Robotti
Value Investors

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Dear Investor,

We are happy to report that 2021 was a very good year for our investments, as we outperformed both our benchmark and the S&P 500. We recognize that the last decade has been a difficult one, but our bottom-up research indicates that what we are seeing now is the ushering in of a new decade that should be a fantastic environment for our investments. We tried to gather our thoughts in a white paper written by Robotti & Company in conjunction with one of our institutional investor partners, van Biema Value Partners to help try and explain what has happened, and what is to come. Below you will find an abridged version of the paper, but of course we are happy to provide the full version upon request. We hope that this helps illuminate our thought process, and why we are so excited about what the future has in store for our investments.

We submit that the *myopia of linear thinking* has resulted in a tremendous misalignment of risk and return. Much of what is taken today as a high-return investment opportunity set is fraught with an unhealthy helping of risk, and much of what is perceived as having low-return potential provides an opportunity for *high returns with lower risk*. Much of the latter set is in fact *very* cheap, with excellent growth potential and high barriers to entry, fortified by the world's focus on climate protection. Structural changes for these attractive investments have been either ignored or mischaracterized as transitory events. This is dawning on investors.

However, appreciating this requires recognition that the period following the Global Financial Crisis (GFC), and extended by the current pandemic, has been highly anomalous and is in fact transitory. Despite the investment world's current amnesia, economic cycles live on and they are growing from within. The evidence is readily available for those willing to look, but it is almost universally ignored. Our ***grass-roots macroeconomic*** observations make that clear.

Interest rates are wrong… and they have been wrong for a long time now.

Interest rates have dominated financial dialogue for years now. There's very good reason for this: the Fed has kept rates depressed since the GFC in 2008. The novelty of the last decade really has been lost on investors. That makes sense. Since that start in response to the GFC, governments have continually flooded the world's economies with liquidity to trickle up economic activity. Repeatedly blips occurred in markets and, in response investors fled to "safety," preeminently US Treasuries. Then the Fed and their ilk bought government debt to stabilize the financial system. Whether it was economic slowdowns, tariff wars, "taper tantrums", etc., the same responses ensued. It has been a financial "Groundhog Day." The result is that most investors have learned these so-called lessons of the "new paradigm" from extensive and expensive experience.

That constancy of strong performance by certain securities has had a huge impact on the flow of funds and the allocation of capital. It's driven a frantic search for yield, squeezing investors into longer-duration assets such as large-capitalization growth stocks, thereby compressing earnings yields to dangerous levels. Year after year, these assets have attracted more and more capital occupying greater proportions of widely referenced indexes.

Index investing has both benefitted and, doubtlessly, contributed to this pattern as passive capital continued to chase momentum. And many fundamental investors have bought in too. Style drift? Time will tell. These businesses became more attractive because widespread economic growth has been tepid throughout the decade. Businesses with a high probability of growing do make for more attractive investments than businesses dependent on broad economic growth, such as those in mature industries, especially those that are historically cyclical.

Current market trends remain reliant on the persistence of the low-rate, low-growth and, perhaps most importantly, low-inflation economic state. But inflation has indisputably arrived. And what's driving that is economic growth. So, it is clearly time to take stock and come to terms with the implications.

Inflation: Here today, gone tomorrow? Keep dreamin'

Markets do not appear to know what to make of today's inflation. The main debate seems to be between those who believe today's inflation is simply a transitory effect of pandemic-induced supply chain disruptions, on the one hand, and those who believe it is still the effect of those same transitory supply chain issues, but more persistent. Either way, inflation is seen as the result of a temporary kink in the supply chain. Both sides seem in agreement that once that clog is cleared, inflation will flush away too.

But while these two sides battle it out over the duration of pandemic-induced inflation, there are more ominous forces hiding in plain sight that would seem to suggest inflation will not drain out as soon as the ports clear. A critical component to this, we believe, is China.

It made perfect sense for rates to fall after taming the hyperinflation of the 1970s. But the continual downward trend since is stark. We note, this stark trend coincides with the dramatic reforms of China's economy under Chairman Deng Xiaoping. Those reforms encouraged investment in private businesses with the aim of transforming an agricultural state into a modern economic superpower, a goal that has clearly been achieved. Though it has not been a smooth trajectory, China's economy has grown at an average annual rate of 9.3% since reforms began.

