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Market Update – *Pick Your Poison*

by David A. Jaffe, M.D.

I've been fond of noting the skill with which stock market pundits can identify the elements of a market move *after the fact*. The current global economic environment leaves one wondering if there's any need to be "Smarter Than a 5th Grader." The U.S. stock market ended the first quarter of 2022 with its biggest decline since the dramatic pandemic-induced market plunge of March 2020, with the S&P 500 posting a drop of 4.60% for the quarter (including reinvested dividends).

There is one unifying factor behind most of the headwinds for stocks – *the worst inflation in 40 years.* The consequences are varied but linked:

- The Federal Reserve is raising interest rates and withdrawing support for fixed income markets in an effort to slow the economy and rein in climbing prices
- Investors worry that the Fed action will precipitate a *recession*, a fear borne out by history
- Bonds, which experience a decline in market value in a rising interest rate environment, have posted their biggest quarterly price drop since 1980
- The U.S. dollar has strengthened, making exports for domestic multi-national companies more expensive (and shrinking profits)

First spawned by the global pandemic and related supply chain disruption, worker shortages, and a surge in demand from well financed consumers emerging from the COVID imposed lockdown, inflationary pressure is now being heightened by the tragic war in Ukraine and associated escalation in energy prices and shortages of commodities including food crops and basic materials.

Some brave market seers actually broadcast their current forecasts, but whether you choose to share camp with the optimists or pessimists, it seems a foolhardy endeavor in such complicated and uncertain economic times. The day traders and computer algorithms may choose to react to short-term measures and fuel market volatility, but how stocks will fare over the next 1-3 years is likely to be determined by how difficult the Fed's task of curbing inflation turns out to be, and whether their efforts trigger a recession.

It seems unlikely that we will have any clarity for months, at best. And it is exactly for this reason that our investment strategy includes stock diversification with exposure to both economically sensitive companies and to those with steady businesses through economic cycles. Further, despite some volatility in the market value of bonds (truly a "paper change" as long as bonds are held to maturity), our short-term ladder, ranging 1-5 years, means that we will always have bonds maturing in a serial fashion and fixed income dollars being reinvested at current interest rates, whether rates are climbing or declining. We are, however, experiencing an unusual coincident drop in both stock and bond prices; the PASI composite stock portfolio declined 5.62% for the quarter (including reinvested dividends), while our corporate bonds posted a fall in price of 4.12%.

There is no denying that this is an uncertain and challenging environment. For perspective, it is worthwhile to recognize that looking backwards through recent economic history, we have weathered a global pandemic (2020), real estate market collapse (2008), deflation of the "dot-com" bubble (2000), emerging markets collapse (1998), bond market "crash" (1994), the Gulf War and associated recession (1990-1991), stock market crash of 1987, and let's conclude with the last period of very high inflation and *double digit* interest rates, the early '80's. While the level of distress and dislocation varies, we ultimately find our way through such difficulties.

"For Keeps"

by Nathan Polackwich, CFA

My most important task at PASI is analyzing the annual reports of the companies that comprise the stock portfolio. The reports start dribbling in around early February and then become a flood by mid-March. Because I spend a meaningful amount of time on each company and PASI usually holds at least thirty stocks, I typically don't catch up until early May.

Along with keeping us informed about our stocks, these reports help us compare the fidelity of our prior thoughts on a company to its current situation. One tends to remember previous views as more accurate than they actually were so keeping a record is essential to improving our investment decision-making. If we were right, great! But if wrong, we must assess the reasons to hopefully avoid similar mistakes in the future.

There are really only two miscalculations you can make when buying a stock – 1) The business doesn't perform as well as you thought, and/or 2) the valuation other investors are willing to pay is less than you had hoped. These two outcomes don't always occur in concert. Sometimes a business underperforms your expectations and yet the stock's valuation rises much higher than you thought possible (often a selling opportunity). Other times, a business exceeds your expectations for profit growth, but the stock price disappoints (often a time to buy more).

