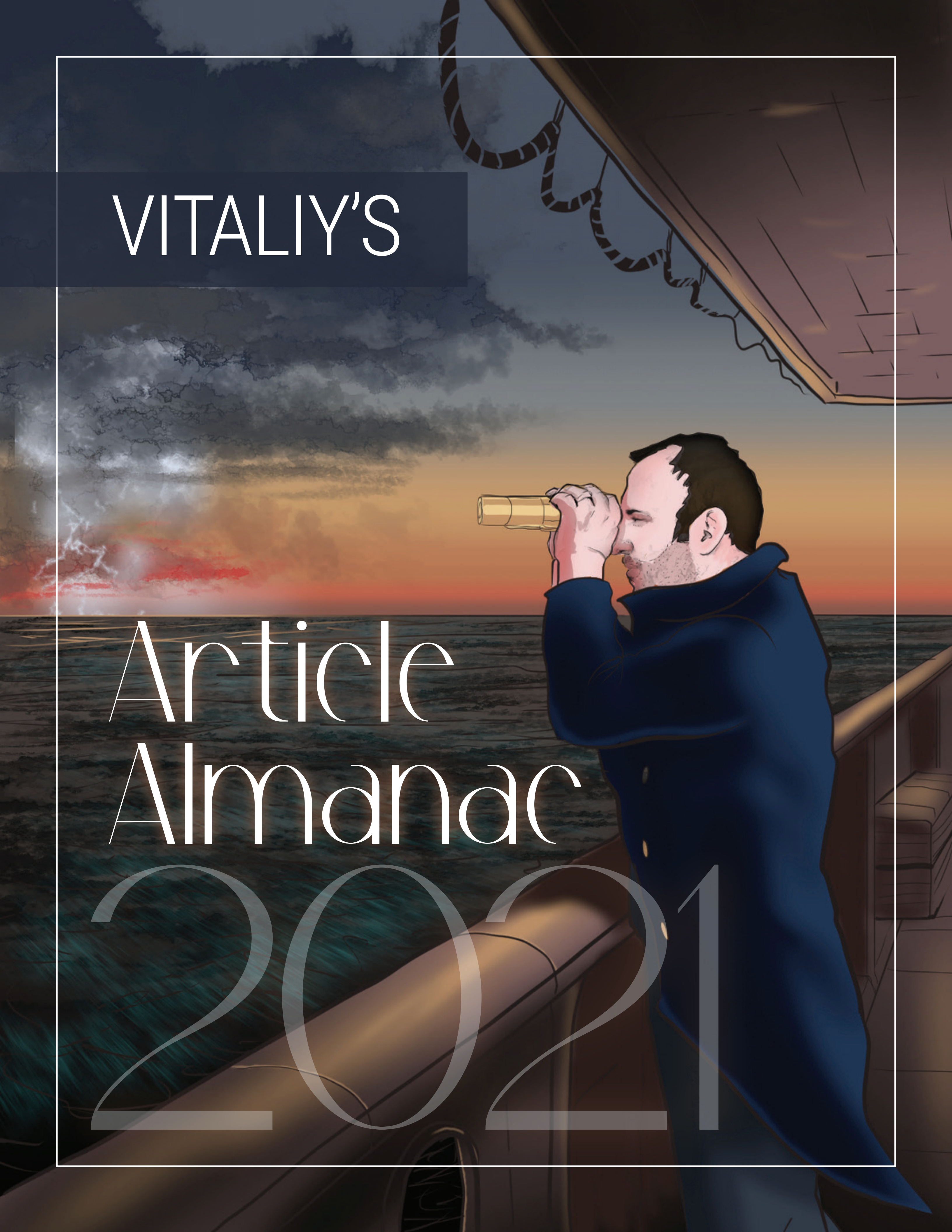


VITALIY'S Article Almanac 2021

Contents

From Vitaliy

I'd like to introduce you to the first Vitaliy's Article Almanac. This almanac houses most of the articles I wrote in 2021, organized into three sections: life, investing, and music.

I thought this almanac would be an easy way for readers to enjoy articles I wrote in the past year. Some readers simply did not get a chance to read them when they landed in their inbox. Others may decide to revisit a few articles. For readers new to my articles, the almanac provides an opportunity to binge read my essays! Netflix brought binge watching to the masses. Podcasts extended bingeing to listening – listeners of my podcasts tell me that they listen to years of my articles in a few weeks while working out or driving to work. (You can find my podcast on investor.fm.) I suppose this almanac is bringing binge reading to the masses. (I get the feeling I am not the first one to do this.)

We did not just slap the articles into a Word document and convert it into a PDF. No, we kicked things up a few notches. Early in 2021 we recruited a very talented artist, Hazen, to create digital paintings to accompany my articles. Up to this point Hazen's art has lived on ContrarianEdge.com and as cover art for my podcasts. Hazen's drawings are now front and center in this almanac. Unless otherwise indicated, all artwork in the Almanac is by Hazen.

I love these drawings for several reasons. First, Hazen is a terrific artist (you'll see). Second, they add another, artistic dimension to my articles. They convey the main message I am trying to communicate via an image. Believe you me, this is anything but easy. Finally, as CEO of IMA I want to make sure I foster a culture of fun and collaboration. These drawings were a fun collaboration between Hazen, Brendan (IMA analyst, giving him an opportunity to see something other than income statements and annual reports), and Anton (our director of marketing). Then our in-house project manager, Dragan, coordinated creation of the almanac while getting input from the rest of the IMA team. My contribution to this process was very minimal. As you can see, this may be an almanac of my articles, but it's really a gift from all of IMA to you.

And yes, of course I included my father's and my brother Alex's art in the almanac as well. There is also a bonus section that has a few of my evergreen articles that are still very relevant today.