China was, of course, able to perform this economic miracle in large part because Chinese businesses were able to produce goods that consumers in more developed economies wanted, and they were able to produce them at a much lower cost than anywhere else. Several factors contributed to this low-cost advantage, not the least of which was extremely cheap labor. As China produced more and more for the rest of the world, their lower-cost advantage became more and more impactful. If roughly half of what you buy was produced at substantial discounts, that is bound to weigh on prices. As a result, inexpensive Chinese goods prevented inflation from taking hold around the globe. China was the source of that giant sucking sound of costs rushing out of the world economy.

It's also worth taking note of the dramatic measures China has taken over the past year in the name of narrowing its wealth gap, an unwelcome byproduct of its economic miracle. Combatting inequities head-on, for instance by gutting the for-profit education sector, may be a quick and easy way to demonstrate this commitment. But ultimately a continuous build-out of China's infrastructure, connecting all its 1.4B people to economic activity will take an enormous amount of broadband cable, steel, and cement. China itself is consuming more and more of the cable, steel, and cement it produces. As a result, less and less Chinese base materials will reach foreign shores, deflating prices here, and thereby compressing the margins of US producers. This dynamic also opens export markets to low cost North American producers. That has, in fact, already been the experience of many basic materials producers in recent years.

If so, it is difficult to see how curing the current pandemic-induced supply chain ills will enable a reintroduction of China's prior deflationary effect here and around the world. There's not much the Fed can do to reduce cost pressures in China.

Strong Demand and the Cost of Energy – Not Just a China Inflationary Headwind

Central to this spike are soaring Chinese energy prices. Demand for energy, both in China and elsewhere, is increasing. For the foreseeable future, much of the energy source will remain carbon-based. And as China has become the number two economy in the world, it has also become the number one carbon emitter. The Chinese government has made no secret of its intent to combat this problem. But doing so (i.e., by building out clean-energy power sources) will require massive amounts of energy. In China (and India, for that matter) that means burning more coal. For both, that includes, at the margin, imported coal. Even electric vehicles, seen as key to fighting pollution, still require energy sources to charge and their production is, of course, energy intensive as well. The incredible proliferation of all things digital – the internet of things – also requires more and more energy. And so strong energy demand, exacerbated by exiting the pandemic, has led to skyrocketing prices. Today, Asia and Europe are alternating competitive bids for limited LNG cargoes; LNG prices in both markets approach 10x the price we pay here in North America. That excess price won't hold but the spread will likely continue to be dramatic. As if matters aren't dire enough, Russia remains the marginal producer, running pipelines into Europe and Asia. If history is a guide, it will wield its power to its advantage.

A Sea Change in Economic Factors – A Different Set of Winners

Our grassroots macroeconomics research tells us that what's driving this is the 'revenge of the old economy', long taken for granted, subsidizing the world's economy but now possessing pricing power. Our research makes it clear that this pricing power is sustainable. We'd also note this is driving some the inflation we are experiencing. After all, one man's pricing power is another man's inflation.

Economic cycles are alive and well.

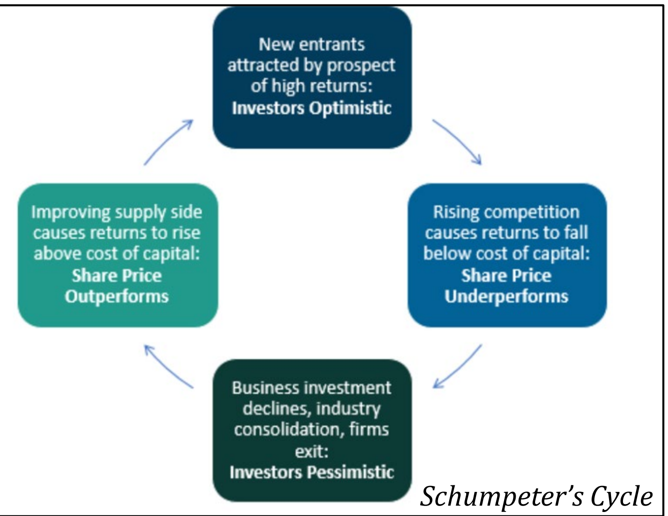
What we see differently than others is that many of basic businesses have experienced structural changes, little noticed by the marketplace. That makes sense. Investors just aren't interested in these businesses. Poor returns have meant that those businesses have been underinvested, restructured and/or downsized. There's also been recurring cycles of consolidation and rationalization among the remaining industry participants.