In *The General Theory of Employment Interest and Money* (1936), the economist John Maynard Keynes famously compared the stock market to a hypothetical newspaper beauty contest where readers must select the six prettiest faces from a hundred photographs. The contest winner is the one whose six choices come closest to matching the most common selections of all the other readers.

As Keynes explained, the best strategy in such a contest is not to choose "those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be." Similarly, most investors and speculators "are concerned, not with what an investment is really worth to a man who buys it 'for keeps,' but with what the market will value it at, under the influence of mass psychology, three months or a year hence."

PASI seeks the stocks of companies we can own "for keeps." We're not in the business (nor do we think it's possible to consistently succeed) of trying to anticipate which stocks will happen to catch investors' and speculators' short-term fancy. What we do know is that while a stock's price may fluctuate significantly from month-to-month and even year-to-year, it will tend to follow the path of its profits over the long-term. A company that makes five times as much money a decade from now is likely to be worth a lot more at that time than it is today – perhaps not exactly five times more, but probably somewhere in the vicinity.

As stock investors we consider ourselves to be owners of businesses. Warren Buffett once counseled, "I hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around daily and that is a candidate for sales when some economic or political event makes you nervous. We hope you instead visualize yourself as a part owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartment house in partnership with members of your family."

The stock price "wiggles" we've experienced in 2022 have so far been a bit more negative than positive. But what's striking to me as I go through this year's stack of annual reports is how phenomenally strong our businesses' underlying fundamentals continue to be. For example,

- In March 2021 Wall Street analysts expected PASI stock United Parcel Service (UPS) to earn $8.28 per share for the year. The Company demolished those estimates by almost 50%, reporting $12.13 in annual earnings. UPS' revenue surged over 18% organically (excluding acquisitions and dispositions), a phenomenal result for a mature, blue-chip company. Since June 2020, the Company has been led by a new CEO, Carol Tomé, who has cut unnecessary costs and shifted UPS' focus to serving more profitable small and medium size businesses (vs. behemoths like Amazon and Walmart) as well as business-to-business shipping. The result has been a surprisingly large profit margin expansion.

- Health insurer Anthem (ANTM) beat its 2021 profit forecasts nicely, earning $25.98 vs. the $24.81 analysts expected. Revenue continued to grow solidly, up 13.2%, following exceptional 17.2% growth the previous year. Anthem is the largest provider of Blue Cross Blue Shield health insurance policies in the U.S. Year-after-year the Company generates impressive returns with low single digit member growth, price increases, and the sale of ancillary services. As an example of the latter, in 2019 Anthem launched IngenioRX, a pharmacy benefit manager to help its customers better handle their drug costs. Just two years later in 2021, IngenioRX produced $25 billion in revenue, accounting for 20% of Anthem's entire business.

- Toolmaker Stanley Black & Decker (SWK) was expected to earn $10.25 last year. They beat that number by nearly a dollar, reporting $11.20 with organic revenue exploding 17%. Following the bursting of the housing bubble in 2008, new construction in the U.S. collapsed, averaging just over 900,000 homes a year vs. 1.5 million from 1970-2008. The result today is a severe shortage of housing as Millennials start families and enter their prime homebuying years. In addition, while housing demand has soared, advances in battery storage technologies are driving a switch from gas to electric tools and a strong upgrade cycle among Stanley's customers.

- Analysts expected regional bank U.S. Bancorp (USB) to earn $3.77 in 2021. Instead the Company posted $5.10 in earnings. USB's charge-off rate (bad loans written-off) was just 0.23% of total loans outstanding, the lowest figure in at least 15 years. Like Stanley Black & Decker, we expect U.S. Bancorp to benefit from the secular growth of the U.S. housing market. In addition to growing its loan book, U.S. Bancorp also generates strong fee income (almost half of total revenue) including from credit/debit card processing, corporate trusts, and investment management.