Feel free to share this almanac with your friends, relatives, coworkers, and perfect strangers you meet.

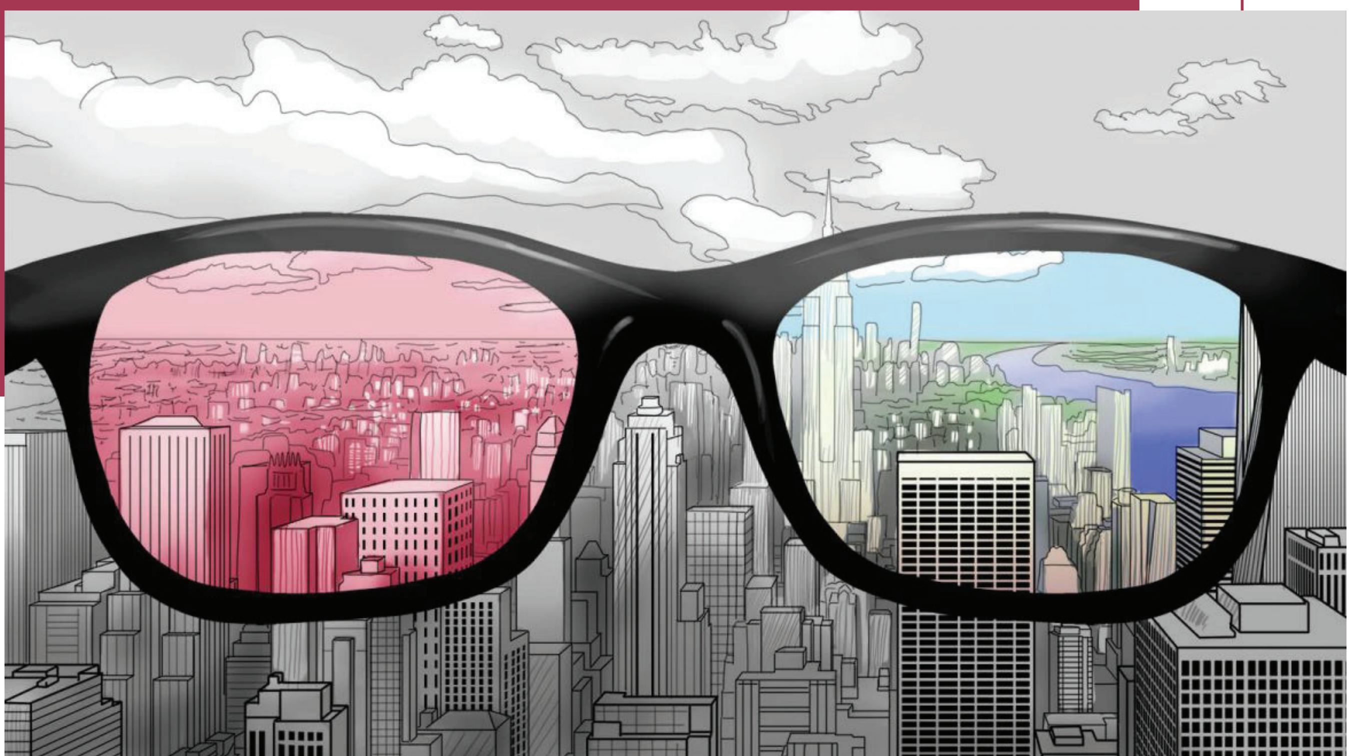
Finally, and most importantly, I hope you have as much fun reading the almanac as we had putting it together.

Vitaliy

life

Painting by my father Naum Katsenelson

A Shift in Perception Transforms Reality



When you arise in the morning think of what a privilege it is to be alive, to think, to enjoy, to love …

MARCUS AURELIUS

2020 will go into our memory banks as a very painful year. Stoicism, particularly the stoic practice of negative visualization, helped me put 2020 into a broader historical context, and compare what happened, which was bad, to what could have happened.

Click to listen to a narration of this article

As I look at 2020, I have very conflicting feelings. On one hand, the year was horribly tragic for many people who lost loved ones and businesses. My heart goes out to the nearly two million people worldwide who have lost their lives to COVID and their grieving families, and to the tens of millions in this country now suffering from economic hardship.

On the other hand, the worst that many people, including me, have suffered from this virus, has been annoying inconvenience. Thankfully, almost all my relatives and friends are in this category. Yes, we cannot see our extended family and friends; yes, we have not been able to travel or go to concerts or sporting events. The events of last year led me to an important personal, philosophical breakthrough. This was the year that I embraced Stoic philosophy.

Stoic philosophers have a valuable practice they call "negative visualization." When bad things happen to you, before you get engulfed by sadness and self-pity, realize that it could have been a lot worse. For those of us who were only indirectly impacted by the virus, 2020 was just a mediocre year, especially if you compare it to what a generation or two before us suffered in Europe in the late 1930s through the mid-1940s. Stoicism helped me put 2020 in a broader, historical context, and helped me compare what happened, which was bad, to what could have happened and how much worse it could have been, at least for me personally.

2020 will go into our memory banks as one of the worst years of our lifetimes for my and my kids' generations (hopefully, it doesn't get worse than this).

Actually, historians think that the worst year suffered by our civilization was 536 AD. The eruption of an Icelandic volcano sent large volumes of ash into the atmosphere, blanketing the whole Earth in smog and blocking the sun. It plunged many parts of the world into darkness for two years. It also changed the Earth's climate, lowering temperatures, killing crops, causing devastating starvation, and sending the world economy into a depression. If this was not enough suffering, the bubonic plague then paid a visit, wiping out 100 million people, almost half of the world's population.

When I visualize the whole planet in 536 AD or Europe engulfed in WWII, 2020 suddenly looks like a year that just messed a little with my social habits.