Again, this has gone on for years now without letting up. That cathartic process of correction, consolidation, rightsizing, and underinvesting in the businesses to get the supply to meet the end market demand has structurally changed a number of these industries.

Economic activity had already been recovering before the pandemic, even if it had been at a glacial pace. End market demand for their products had strengthened to take up much of the capacity of these businesses. The recovery out of the pandemic provided these businesses pricing power, enabling them to generate very significant, positive returns that continue to improve. As a result, we've performed well this year. Both the separate accounts we manage and the private funds we manage are up 30%+ net this year. So, yes, our investors have experienced good performance.

Of course, plenty of equity investors did well last year. The important question is: where we are today? What do we own today and what are the valuations of what we own today?

That's why we're excited. Despite a loss of faith in the concept, VALUATION DOES MATTER! We own companies that trade at single-digit PE multiples eight times, seven times, six times, five times, trailing earnings, some even lower valuations than that. These businesses are extremely modestly valued. And how is that? Once again, it's the myopia of linear thinking. Everybody knows that these businesses, historically, have been cyclical. Many historically are commodity businesses. And, yes, they're doing well today, but the cycle will turn again. Investors haven't looked at the underlying fundamentals. These businesses have consolidated down and are structurally different than they've been in the past. And not only are these much higher earnings sustainable, in many cases we see the ability for them to grow profitability clearly and demonstrably.



Schumpeter's Cycle

Further feeding the profitability outlook of these businesses is the low-cost energy advantages of their North American operations. As noted earlier, energy demands worldwide are strong. Energy intensive, industrial businesses operating in North America are advantaged due to the abundant supply of low-cost natural gas indefinitely "stranded" here. Profit margins and returns on capital are enhanced. Of course, one of the tarnishes is that by description, these are cyclical businesses. Even though we argue many industry structures have fundamentally changed, we realized that outsized profits can mitigate this condition. And eventually, the next "down cycle" will somehow come. A current new additional benefit is that the sustainability of this up cycle seems likely. Why? A well proven axiom in cyclical businesses is "the cure for high prices is high prices." As identified by Economist Joseph Schumpeter, new entrants are attracted by the prospect of high returns. That hasn't changed. But not so fast! Embedded in that phrase is the concept that high returns on capital draw in new competitors and new capacity. The world today has a heightened concern about the environment. Climate concerns are prevalent and pervasive, which is creating a barrier to entry. In many cases, this concern will stifle normal capital flows. We know that's true in the fossil fuel business. Societal pressures push against developing new resources. Investors themselves are looking for cash returns versus the historical push to reinvest capital. All these factors are mitigating the supply response that always comes with high prices and high profitability, period. Does that mean that there's an extended period of high profits and high profitability? Looks like a reasonable bet to us. We see the sustainability to outsized returns as different than had ever been the case before.

Revenge of the stock picker

As capital flows, some of it already has come back into companies which fall into the buckets of "small-cap" and "value." Initially, how does capital do that? Well, obviously we all have learned to do it through some kind of passive vehicle. It is an efficient way of deploying plenty of capital at a "low cost" that has worked extremely well for the last 10 years. It is Index investing. But it is very different when applied to the small-cap universe versus the large cap universe. Of course, the way to outperform the S&P 500 over the last decade was to own just the largest companies in the index. Because you get that select group, indexing works well for large cap. It's not the same thing when you're talking about a small cap index. The dispersion of companies is significantly greater and, therefore, performance will vary more across this universe.

Some businesses will be better positioned to allocate the cash they will generate. For the most part, these businesses are statistically cheap, trading at mid-single digit multiples of trailing earnings that do not yet factor in the growth realized from increased demand and the attendant pricing power (inflation, to most of the world) that they have acquired when the world wasn't looking. Some, without pricing power, will be hurt by inflation. The differentiator is finding those companies on the right side of increasing price equation with the best operational management teams, the greatest capital allocation opportunities and, crucially, those that are managed by skilled, savvy, proven capital allocators who can successfully increase shareholder value, which is clearly critical to maximizing this opportunity. Increasingly rare resources are experienced, rational, fundamental stock pickers who will have a tremendous advantage, especially over some small-cap, value indices which buy 'em all. You can understand why we're as giddy as school children as we look ahead.

Thank you for your continued confidence, and we wish you and your family a happy and healthy 2022.

All the best,

Bob