- Early last year analysts expected Alphabet, Inc. (GOOG) to hit $67.81 in earnings in 2021. Alphabet almost *doubled* those estimates, making a ridiculous $112.20 with revenue up an otherworldly 41.2%. Alphabet is a beneficiary of the network effect. The more people use the Google search engine, the more data it collects, and the better its search engine becomes, further widening its competitive advantages. The Company uses machine learning (artificial intelligence) to improve search results and is applying this technology to other products such as speech recognition, Gmail (Smart Reply), Google Photos, Maps, and its cloud services for business data management (Google Cloud Platform). Alphabet's margins have been hampered in recent years as less profitable smartphone ad revenue grew much faster than the desktop business (with smartphones Alphabet must pay access providers like Apple a fee). But with the shift to mobile ads now largely complete, Alphabet's operating margin will likely expand, providing another boost to profits in addition to its spectacular revenue growth.

- Social media company Meta Platforms (Facebook or FB) reported $13.77 in 2021 earnings, well above the $11.29 analysts were anticipating. Revenue also grew a whopping 37%. Like Alphabet, Facebook benefits from the network effect – the more people use Facebook and Instagram (now over 2.9 billion monthly users), the more interesting content they upload, and the more other people want to join. Although Apple's recent privacy changes have made it more difficult for Facebook to gather some of the data it needs to target advertisements, in 2021 Facebook still managed to deliver 10% more ads and increase prices 24% per ad. Four years ago six million businesses actively advertised on Facebook. Now over 10 million do and that number should continue to rise, as over 200 million businesses around the world (93% of the total) already have a Facebook or Instagram presence.

In addition to their exceptional business performance, the companies above also emphasize how difficult (actually impossible) it is to predict short-term stock returns. Although we know that all six companies' businesses performed superbly and exceeded expectations by various amounts for the year, here's how their stocks did over the last 12 months: UPS +30%, Anthem +33%, Stanley Black & Decker -28%, U.S. Bancorp -1%, Alphabet +39%, and Facebook -21%. Even if you knew exactly how well each business would do, it would have been impossible to predict how each stock would perform.

The same is true for the overall economy. Over the past two years the world has endured the worst pandemic in a century, an almost complete breakdown of global supply chains, the highest inflation in 40 years, the beginning of Federal Reserve interest rate hikes, and a major land war in Europe. Even if you knew all this was coming, who could have predicted the U.S. stock market would be 41% higher than at the start of 2020?

The lesson? Stock prices will fluctuate in the short-term and there will always be worrisome global events. But don't overthink things. Even if economic or political outcomes go as badly as you fear, the last two years should convince you that stocks may rise anyway! And amazingly, profit growth has been so strong that PASI stocks all still trade at highly reasonable – and in many cases compelling – valuations. So long as you own great compounding businesses "for keeps" like we do, bad times are always just opportunities to buy more.

Fiserv: The Engine that Moves Money

by Jeremy Goldberg, CFA

Payment processing has come a long way since The Western Union Telegraph Company launched the first electronic fund transfers system in 1871. Now, more than 15 million same-day wire transfers are processed *per day* in the U.S.[1] The old saying, "Money makes the world go 'round" isn't just a clever line from Broadway. Economic productivity *requires* the movement of money, and the importance of accurate and safe payment processing systems cannot be overstated. This underpins our thesis on Fiserv Inc (FISV). You have likely used one of Fiserv's point-of-sale (POS) systems when purchasing an item in-store or online, and you have probably interacted with the company's digital infrastructure when using online banking. As a global provider of payments and financial services technology (FinTech) solutions – with the scale and technical expertise second to none – we believe Fiserv will remain the leader of money movement.

Fiserv's **FinTech** segment (20% of company profits) provides the most mission-critical systems used in global banking operations, from processing deposit and loan accounts and posting daily transactions to managing general ledgers and central information files. FinTech also provides complementary technology solutions like digital banking, cash management, financial and risk

[1] Monthly Fedwire Funds Service Statistics report from the Federal Reserve Bank Services (www.frbservices.org)

management, and professional services and consulting. Fiserv has proven to be a key partner for retail customers, small banks, and global financial institutions. Multi-year contracts and high switching costs enable Fiserv to have a customer retention rate approaching 99% annually, and high levels of Consumer Price Index (CPI) clauses shelter FinTech's business from inflation.