Also, unlike our ancestors, today we are armed with fruits of the technological progress from the last 150 years. If 536 AD were replayed today, it would not be fun, but we are now so much better prepared to deal with what Mother Nature can throw at us.

Also think what would have happened to the global economy if COVID had hit us two decades earlier, before technological advancements – faster networks, the cloud, software tools – allowed most white collar workers to continue slaving away in the comfort of their basements. Think about vaccine development, which used to take years and in some cases decades, but this time around took just months.

Stoics have another piece of advice for us. Epictetus said, "People are not disturbed by things, but by the views they take of them." It is amazing how much impact "the view we take" has on our wellbeing. Though you cannot change reality, you can do plenty with how you interpret it and thus how you feel.

Instead of focusing on all the insignificant and petty ways I was inconvenienced in 2020, I focus on the fact that I got to spend more time with my kids, especially my 19-year-old son, Jonah, who otherwise would have been in college. He is living at home, taking classes online, and will go to CU Boulder in-person in the fall. I am also thankful that I got to spend a lot more time with my daughters.

The virus motivated me to double down on my health. In addition to working out twice a week with a trainer (I started this about three years ago), in December I started rowing 15 minutes a day in the comfort of my living room (I'll gradually take it up to 30 minutes). In 2020 I also focused on mental health. I meditate and walk in the park for about an hour every single day.

The virus has made me appreciate little things even more. As I am writing this, my six-year-old daughter, Mia Sarah, has woken up, come downstairs, and hugged me. She does this daily – my very favorite moment of the day.

Maybe our interpretation of things does change reality after all.

Girls' Gambit

One of my jobs as a parent is to instill in my kids that they can do anything they really want to do.

VITALIY KATSENELSON

It all started after my daughter, Hannah, watched The Queen's Gambit for a homework assignment. She told me I had to watch it. I did, and loved it. But then Hannah said, "Dad, let's play chess!"

Click to listen to a narration of this article

It all started after Hannah watched *The Queen's Gambit* for a homework assignment. She told me I had to watch it. I did. I loved it. But then Hannah said, "Dad, let's play chess."

Okay, I have to pause and rewind. I grew up in Russia, where chess was a spectator sport, almost (though not quite) what Hockey (I am intentionally capitalizing the "H") is for Canadians. I probably first played chess with my father when I was five years old. I never took formal chess lessons. I played casually; I was never great at it, just an average intuitive player.

My son Jonah, who is now 19, started playing chess in kindergarten. Chess is something Jonah and I shared daily after dinner for years. In the beginning he enjoyed chess and participated in and won some tournaments. But he lost his love for the game after making the mistake of choosing a chess teacher who was wrong for him. (I wrote about this in the past.)

His teacher was a retired Russian engineer and ex-Moscow champion, a terrific human being who was not an appropriate pedagogue for an eleven-year-old. His teaching style was remarkably similar to that of many Soviet teachers I encountered as a kid (which is why I was never a good student in Russia but blossomed in the US). He knew his subject incredibly well; he was very efficient; and he would have been a great teacher for a self-confident adult. But not for an eleven-year-old child. He simply lacked kindness and playfulness.

I realize now that his job was not just to teach Jonah chess but also to support and grow that little flame of love for chess my young son had. Jonah's lessons lasted about two years. Even after he stopped taking lessons, he still played in tournaments; but his opponents progressed as they dedicated themselves to studying chess, while Jonah just showed up.

If you asked Jonah today, he'd tell you that the part he enjoyed about tournaments was not the matches themselves but the lunch break. I was the one taking him to the tournaments (my wife stayed home with our daughters). Jonah and I had this little tradition where we'd go to a Japanese fast-food restaurant, where I'd let him get Izzy (a bubbly soda drink), and then we'd top it off with a visit to Dairy Queen, which was next door. I tell you, all my kids' best moments revolve around food. Though I have a feeling it was more than food; it was our spending time together.

Hannah is four years younger than Jonah. She never took formal chess lessons. I taught her chess when she was seven. After my experience with Jonah, I never pushed chess on her. If I am honest with myself, I am not sure if I subconsciously made this decision because of Jonah's difficult experience or because Hannah is a girl. I'll never know the answer because it was a mindless decision; I don't think I gave it much thought.

If I did not nudge Hannah to pursue chess because she was a girl, then I could not have been more wrong.

Chess has historically been predominantly a men's sport, probably because it resembles a battle. Intellectually I was always bothered by the fact that there were men's and women's divisions. Unlike athletic sports such as running, soccer, or weightlifting, where differences in male and female physiology make a difference, chess is a sport of thinking. Putting men and women into different divisions somewhat implies different mental capacities of each sex.

One of my jobs as a parent is to instill in my kids that they can do anything they really want to do. However, I now realize that with my daughters I must work extra hard on this. I have to keep repeating to them that other than a very few biologically limiting tasks (like childbearing and breastfeeding) there is no such a thing as man's or woman's job.

The Queen's Gambit ignited a little flame of chess interest in Hannah. So we played chess. After we had played for a few weeks, I added a little bit of fuel to that flame and found Hannah a chess teacher. This time I was more careful. She is taking lessons from Azzama, a 25-year-old Russian-born woman and chess master from Chicago (this is the beauty of online learning). Hannah absolutely adores Azzama. She makes classes so interesting that Hannah went from taking lessons once a week to twice.

Interesting side effects from this: Hannah's younger, seven-year-old sister, Mia Sarah, seeing Hannah taking her chess lessons, expressed an interest in chess, too. So now Azzama has another student. And then last Saturday I was sitting here reading a book and I overheard Mia Sarah teaching my wife chess moves. Soon we are going to have chess tournaments in the Katsenelson household – two feeble men against three strong women.

