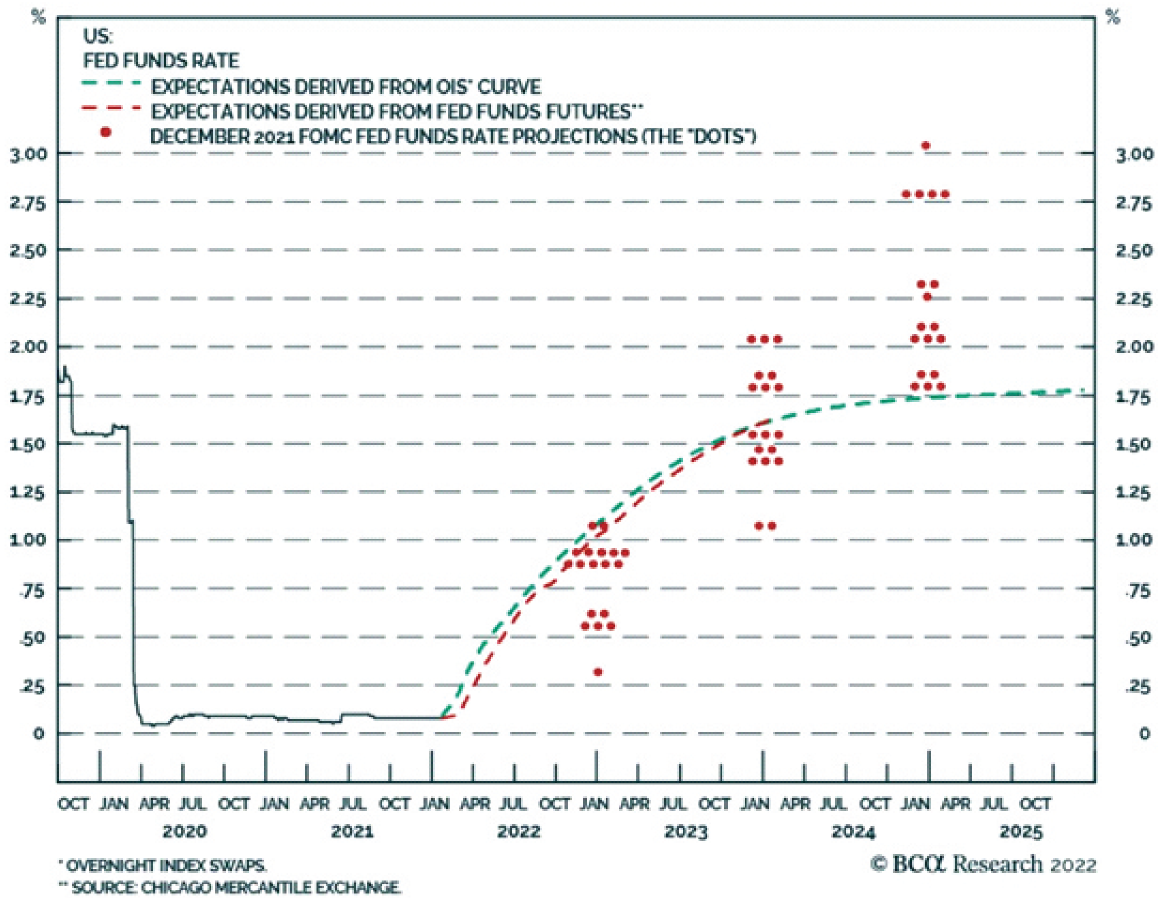
Federal Reserve Chairman Powell and other members have suggested that short term rates will rise, and the Quantitative Easing program will end. The bond market witnessed very large moves in rates with the 10-year yield rising from 1.52% at the end of 2021 to 1.87% by January 18, 2022 and the 30-year yield rising from 1.90% to 2.18% over the same period. The absolute levels of bond yields remain low by historical standards, but the percent change and the rate of change were both dramatic. The i-shares 20+ year Treasury bond ETF (TLT) is down 5.11% on a YTD basis[3]. Over the last one year, market trading has been dominated by perceptions about how sticky inflation could be and the impact on monetary policy. However, it appears that the changing inflation expectations have been only for the near term and future expectations have not changed very much. The first chart below shows inflation expectations over the next five years and how it has changed over the last six months. The second chart shows inflation expectations over the period 5-10 years ahead and the change in those very forward expectations over time.



