

## GREETINGS FROM THE NORTHWEST!

It's a new year, and, I hope, a happy one! I had to check the calendar to believe that it's been three years now since I took the helm from Jim and began writing the opening lines of these newsletters, and what a three years it's been! It's a matter of fact that none of us truly knows what the future holds, but I must say, "How could I have known" that Covid would shut down the economy in just a matter of weeks, tanking the stock market with it, and that massive government aid and a taste for speculation would propel markets to new highs while the pandemic still raged?

In that first newsletter we were already expressing concern that markets were pricey and that risk-taking behavior was higher than warranted. Patrick shared the CNN Money Fear & Greed Index, with the indicator firmly planted in the "Extreme Greed" quadrant. I did not track that meter much over the next year, but it must have been quite dynamic as the events unfolded. As I write this, it is firmly in the "Fear" quadrant.

We know now, that in fact, many assets were overpriced, and some hard lessons were learned by those who chased performance or went all in on the "highfliers." I'm glad that I never participated in the Crypto Craze and both Patrick and I gave consistent advice against it. That's just a foundational part of who we are and how we think, rather than some precognition or other talent. Our beliefs and our processes have served us well as the market has deflated off its highs this year and will continue to provide a buffer against what may come.



### OF NOTE

:: Cairn welcomes Stefanie Schneider as our Client Service Manager!

### CAIRN CLOSED:

:: MLK Day Monday January 16  
:: Presidents Day Monday February 20

### IT'S ALMOST TAX TIME:

:: 1099-Rs available late January  
:: 1099-Composites available late February  
:: 2022 IRA Contributions due by April 18

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*—Tim Mosier*

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—Patrick Mason

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Speaking of which, I see 2023 as a year of reckoning with number of issues, not all financial in nature. A new burst of economic growth is unlikely to happen until inflation is back to reasonable levels. We'll all have to live with new higher interest rates and adapt our personal economic decisions around them. So too, our political leaders will need to grapple with this, as the cost of funding their unprecedented spending is no longer free. The war in Ukraine needs to get resolved in favor of Ukraine for many reasons; one is that the adoption of Ukraine into the European community and the rebuilding that will follow may well be “the thing” that launches our next recovery. The opposite outcome is too bleak to consider.

With that I'll hand things over to Patrick for a more specific and detailed examination of your investment prospects.

### PATRICK'S PART

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What a difference a year makes. As Tim mentioned, at the start of 2022 investors were trumpeting the strong stock market returns and accommodative fiscal and monetary policy that 2021 witnessed. Although 2021 had ended well, we discussed in our [4th quarter letter](#) that inflation pressures were starting to alter consumer sentiment, which could have a profound impact on corporate profits and valuations. Well, here we are a year later, and valuations have slightly improved, with the S&P 500 having fallen over 18%, whereas international stocks measured by the MSCI EAFE fared slightly better, declining by over 14%. Negative performance in the bond market is what caught most investors by surprise, with the Bloomberg US Aggregate declining more than 13%. Seeing both

stocks and bonds decline at the same time is not something most investors are used to experiencing, leaving the unprepared asking, “Where can I hide?”

Thankfully, we at Cairn were prepared for what had transpired and were able to avoid many of the large drawdowns in stocks and bonds. Our disciplined process is built around finding unrecognized value in companies and asset classes, and then making sure we are compensated enough for the risks that could unfold. If we are not finding opportunities, we are more than willing to hold cash, which was one of the best performing asset classes in 2022! Many of you have expressed concerns in the past about holding cash, since interest rates were at very low levels. My response was always two-pronged: First, cash gives you instant optionality to do something different without having to sell something in your portfolio that you might not want to sell. Second, cash is the BEST short-term inflation hedge. As inflation and short-term rates start to rise, your cash rate adjusts and the nominal value of your cash does not go down, unlike stocks and bonds.