I have to tell you, though, that the best part about all this is that I am playing chess almost daily with my daughters. The beauty of this game is that I cannot lose: If I win, I win. If I lose, I still win as a father – I'm as happy for their win as they are. Of course, with my wife, the only way I can win is if I lose. Now I am looking forward to the days when my daughters will be beating their older brother, who is currently very smug about his game. Hopefully not for too long.

P.S. For the chess geeks: Azzama uses Chess.com as a teaching tool for Hannah and ChessKid.com for Mia Sarah. ChessKid.com seems to be a wonderful teaching tool for beginners; it further gamifies chess learning for kids.

Go Ahead, Covet Your Neighbor's Wife

No person has the power to have everything they want, but it is in their power not to want what they don't have, and to cheerfully put to good use what they do have.

SENECA

I recently asked another value investor if he wanted Warren Buffett's success. While this may seem like a rhetorical question, the truth is many value investors are quietly envious of Buffett.

Click to listen to a narration of this article

had a deep, existential, meaning-of-life type of conversation with a friend of mine, another value investor. I asked him, do you want Warren Buffett's success?

He was somewhat stunned by the question, and asked: "Is that a rhetorical question?"

It was not.

I told him about a nugget of Jewish wisdom my wife shared with me. But first, let's revisit one of the Ten Commandments: Don't covet. Or more precisely, don't covet your neighbor's wife. To be even more precise, I am not talking about outright adultery here, but rather about thoughts you may have about the desirability of your neighbor's wife. And to make it even clearer: not *my* neighbor's wife (I don't want my neighbor reading this and getting any ideas).

Here is that practical Jewish wisdom (severely paraphrased by me). Go ahead and covet your neighbor's wife, but don't just covet her beautiful eyes, her soft voice, and her stunning figure. Covet her in her entirety. Don't forget about her mother who would insist you kiss her on the lips every time you see her and who loves to dispense unlimited quantities of unsolicited advice. Or her brother who needs to get bailed of jail every other week. Don't forget about the hours that neighbor's wife spends in front of the mirror (forgetting about her hubby and the kids) and her weekly shopping and spa trips that would empty your bank account in a New York second.

So covet away! But covet the whole package. The antidote to coveting is holistic coveting.

So when you covet Buffett's success, do it holistically, too. Not just the empire he built and the billions he accumulated (that he'll give away anyway) but the life he led. When I read Alice Schroeder's *The Snowball*, the main point I got out of the book was *not* to be like Buffett. I was lucky I read it when my kids were still young. Buffett's obsession with the stock market was anything but healthy. He got tomorrow's newspaper delivered to him the evening before. He spent every living moment in his study, completely neglecting his wife and children. His wife, the love of his life, could not take this anymore and left him. So, do you still covet what Buffett has?

Would Buffett have achieved the degree of financial success that he has without sacrificing his marriage or neglecting his children? We will never have an answer to this question. Maybe he could have, but he would have been a billionaire with a small *b* and would not have the global adulation that came with his capital *B* wealth.

My gut sense tells me (though it could be completely wrong) that if he was given a do-over, Buffett would not focus on embracing tech companies early in his career (i.e. buying Microsoft or Apple at IPO) and would tweak how much attention he paid to his wife and kids.

THE BRIGHT SIDE OF COVETING

Coveting is a lot less interesting to me than its more toxic cousin, envy. Envy is coveting (desiring) what another person has *and then* resenting the person for that. Envy poisons people's lives. But if we learn how not to covet, we may be able to kill envy in its tracks.

Warren Buffett nailed it when he said, "As an investor, you get something out of all the deadly sins – except for envy. Being envious of someone else is pretty stupid. Wishing them badly, or wishing you did as well as they did – all it does is ruin your day. Doesn't hurt them at all, and there's zero upside to it."

Charlie Munger, Buffett's partner, made an interesting contribution on the topic of envy:

Mozart … here's the greatest musical talent maybe that ever lived. And what was his life like? It was bitterly unhappy, and he died young. That's the life of Mozart. What the hell did Mozart do to screw it up? Two things that are guaranteed to create a lot of misery – he overspent his income scrupulously – that's number one. That is really stupid. And that other thing was, his life was full of jealousies and resentments. If you overspend your income and be full of jealousy and resentments, you can have a lousy, unhappy life and die young. All you've got to do is learn from Mozart.

Stoics have an interesting approach to coveting (and thus envy). They apply Epictetus' dichotomy of control (the crown jewel of Stoicism) to it. They divide things into internals and externals. Internals– our values, attitudes, behavior, and yes, desires too – are up to us. We get to make choices as to what we desire. Desires are in our immediate control.

Everything that is not up to us – and the laundry list there is very long – is external. The neighbor's wife and Buffett's wealth are externals. Hitching our wagon to the desire of external things beyond our control is subjecting ourselves to a miserable existence. (I discuss this subject in much greater detail in my write-up of *The Subtle Art of Not Giving a F*ck*.)

We have a lot of power within us to get rid of suffering if we make the decision not to want wrong things. Seneca explained it perfectly: "No person has the power to have everything they want, but it is in their power not to want what they don't have, and to cheerfully put to good use what they do have."

But this is where things get interesting. Stoics would recommend that you look at Buffett and desire his virtues that you admire – make them internal. I've talked about what I have learned from Buffett's mistakes, but there is so much more I've learned from him.

Here are a few examples.

The newspaper test. How would you feel about any given action if you knew it was going to be written up the next day in the newspaper? Reputation takes a lifetime to build and five minutes to lose. In other words, always behave honorably. Always!

Buffett's definition of success (he probably came to it later in life). Behave in a way that makes people you care about love you. He said, "If you get to my age in life and nobody thinks well of you, I don't care how big your bank account is, your life is a disaster."