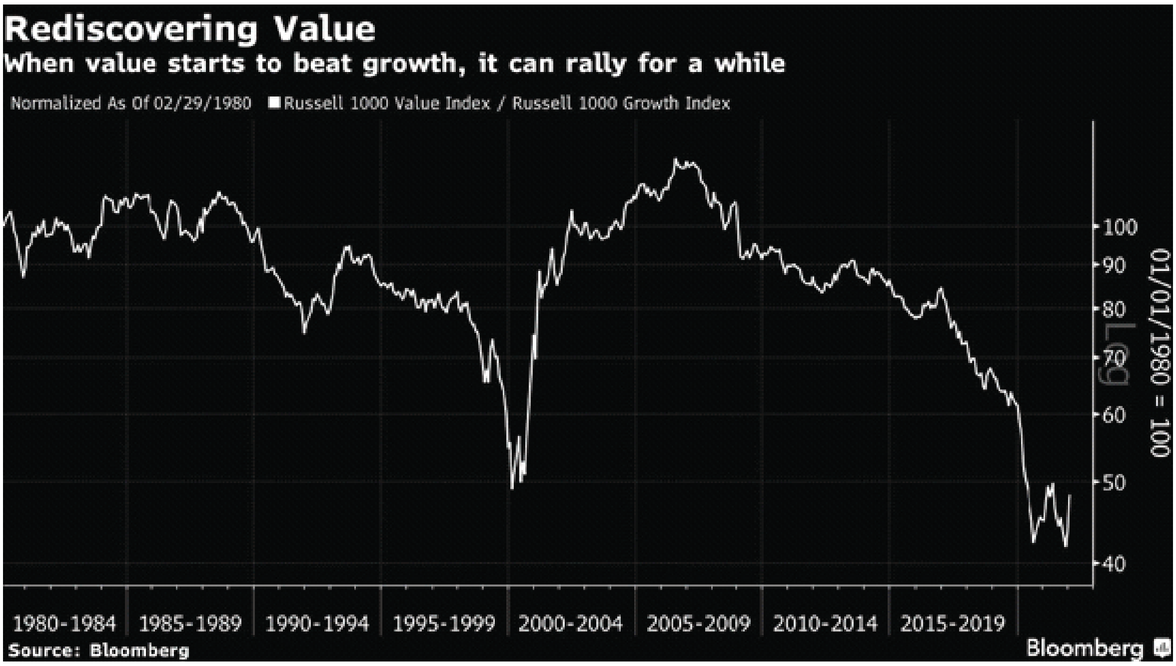
3. https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf

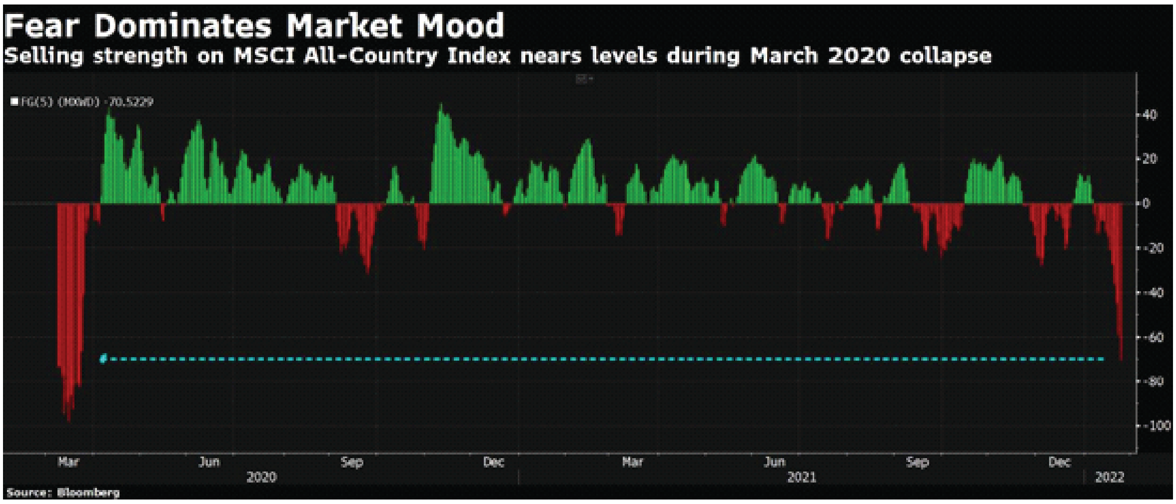


Market expectations are that the Federal Reserve will raise rates 3-5 times this year and then potentially another 2-4 times over the following 18 months, with the tightening cycle being complete with the Fed Funds rate at 1.75%.