Many of the Covid darlings that rewarded investors in 2020 and 2021 saw their share prices drop by 50-80% in the last year as interest rates increased and concerns about future growth took center stage. We have discussed this many times in the past, that the price paid for an asset is the largest determiner of your future return. Growth investors learned

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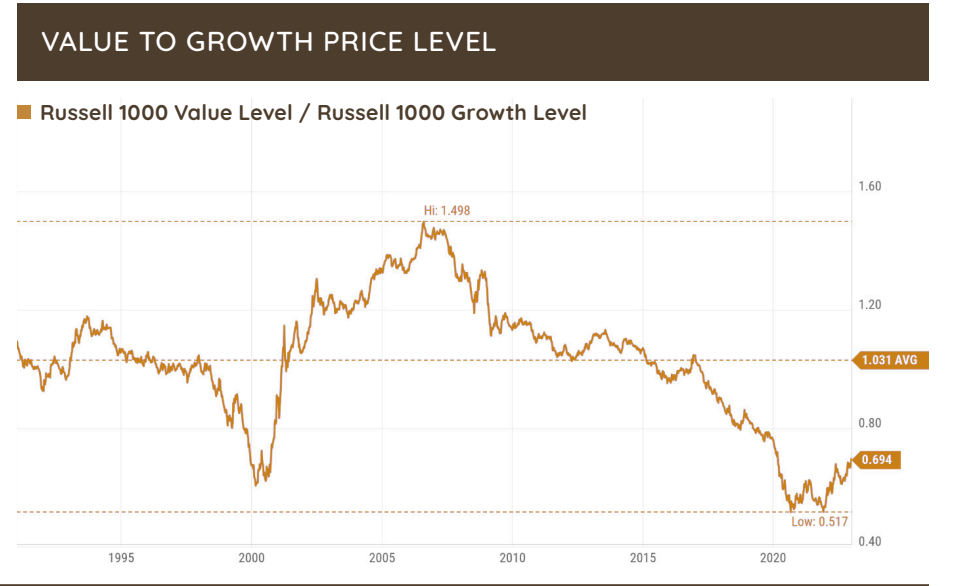
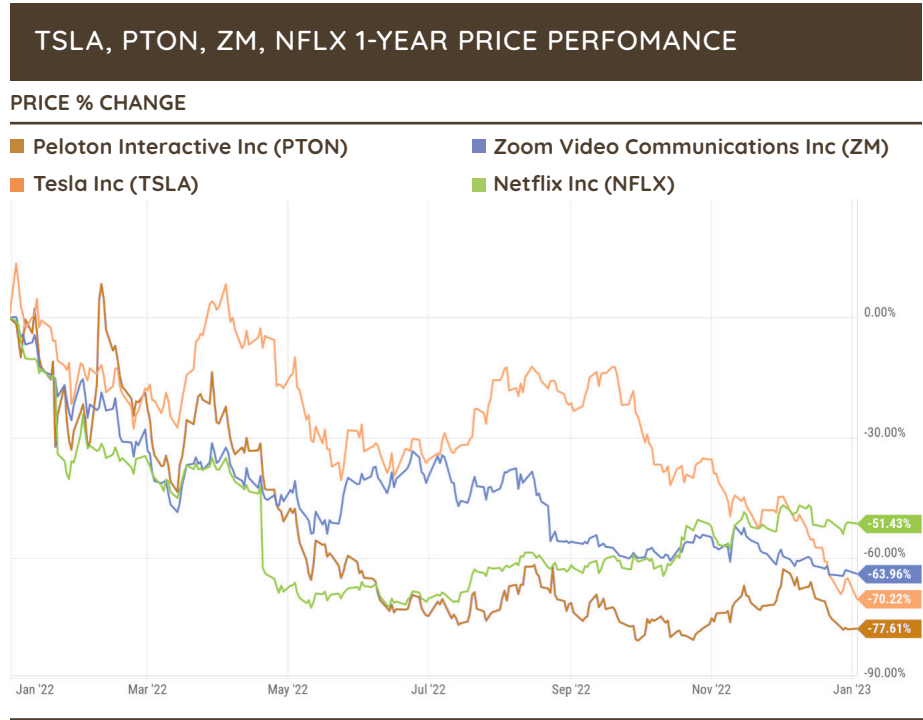
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this lesson in real time. The chart below shows the one-year price performance of four of the Covid darlings; Tesla, Netflix, Zoom Video, and Peloton Interactive.