Buffett has a friend who survived the Holocaust. When she looks at people, she only asks one question: Would they hide me? Buffett said, "When you are 70 and you look back at your life, and you have a lot of people who would hide you, then you'll have had a very successful life."

"Praise by name, criticize by category." You'll never hear Buffett speak negatively about anyone in public, and at the same time he is generous with his public praise of specific individuals.

Charlie Munger characterized Buffett as "a constant learning machine." That is a very admirable quality. I've attended almost a dozen Berkshire Hathaway meetings, where Buffett and Munger answer questions from shareholders for almost six hours, taking only a lunch break. Every single time, I've learned something new from each of them.

Buffett had a tremendous impact on me as a writer. His annual letters, despite discussing often complex, boring finance subjects, are educational, interesting, funny, and accessible to an average reader.

And of course, he had an immense impact on me and millions of others as an investor.

By the way, if you have not read my "Six Commandments of Value Investing," which is a chapter from the book *Intellectual Investor* that I may finish one day, it was heavily influenced by Buffett and his mentor Ben Graham. You can read it here.

My Interview with World Class Performer

Time discovers truth.

SENECA

I was recently interviewed by the website WorldClassPerformer.com. What follows are a series of questions about my background, influences and habits.

Click to listen to a narration of this article

WHAT BOOK(S) HAVE INFLUENCED YOUR LIFE THE MOST? WHY?

Over the last few years two books have had a very significant impact on my life: *The Subtle Art of Not Giving a F*ck*, by Mark Manson, and *The Guide to the Good Life*, by William Irvine.

Mark Manson's book sent me on a quest to reassess my personal values. The title misrepresents the book, whose message is not to stop caring, but if you value everything, you value nothing. We should be thoughtful and deliberate as we decide on what we value. I wrote a long essay about that; you can read it here.

William Irvine's book introduced me to Stoicism and got me completely hooked on Stoic philosophy. Today I view Stoicism as an operating system for life.

Both books made me reevaluate what is important in life and what is not.

DO YOU HAVE ANY QUOTES YOU LIVE BY OR THINK OF OFTEN?

I probably will have a different answer on any given day.

When I am deeply engrossed in investing, two quotes from Stoics come to mind. The first one is from Seneca: "Time discovers truth."

I think about this one a lot when I am researching a company. The truth in this case being what the company is worth. The truth is already there, and time will eventually discover it. I just need to discover it before time does.

I also think about this quote when I have discussions or debates with people. I have stopped debating topics with people who are in the conversation just to prove their point but not to learn. Almost any conversation about politics falls into this bucket.

Another quote from Marcus Aurelius has been on my mind lately: "The object of life is not to be on the side of the majority, but to escape finding oneself in the ranks of the insane." We are living through 1999 Dotcom-like euphoria in the stock market now (I wrote about it here). If you are not careful, the fumes of this euphoria will intoxicate you and you will eventually join "the ranks of the insane." I am doubling, tripling down on our rational investment process.

When it comes to my personal life, I try to live by Warren Buffett's newspaper test quote: "How would you feel about any decision if you knew it was going to be written up in the local newspaper the next day?" Decision making becomes a lot easier, and you stop making compromises with your soul. Simplifies your life, a lot.

WHERE DID YOU GROW UP, AND WHAT WAS YOUR CHILDHOOD LIKE? DID YOU HAVE ANY PARTICULAR EXPERIENCES/ STORIES THAT SHAPED YOUR ADULT LIFE?

I grew up in Soviet Russia. This experience made me appreciate the rule of law and free markets. I detest corruption. To paraphrase George Orwell, corruption makes some people more equal than others. I also absolutely hated the feeling of powerlessness when certain parts of my life depended on the arbitrary decisions of others.

On the positive side, I won the lottery with my parents. They were a bit delusional, as they had this belief that I could achieve anything I put my energy into. It was a belief based on zero evidence. I was a very late bloomer. I think my 15-year-old daughter is more mature now than I was at 21. This belief in me by my parents supercharged me into what I am today.

WHAT IS SOMETHING YOU WISH YOU WOULD HAVE REALIZED EARLIER IN YOUR LIFE?

I don't have to win every argument. Being kind is more important than having to prove to someone that you are right.

WHAT ARE BAD RECOMMENDATIONS YOU HEAR IN YOUR PROFESSION OR AREA OF EXPERTISE?

Many today find a false sense of security in "diversifying" among dozens of ETFs. They find safety in numbers. But if the market is overvalued, which I believe it is, owning a lot of overvalued assets will not protect you from losses and is likely to bring you a decade of no returns.

This still bewilders me. The higher stocks go, the more excited people get about future returns. But mathematically the opposite is true. I don't want to get too much into the weeds of the stock market, but stock prices go up in the long run for two reasons: earnings growth and how much people are willing to pay for earnings increases (the price-to-earnings ratio). Earnings on average have grown 4–6% a year or so. Over the last decade a very large portion of returns came from stocks just getting more expensive. Imagine you are rolling a large rock uphill in the fog. You don't really know where the hill ends, but you know it does, and at some point, once you reach the top, your rock will roll down the other side. This is what happens to overvalued stocks: They get more expensive until they don't, and then they get cheap fast and stay there. I've written two books on this subject. So I probably should stop before I write another one here.

TELL ME ABOUT ONE OF THE DARKER PERIODS YOU'VE EXPERIENCED IN LIFE. HOW DID YOU COME OUT OF IT, AND WHAT DID YOU LEARN FROM IT?

Losing my mother from brain cancer when I was 11 was hard. My child mind never really accepted that I would never see her again. This experience brought me closer to my father, and I have to thank him for not being overly scarred by her death. I'm not sure I can give useful advice in this area.