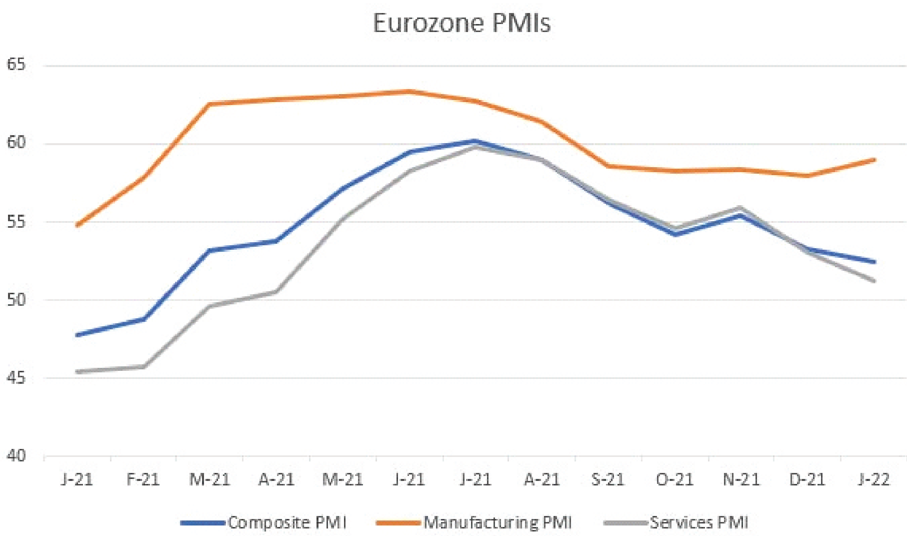


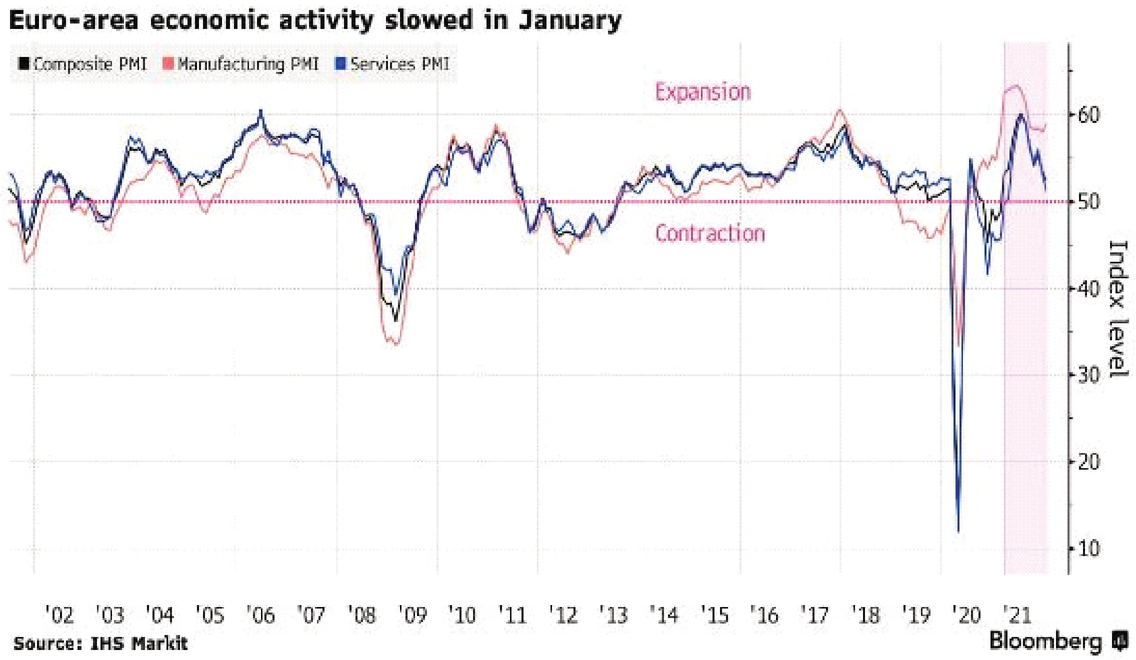
The change in expectations in terms of monetary conditions have brought some fear back in risk assets. Companies trading at lofty valuations, meme stocks and crypto assets have all had significant corrections. Value stocks are outperforming after a long metaphorical winter of underperformance. For now, cash flow appears to matter more than stories of growth.