Fiserv's two other business lines, **Payments** (45% of profits) and **Acceptance** (35% of profits), work together to offer complete money movement capabilities from consumer bank accounts to merchant bank accounts. Paying with cash is simple. It's a direct, physical transaction where no technology is needed. Consumers, however, increasingly prefer other (debatably more convenient) payment methods, like credit and debit cards, physical and electronic checks, gift cards, and peer-to-peer payment apps. Despite easy-to-use interfaces and fast payment processing, noncash transactions are a complicated process involving multiple intermediaries and additional fees. To further complicate matters, various sales channels need to be integrated too, like brick-and-mortar retailers, online websites, and mobile devices (phone or tablet). Now, even virtual assistants can initiate transactions by voice command!

This is where Fiserv adds significant value to both businesses and consumers. In today's physical *and* digital economy, businesses must be able to accept payments easily, process payments securely, and settle funds quickly regardless of a payment method. Let's consider the steps in a standard credit card-based transaction:

1) A Business captures Customer credit card details at checkout via a *POS system* (in-person) or *payment gateway* (online or "card-not-present" transaction).
2) The Business' payment processor routes encrypted payment details through the credit card network (Visa, Mastercard, Discover, American Express) to the Customer bank.
3) The Customer bank approves or declines the transaction, and the *payment processor* returns the decision to the *POS system* or *payment gateway* via the same channels.
4) When transactions are approved, the Customer bank releases funds to the Business' holding account until funds settle, which typically takes 48 hours.
5) Once settled, funds are distributed into the Business' bank account *minus* fees. The Business must pay an interchange fee to the Customer bank, a service fee to the credit card network, and a processing fee to the payment processor.

Fiserv's **Acceptance** segment allows businesses to capture payment information via a *POS system* or *payment gateway* and offers its own *payment processor* for an all-in-one solution. With leading financial hardware, software, and cloud capabilities, Acceptance has two major products lines: Clover for small and medium-sized businesses and Carat for large businesses. The image to the right is an example of some of Clover's POS system hardware.

Both Clover and Carat compete with Block, Inc (formerly Square). Fiserv management has yet to release gross payment volumes for Carat, but we know Clover processed an annualized payment volume of $201 billion as of 4Q 2021 as opposed to Block's $185 billion. Of note, the Acceptance segment is only 35% of Fiserv's profits. *So Clover – one part of Fiserv's Acceptance* *segment – processes more payment volume than all of Block's business, but Fiserv's market capitalization is $65.2 billion vs. Block's $71.5 billion.* We are happy to take advantage of this ostensible market anomaly.

While the Acceptance segment handles the transaction for the Business, the **Payments** segment handles the transaction for the financial institution. Fiserv's Payments software enables financial institutions to process digital transactions, including debit and credit card usage, online bill pay, and ATM withdrawals. This technology even provides the interface, risk management, alerting, and settlement services to clients using Zelle, the peer-to-peer payment service offered by nearly every bank in the U.S.

Money movement is evolving, and financial institutions will continue to benefit from shifting in-house technology to third-party providers that can keep pace with regulatory, cybersecurity, and operating environment changes. We believe there's no better partner than Fiserv. The company offers omnichannel payment solutions, retains significant capital and human resources, and is winning market share. Boasting 7% to 9% organic revenue growth over the medium-term, substantial recurring cash flows, and minimal default risk, Fiserv's fundamentals are first class. The company is expected to earn (on an adjusted basis) $6.44 in 2022 and $7.45 in 2023, valuing shares using a forward price-to-earnings ratio at 15.5x and 13.4x, respectively. Coupled with a strong track record of compounding earnings, we judge Fiserv shares a compelling buy!

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