Professionally, 2015 was an incredibly difficult year. I found it was important to divorce my personal self-worth (my ego) from the success (especially the temporary success) of our investment portfolios. Realizing that every investor, even great investors, have gone and will go through times when they felt dumber than a rock was a bit liberating. I learned, when I have good years, to bottle up that feeling of temporary smartness, because I'll need to uncork it sooner than I think.

Ironically, 2015 is probably the best thing that ever happened to me professionally, as it led to the improvement of our investment process. In fact, I wrote a very lengthy essay about that in 2017, but only shared it with a very few friends and never published it – it was too painful. But I decided to include the essay in my next book, *Soul in the Game*. (If you'd like to be notified of its release, sign up here).

WHAT IS ONE THING YOU DO THAT YOU FEEL HAS BEEN THE BIGGEST CONTRIBUTOR TO YOUR SUCCESS SO FAR?

I hate this type of question – by answering it I am patting myself on the back and saying that I am successful. But I'll answer it from this perspective: I have far exceeded the expectations I had for myself when I was a teenager (though in all honesty they were incredibly low).

Two things that have contributed a lot to my success are parents and writing.

As I mentioned about my parents, I won the lottery there.

With regard to writing, I am not talking about my accomplishments in publishing books or writing articles for prestigious publications. Those things are very secondary. Writing has made me a much better thinker. Some people exercise daily; I write daily. I spend about two hours in the early morning staring at the computer and thinking. Sometimes this thinking spills into an essay, and sometimes I walk away leaving a blank page behind. But this focused thinking is responsible for any original thought I have. Writing forces me to think.

WHAT IS YOUR MORNING ROUTINE? PLEASE INCLUDE THE TIME YOU WAKE UP.

Ideally, I wake at 4:30 am. Make a cup of Americano. Put my headphones on and write. I say ideally because I am paranoid about getting enough sleep. If I go to sleep late, I may allow myself to sleep late – to 5:30 or 6. But even if I get up late, I still put in an hour of writing every single day. I find that writing daily is very important to me because it is like a muscle that you want to exercise daily. Plus, to be honest, I really enjoy it.

WHAT HABIT OR BEHAVIOR THAT YOU HAVE PURSUED FOR A FEW YEARS HAS MOST IMPROVED YOUR LIFE?

Writing is the most important one.

When I got into my 40s I realized that I had to pay attention to my health. When you are young you take health for granted. You assume you'll always have it.

There are basically three things you can do for your physical health: eat and sleep well and work out.

I found that I have good willpower when it comes to abandoning bad habits (I quit smoking when I was 21 after smoking for six years – one of my proudest achievements). But I realized I need external pressure to create and stick with good habits. I tried to exercise in the past, and every single time I gave up after a month or so. Then, three years ago, I started working out with a personal trainer. My brother Alex and I meet him twice a week in the gym at the IMA office. Unless I am traveling, this workout is a non-cancellable appointment on my calendar.

I've also been playing with my diet. I cut out sugar (I wrote about it here). My cholesterol numbers improved tremendously.

And then there is sleep. I used to admire people who slept four or five hours a night. Like the rest of the country, I chanted the "I'll sleep when I'm dead" mantra. After reading *Why We Sleep*, by Matthew Walker, I realized how important sleep is for daily productivity and for longevity. I might have gone a bit off the deep end with this – a year ago I got an Oura ring that tracks my sleep. I wrote an in-depth essay on the subject of sleep, and you can read it here.

The pandemic also made me better appreciate my mental health. I go for daily one-hour walks in the park. In the wintertime I do this during midday, but in summer I usually do it early in the morning. I listen to podcasts, earnings calls, audiobooks, or just music. Once or twice a week I take these walks with one of my friends. The pandemic turned my walks into a substitute for lunch meetings.

Finally, I've been meditating for about a year. I am a very light meditator; I only do it 10 minutes a day. I find that it is enough for me.

WHAT ARE YOUR STRATEGIES FOR BEING PRODUCTIVE AND USING YOUR TIME MOST EFFICIENTLY?

I say "no" a lot. I don't do "let's meet for coffee." I used to feel bad about being selfish with my time, but then I realized that my most important responsibility is to my immediate family and close friends. The time I spend on a "let's meet for coffee" meeting is time taken away from a game of chess with my daughter Hannah or a walk in the park with a friend. Once I started to look at things from this perspective, any guilt I had from saying "no" dissipated.

I also realized that I can scale my writing but not my time. A few times a week I have students reach out to me for career advice. After a while I realized that I was repeating the same thing in these conversations. So I summarized my career advice in this letter for young investors, and even went a step further by creating a value investing curriculum for anyone who is interested in value investing.

Finally, I delegate a lot. I use money to buy time. I have a terrific assistant who manages my calendar and my calls. This saves me a lot of time from tasks where I add zero value.

Unconditional Love

The innate instinct of self-preservation was replaced by willingness to give up my life for my kids.

VITALIY KATSENELSON

I recount the first time I felt fear. Not the fear of losing my own life, but the fear a parent feels when their kids are at risk. I remember this harrowing episode, and what it taught me about being a parent.

Click to listen to a narration of this article

A few years ago, my older kids, Jonah and Hannah, and I went snorkeling in Fort Lauderdale. We went out on a big boat that could probably carry up to 80 people, but there were only eight snorkelers (including us) on board and two crew members. We went about two miles off the Fort Lauderdale coast. (We could still see the city skyline.)

The captain dropped anchor. We put on fins and inflatable life vests. The captain told us to inflate the vests only about a third of the way, so we would still be able to put our heads in the water and snorkel. We let other people in the group get in the water first, then in went Jonah (then 16), followed closely by Hannah (then 11). I was going to go in right after them, but my fin was loose and I had to adjust it. I was in the water maybe 30 seconds later, but I noticed that Jonah and Hannah were already 100 feet away from the boat. I swam to them, and by the time I reached them the boat was already four hundred feet away from us, and the distance was growing.