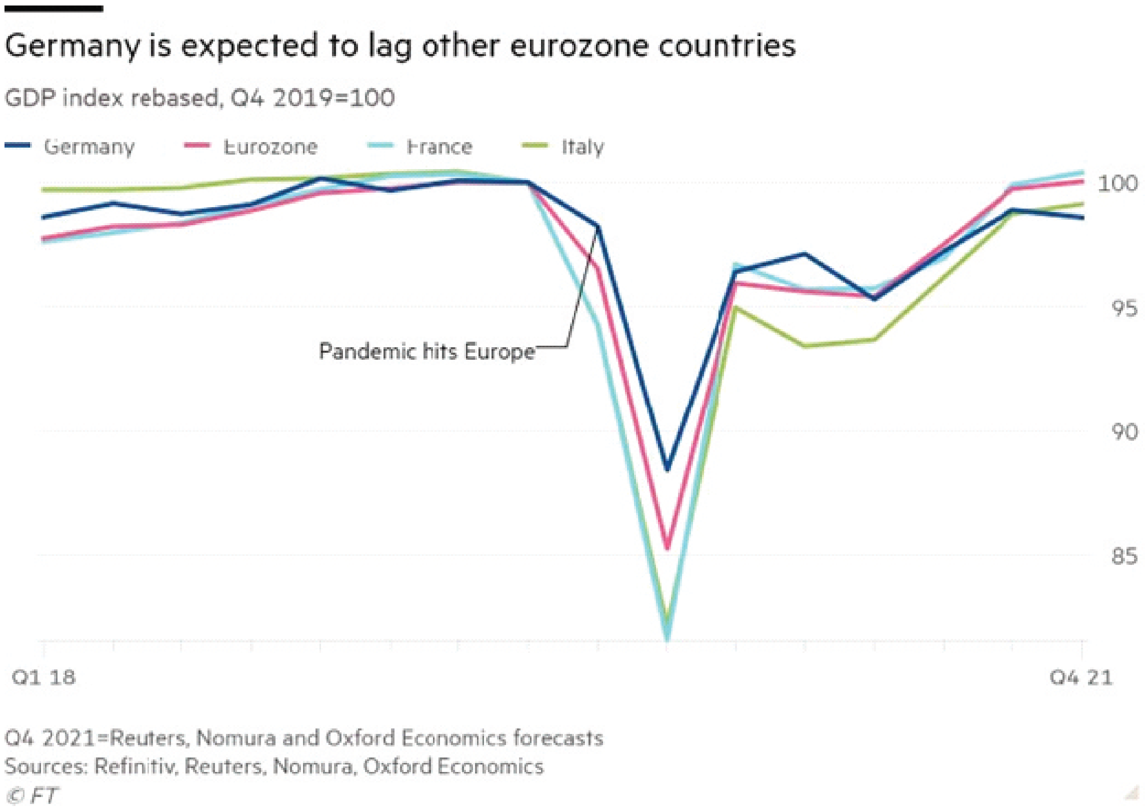




European markets performed better in 2021 vs 2020 (MSCI Europe +16.30% vs 5.38%). Greater focus on cash flow and dividends makes Europe more attractive. Economic conditions improved through mid-year 2021 but appear to be rolling over.







Germany has been a laggard in the economic rebound, and this appears to be due to the larger exposure to global supply chain bottlenecks and a weaker recovery in consumer spending[4].

The great risk to Europe this year is geo-political- the risk of conflict at its eastern border. Russia, which retains a relatively strong military but with much diminished economic power, feels threatened by NATO expansion to countries which were formerly in Russia's orbit. Any open conflict brings the threat of Western sanctions, but the interests of the United States and Europe may diverge when it comes to the scope of such sanctions.

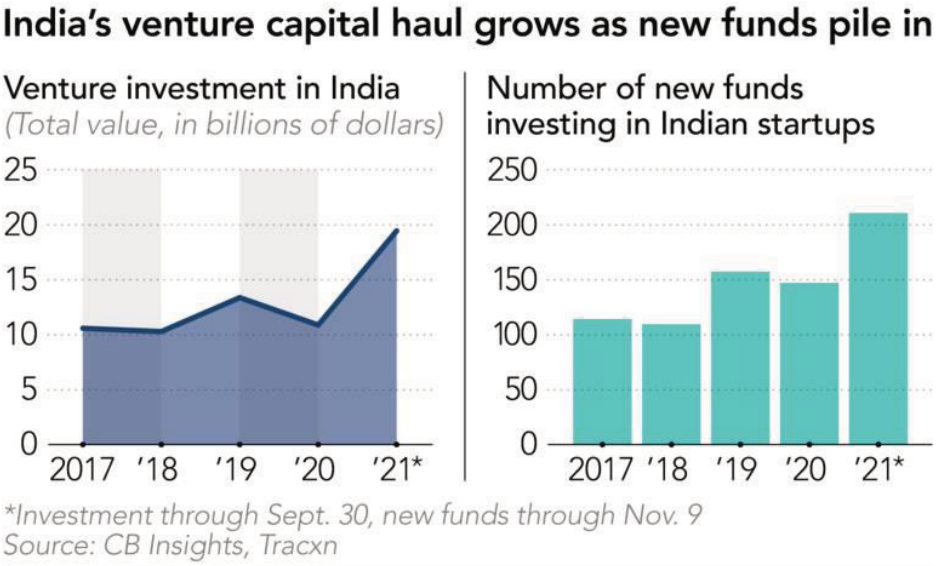
4. Financial Times January 26, 2022

Europe depends on Russia for much of its Natural Gas supply and punitive sanctions against Russia brings the threat of Gas supply cut-off and substantial economic hardship. Our base case is that the conflict between Russia and Ukraine, and the indirect conflict with NATO, will remain a cold conflict. It appears that more normal relationship between Russia and the West would benefit both parties. The greater threat both could face in the medium term appears to be the growing military power of China, where the combination of economic strength and an anachronistic political system, has given rise to a dangerous nationalism that seeks to pressure neighboring countries and dominate the Indo-Pacific region. For the West, China's military muscle can lead to a weakening of the post-World War II order that has prevented large-scale conflict, maintained peace quite broadly and allowed a remarkable period of economic expansion. Russia has a large border with China, across much of its sparsely populated Siberian region. It is a region that is difficult to defend if there is conventional war with a strong economic and military power, that also has a much larger population.