Equal weight ownership of these companies would have produced a return of -64% in 2022. I have nothing against any of these four companies (I love my Peloton); I just use them as an example that large losses can be realized by paying too high a price for even disruptive and innovative companies. In fact, of these four companies, only Tesla has had a

positive price performance over the last 3 years. Large losses destroy compounding much faster than the benefit of a large unrealized gain.

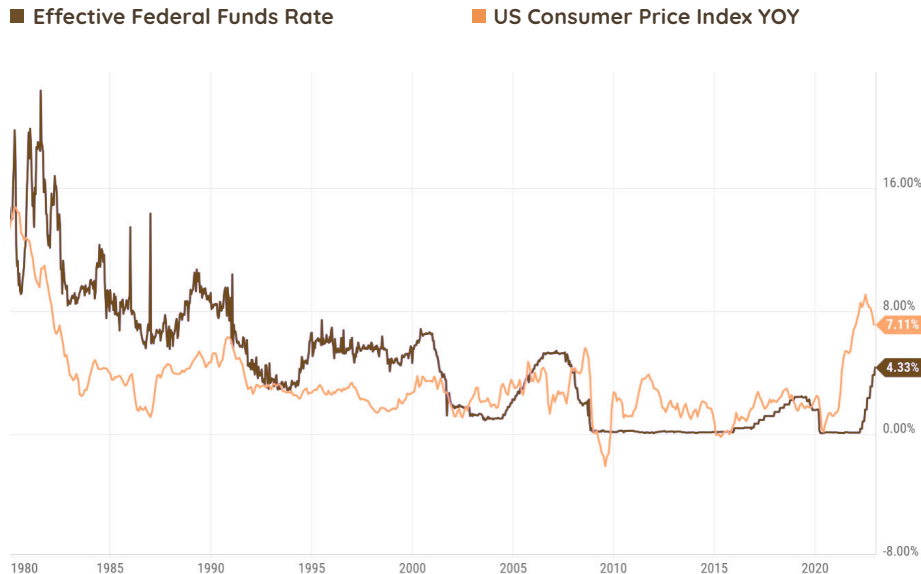
Our disciplined value philosophy also served us relatively well during 2022. I must admit, my patience was put to the test from 2014-2021 as value underperformed growth by a wide margin, prompting many headlines stating that value was dead. Though one year does not signal a complete shift in trend, I am happy to hear that argument going silent. As the chart below shows, value stocks have outperformed growth stocks by over 30% from their lows of November 2021. If history is any guide, we are still in the early stages of this outperformance, especially given the current inflation and interest rate backdrop.



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Concerning inflation and interest rates, as we have said many times, we are not in the business of predicting the direction of inflation and interest rates but will observe where we are now to make decisions. Our view based on the current data is that inflation will continue to come down from its peak levels witnessed in the fall. Many pressures that caused the spike in inflation will inevitably roll off as the months go on. The Fed has stated that they intend to keep short-term rates higher than inflation for longer than what capital markets might expect. We will see. Historically, the Fed has changed their tune as soon as financial stress gets too painful. The strong performance of stocks during the 4th quarter seems to point to the “hope” that the Fed will have to reverse course sooner than later. But as a reminder, the Fed has never cut rates when inflation is above the Fed Funds Rate. And looking at the chart below, we still have a way to go.

### INFLATION AND FED FUNDS RATE



As we enter a new year, our portfolio positioning remains defensive as risks are still tilted towards the downside. If we get a more material retreat in valuations or price behavior improves, we will be more than happy to put some of our excess cash to work. From an asset class perspective, we still have a positive intermediate term view on international stocks, though that was not materially helpful during 2022. With the strength in the US Dollar starting to subside, international equities could provide a nice tailwind in the future as valuations are much more attractive than broad US stocks. Thank you again for your continued trust and support. I'm always happy to discuss any of these topics in more detail, so drop me a line anytime. —Patrick Mason

Thank you, Patrick. You may have noticed that a smiling new face has been added to our team in the form of Stefanie Schneider. Hopefully, more of you will make it into the office as the season turns, and have a chance to introduce yourself. Remember, the coffee is always hot and free.

Happy Trails,

Tim Mosier, President,  
Cairn Investment Group, Inc.