I am not sure if Jonah or Hannah realized what was happening. We were alone in the ocean, being washed farther away from the coast and the boat by a strong current. To make things a lot worse, almost as if on cue, as soon as we had dropped anchor, the weather had changed. The wind picked up and the dead-still ocean turned very unsettled.

Now we were engulfed by large waves. On the boat these waves were just slightly inconvenient, but in the water they seemed to be the size of multistory buildings and were throwing us around. I had never felt so powerless in my life. Nature was so much bigger than we were, and the current was quickly taking us away from safety. In moments like that, you have no control over your life. None.

I was scared. But this was the first time in my life that I experienced selfless fear. At that moment, what happened to me suddenly did not matter. All I wanted was for my kids to be okay. As we floundered in these huge waves, I forced myself to speak slowly and calmly. I did not want to scare the kids. Our vests were deflated, and the waves were threatening to pull us under. I told Jonah to fully inflate his vest. I inflated Hannah's and then mine. (If I had been totally rational, I would have inflated my vest first. But what parent is rational when your kids are in danger?) Once our vests were full, I felt safer. The kids and I grabbed hands and held on to each other.

A crew member jumped into the ocean with a red (*Baywatch*-type) floatie and collected all the snorkelers together. (The others were up to several hundred feet away from us.) The captain unhitched the anchor from the boat and tied its rope to a buoy to so he could find it later. Then he brought the boat around and collected us, and then picked up the anchor.

I cannot tell you how long that feeling of fear of losing my kids lasted; it may have been seconds and was probably less than a minute. But today I look at it as a period, not a moment, in my life. As I recall that feeling, my heart starts beating faster. I have never experienced that feeling before or since, and I really hope to never experience it again.

I talked to Jonah and Hannah about this trip recently, and they don't remember being scared or even particularly excited. But this was not my first harrowing experience in the ocean. When I was 17 and a cadet at the Murmansk Marine College in Russia, I went with my class on a two-month journey around Europe on the tall ship Kruzenshtern* (wiki, short video). We left Tallin, Estonia, sailed to the Canary Islands, spent New Year's Day 1990 in Greece, and finished our trip in Odessa. In the Mediterranean we faced a true storm, with our four-masted barque rolling through the sea as if it was a giant roller coaster. I remember working on the deck of the ship, repositioning sails and being hit by giant waves. I was 17, fearless, not too smart, and, most importantly, not a father (I only had to worry about myself).

As I am writing this I have realized that the Fort Lauderdale experience lacks Hollywood-level drama. Thank god! But for less than a minute, the fear of losing my kids was incredibly real. This was probably the first time I truly felt what the true, unconditional love of being a parent meant. The innate instinct of self-preservation was gone, replaced by another instinct that was dormant before: being willing to give up my life for my kids.

* As I was writing this, I found this documentary about the Kruzenshtern. My experience onboard was very similar to that of these cadets; I even wore an identical uniform (though I did not have a mobile phone and had to send old-fashioned telegrams to my parents).

Rooting For The Underdog

My kids are not looking forward to the opera. They do however regard the opera as part of the family tradition.

VITALIY KATSENELSON

For the longest time, my son Jonah would beat his younger sister Hannah at just about everything. That all changed when we watched The Queen's Gambit earlier this year.

Click to listen to a narration of this article

T*he Queen's Gambit* show is one of the best things that has happened to my family. I wrote a long essay on this subject (read it here), so this is a follow-up.

Hannah (15) watched the movie late last year and started playing chess – she even got a chess teacher. Then her seven-year-old sister Mia Sarah saw her playing chess and asked for a chess teacher, too. Their older brother, Jonah (20), saw his two sisters buried in chess and started playing again, too.

This is where things got more interesting.

Jonah is 6'3 and built like an athlete. He is used to being better than Hannah at everything – basketball, golf, skiing. Age and physical strength gave him an advantage in physical sports. But in chess his physical strength is irrelevant – it's a domain where Hannah can challenge him. What makes things worse is that chess was one of Jonah's domains – he took chess lessons from a young age and played in tournaments (and even won some). Hannah had played maybe a dozen games before this year.

Even a few months ago, in May, the 6'3 giant would crush his 5'2 little sister consistently, with an enormous, smug smile and colorful joking remarks that told her, you are a tourist in my domain.

But Hannah has been studying chess non-stop. Most importantly, she has been *deliberately* playing 10–15 games a day. What makes it deliberate? The feedback loop. After every single game, she puts the game through an analyzer, a feature on chess.com that walks her through the efficacy of every move (both hers and her opponent's). Also, in addition to weekly lessons with her teacher, she watches several hours of chess lessons a day on YouTube and solves chess puzzles on chess.com. I am guesstimating that by now she has played almost as many games Jonah has in his lifetime, except that she has learned more from them because of her deliberateness.

(Deliberate practice is a very important topic that I am just glossing over here. I am going to write about it in greater depth in the future. In the meantime, if you are interested, read James Clear's post or Anders Ericsson's book *Peak*.)

Jonah and Hannah have been playing a lot lately and Jonah's dominance has dissipated – they are playing at the same level. As a parent I am not supposed to take sides between children. I love them equally. But I've been rooting for the underdog.

Jonah has an incredibly kind heart but a sensitive male ego when it comes to losing to his younger sister. In one of my articles, I mistakenly said that Hannah was a better skier than Jonah (she is not). Jonah is still adorably annoyed by it – he throws his hands in the air and with a puzzled look says, "Dad, how could you even think or write this?"

Hannah approaches winning or losing to Jonah as a good Stoic. She is happy when she wins, indifferent when she loses. (Stoics call this positive preference: "I'd rather be rich than poor, but either outcome is fine with me.")