The IMF recently downgraded economic growth assumptions for China for 2022 from 5.7% to 4.8% [5]. They suggested that greater state intervention was resulting in the traditional investment-led growth and delayed transition to the higher quality consumption-led growth. We have discussed in past letters that the GDP growth figure in China is a top-down *diktat* and local government officials are under pressure to borrow and invest to reach the Chinese Communist Party's (CCP) goal. In recent years this quite often leads to low-return investments in infrastructure or factories and inventory for exports. Economic growth over the last decade has been driven by rising debt intensity, as the additional debt needed for each additional unit of GDP growth has continued to rise. The economist Michael Pettis has used the term "bezzle" (definition - temporary gap between the perceived value of a portfolio of assets and its long-term economic value) to explain the disconnect between reported GDP growth in China vs true economic value creation[6]. He suggests that Chinese regulators have buried the bezzle in the bad debt of the country's banking system by setting deposit rates far below nominal GDP growth, and banks and corporate borrowers could effectively reduce the true cost of borrowing through the consumer subsidized low deposit rates. Bezzle can lead to higher levels of investment than is economically justified and its reversal (which will happen when imbalances rise too high) will depress growth.

Economic growth in India rebounded in 2021 and is expected to remain strong in 2022. IMF projects growth for FY 2022 (April 2021 to March 2022) at 9.0% and for FY 23 at 7.1%. The current government has pursued a large number of meaningful economic reforms which we think sets up the country for robust growth in the medium to long-term. Venture capital inflows into the country are at an all-time high - $19.5 billion for the year, through the third quarter of 2021. Tax collection remains strong and investments in much needed infrastructure and effective social programs have increased.

5. Wall Street Journal January 28, 2022 *6. https://carnegieendowment.org/chinafinancialmarkets/85179*



We expect 2022 to be somewhat choppy as the markets adjust to inflation expectations, a hawkish Fed, and the impact of rates on the Economy. Fed Chairman Powell tone on rates may be part of an attempt to adjust inflation expectations without having to tighten monetary policy to an extent where economic growth is significantly impacted. It appears that the Federal Reserve's change in tone is having an impact on the structure of rates.

The US Yield curve has flattened significantly suggesting slowing economic growth and inflation ahead. While it is difficult to predict when the supply chain problems get sorted out, given the global pandemic, we think inflationary pressures are likely to moderate as we head to 2023. The MSCI US Index was down about 10% (as of January 27, 2021), but the last several months have seen deep corrections in high valuation stocks, with a large part of the Nasdaq in deep bear market territory. We expect markets to recover and post a low return (5-10%) for the full year.

Updates on Portfolios (detailed performances since inception can be seen in Appendix I):

2021 PERFORMANCE	Portfolio	Benchmark	Morningstar Category Median
INTERNATIONAL VALUE	14.45%	10.89%	11.40%
GLOBAL	24.03%	18.54%	18.04%
EMERGING MARKETS	4.94%	(2.54%)	0.08%

We are happy and grateful that all three strategies had strong performances against their respective benchmarks. The turnover in the portfolios remains low ranging from 6.76% for International Value, 15.33% for Emerging Markets and 18.67% for Global (all are annualized and inception to 12/31/2021 and include additions and reductions in portfolio positions). The portfolios are also focused with the number of companies in the 20-30 range. Our investment philosophy can be summarized as:

- Principally bottom-up, fundamental investors
- Generational outlook, companies that can be held as long-term investments
- Purchase at attractive discount to intrinsic value
- Risk is the permanent loss of capital (we view volatility as an opportunity and not a long-term risk)
- We focus on cash flow generation and return on capital
- We assess management's capital allocation decisions alignment with minority shareholder interests

The International Value portfolio has an additional focus on current shareholder returns in the form of dividends or share buybacks. This portfolio has a current weighted average current dividend yield of 3.3% and an average Free Cash Flow Yield of 6.0%.

Portfolio changes and performance attribution

Global: We added three new names- Lockheed Martin, Oracle, and Intel. We reduced positions in PayPal and Twitter at the start of the year, and in Costco, Alphabet and SEI towards the end of the year. Performance was driven by the fact that our largest positions Alphabet and Wells Fargo performed well. The new additions are all companies which we assess to be fundamentally strong but had underperformed due to issues that we think will be addressed over the next several years. The Global strategy has a short track record but has added significant value in terms of outperforming the MSCI ACWI benchmark and the Morningstar Peer Group.

International Value: We added BASF, SAP, and Perrigo during the year. We exited Fanuc and Banco de Chile. The new companies in the portfolio trade at very attractive valuations in terms of cash flow and dividends and are engaged in actions that are improving company fundamentals incrementally. We believe they represent better long-term value than the positions we exited. Performance was driven by some of our larger positions like ICICI Bank (closed the discount to peer HDFC Bank), Diageo (strong pricing power) and Eaton (focus on margins and long-term growth). All of these are positions we have held for a long time. The International Value strategy has performed in the top decile over the long term, with substantial value-add.

Emerging Markets: we added Unilever to the portfolio and acquired Brazilian company Asai through a spin-off from a position in CBD. Unilever has large exposure to many emerging countries like India and Indonesia and has underperformed for several years. We think the company's brands and distribution are long term winners. The recent acquisition of a stake by activist investor Nelson Peltz's Trian Partners is in line with our thinking that there is significant value in the company. Some of the highlights of our analysis (see below) indicate that the company has shown steady growth and maintained strong profitability and return on capital.

Unilever	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	Total
Start (Euro Bn)	**51.3**	**49.8**	**48.4**	**53.3**	**52.7**	**53.7**	**51.0**	**52.0**	
Volume	2.2%	1.0%	2.1%	0.9%	1.0%	2.0%	1.2%	1.6%	12.0%
Value Growth	2.2%	1.9%	1.9%	2.8%	2.4%	0.8%	1.6%	0.3%	13.9%
Acquisitions				0.6%	0.9%	2.0%	0.7%	1.4%	5.60%
Disposals	-1.1%	-0.9%	-0.1%			-3.0%	-3.0%	-0.2%	-8.30%
Currency	-5.9%	-4.6%	5.9%	-5.1%	-2.1%	-6.7%	1.5%	-5.4%	-22.4%
End year	**49.8**	**48.4**	**53.3**	**52.7**	**53.7**	**51.0**	**52.0**	**50.7**	

Return Ratios

Ratios	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Return Ratios											
Core ROIC	23.6%	21.4%	23.3%	25.3%	25.9%	21.3%	20.8%	19.6%	23.0%	20.8%	20.7%
Pre-tax ROIC	27.6%	23.6%	28.1%	30.5%	32.5%	26.5%	24.7%	24.3%	25.9%	25.0%	23.0%
Return On Equity	31.7%	31.4%	31.4%	36.7%	40.4%	34.1%	33.9%	43.3%	86.1%	45.7%	39.8%
Return On Equity (ROE)											
Net Profit Margin	10.4%	9.7%	9.4%	10.6%	11.4%	9.9%	10.5%	11.0%	19.3%	11.6%	12.0%
Assets Turnover	1.08	0.98	1.11	1.09	1.01	1.02	0.93	0.89	0.83	0.80	0.75
Leverage	2.84	3.32	3.00	3.17	3.52	3.39	3.45	4.42	5.36	4.91	4.43
Profitability Ratios											
Gross Profit Margin	41.5%	39.9%	46.9%	47.9%	47.7%	48.5%	48.8%	49.2%	43.7%	44.0%	43.5%
Operating Margin	14.3%	13.8%	13.6%	15.1%	16.5%	14.1%	14.8%	16.5%	18.6%	19.1%	18.5%
Net Profit Margin	10.4%	9.7%	9.4%	10.6%	11.4%	9.9%	10.5%	11.0%	19.3%	11.6%	12.0%

Positions exited during the year were Universal Robina & Arcos Dorados (better risk/reward in Unilever), Tencent Music (sold on run-up, before the Archegos blow-up), Ping An Insurance (consolidated position in AIA with proceeds). Our underweight to China which impacted performance negatively in 2020, helped in 2021. The Emerging markets strategy does not have local access to several of the larger emerging markets- India, Taiwan, South Korea, and Brazil. This limits our ability to add value. The 5-year performance is in the upper 1/third of active managers in the Morningstar universe despite this significant handicap.

We would like to welcome on board Analyst Sheel Shah, who has helped our research efforts. We would also like to thank our partner firm Sameeksha Capital and its founder, Bhavin Shah.

APPENDIX I

INTERNATIONAL VALUE

	Portfolio	MSCI EAFE Value	Morningstar FV Category	Comment
2016	(3.20%)	6.90%	n/a	*Start date 8/1/2016*
2017	24.27%	21.43%	22.08%	
2018	(14.28%)	(14.78%)	(15.50%)	
2019	22.84%	16.09%	17.83%	
2020	7.62%	(2.63%)	0.93%	
2021	14.45%	10.89%	11.40%	*YTD 12/31/2021*
ITD	55.93%	38.65%	n/a	*Cumulative (8/1/2016 to 12/31/2021)*
ITD	8.55%	6.22%	n/a	*Annualized (8/1/2016 to 12/31/2021)*
1-year	14.45%	10.89%	11.82%	*Annualized*
3-year	14.80%	7.82%	10.15%	*Annualized*
5-year	10.01%	5.34%	6.78%	*Annualized*
5- year Analytics				
Sharpe ratio	0.63			
Sortino ratio	1.03			
Upside capture	87.78%			
Downside capture	69.93%			

GLOBAL

	Portfolio	MSCI ACWI	Morningstar WLS Blend Category	Comment
2020	31.80%	23.10%	n/a	*Start date 7/1/2020*
2021	24.03%	18.54%	18.04%	*YTD 12/31/2021*
ITD	63.48%	45.92%	n/a	*Cumulative (7/1/2020 to 12/31/2021)*
ITD	38.77%	28.65%	n/a	*Annualized (7/1/2020 to 12/31/2021)*
1-year	24.03%	17.73%	19.27%	*Annualized*
ITD Analytics				
Sharpe ratio	2.68			
Sortino ratio	9.21			
Upside capture	110.93%			
Downside capture	55.45%			

EMERGING MARKETS

	Portfolio	MSCI EM	Morningstar EM Category	Comment
2016	2.71%	8.67%	5.42%	*Start date 6/1/2016*
2017	41.92%	37.06%	34.17%	
2018	(11.93%)	(14.58%)	(16.07%)	
2019	19.63%	18.42%	19.26%	
2020	6.70%	18.31%	17.91%	
2021	4.94%	(2.54%)	0.08%	*YTD 12/31/2021*
ITD	72.10%	73.99%	67.07%	*Cumulative (6/1/2016 to 12/31/2021)*
ITD	10.21%	10.43%	9.63%	*Annualized (6/1/2016 to 12/31/2021)*
1-year	4.94%	(2.54%)	0.40%	*Annualized*
3-year	10.22%	10.97%	12.42%	*Annualized*
5-year	10.85%	9.87%	10.00%	*Annualized*
5- year Analytics				
Sharpe ratio	0.52			
Sortino ratio	0.76			
Upside capture	108.33%			
Downside capture	94.01%			