I think in a few months Hannah will be consistently crushing Jonah in chess. I may start rooting for Jonah soon. Both kids are equally smart. Hannah simply has more time on her hands. Jonah is going to CU Boulder this fall. He'll be living on his own, taking a full load of classes, and enjoying a busy college social life. And Hannah takes chess a lot more seriously than Jonah.

As I am writing this, I have a big smile on my face. I love seeing this very friendly sibling rivalry. Most importantly, chess is bringing them together. They are playing each other on chess.com even when they are apart.

In a few days, Jonah, Hannah, and I are driving to Santa Fe for what has turned into an annual trip. We are going to walk the galleries on the Canyon Road, go to our favorite Indian restaurant, and of course we'll take in the Santa Fe Opera. We'll see Tchaikovsky's *Evgeniy Onegin*. We've been doing this trip for nine years. It is now a firm Katsenelson family tradition, and next year we'll take Mia Sarah with us.

Let me make this clear: My kids are not looking forward to the opera (Jonah prefers J. Cole to Tchaikovsky). They do however regard the opera as part of the family tradition. In fact, when I asked Jonah if he'd recommend our outing to anyone else, he said, "No, Santa Fe is something *we* do. It is *our* tradition." This made me think that to him this trip is pretty special, because we've gone there since he was a little pup. Despite his indifference to opera, going to the Santa Fe opera is an opportunity to relive happy memories of his childhood while listening to music that he may not necessarily enjoy (yet).

Hannah and I went to Santa Fe in October of 2020 without Jonah (he was in Hawaii). On the way there we listened to Andy Weir's book *The Martian*. It is a well-written, funny, educational, captivating read (or listen). I wrote about this book and our trip; you can read it here. This year on the car ride we are going to listen to Weir's *Project Hail Mary*. And of course, we'll be debating which music to listen to in the car (that's part of any long car ride we take together), and Jonah and Hannah will be playing chess non-stop. I cannot wait.

Winning the Ovarian Lottery

At least a billion people on earth at this moment who would consider their prayers answered if they could trade places with you.

SAM HARRIS

Close your eyes and imagine that you have just woken up in Kabul. The streets are overrun by Taliban. Whatever semblance of civility that existed yesterday is gone, replaced by medieval lawlessness.

Now, imagine you are the parent of Afghan children.

If you are reading this, you won ovarian lottery. Be thankful. Whatever problems you are facing are small in comparison to those of the Afghans.

Marcus Aurelius said: “Don’t imagine having things that you don’t have. Rather, pick the best of the things that you do have and think of how much you would want them if you didn’t have them.”I don’t usually write preachy essays (okay, maybe a few). But the above thoughts have been circulating around my mind nonstop for the last few days. They feel more important than anything else I can write at this moment.

Why Do I Write a 27-page Letter To Clients

Being in the pilot's chair and in the passenger cabin comes down to control and information.

VITALIY KATSENELSON

In these letters I diligently walk clients through our research on stocks we own, including those we have recently bought and sold. I cover how we value them, why we own them, etc.

Click to listen to a narration of this article

Four times a year I write letters to IMA clients. In these letters I diligently walk clients through our research on stocks we own, including those we have recently bought and sold. I cover how we value them, why we own them, etc. I update clients on our thoughts on the economy and the market. I call these musings "seasonal," not quarterly, letters. There is a good reason for that. Quarters follow a discrete calendar, while my writing muse has a mind of her own and keeps her own schedule. Also, I like to wait until our companies report their quarterly results before I write about their progress. I usually wait a month after the quarter ends before I start working on the letter. These letters are very in-depth and lengthy – some run as long as 30 pages.

It takes me two to three weeks, two hours a day, to write a seasonal letter.

Why do I write them?

I spoke to my friends in the investment industry who write letters to clients, and they told me that their clients rarely read their letters. Though there is no reading or speed-reading exam to become an IMA client, and these letters are not followed up by a written exam, I have found that the majority of IMA clients do read these letters. Just as companies get the shareholders they deserve, investment firms attract clients who are like-minded. IMA clients tend to be readers, and they have the intellectual curiosity to learn what is happening in their portfolios and why.

Let me tell you a story. I have a client who is a retired airline pilot. As we sat together in my office, I mentioned to him that I was afraid of flying. I fly a lot (pre-COVID), but every time I am on a plane and it starts shaking and chattering due to turbulence, I become a little bit more religious. I tell myself that these things happen all the time and that most plane crashes happen on the takeoff or landing. There is a turf war inside me between rationality and fear.

My client (the airline pilot) told me that when he's in the pilot's chair in the cabin, he's not nervous. But when he flies as a passenger and the plane goes through a rough patch, he gets nervous, too. At first, I was a bit surprised by that.

Then I realized that the difference between being in the pilot's chair and in the passenger cabin comes down to control and information. When you are the pilot you have control and information about what is happening.

When you're a passenger, you find solace in the fact that Boeing engineers don't just take trains but frequent these planes, too, and that the pilot doesn't have his own parachute and thus has skin in the game. Also, that dying in a plane crash carries roughly the same probability as winning the lottery. (This is why I don't play the lottery; I don't want to irritate the probability gods). Also, this is why my family and I own the same stocks as our clients.

Much the same applies to IMA's clients and their portfolios. We spend hundreds of hours analyzing each company in our portfolios. For IMA clients, without my letters these companies are just ticker symbols – clients are not even in the passenger cabin; they are down in a dark corner of the cargo bay. With my letters I try to bring them into the cockpit (though I still have control of the levers). I want them to understand what we see in each company, how we value it, and what our strategy is in with dealing with the uncertainties of the global economy. Arguably, when there is no turbulence these letters bring little value; but when there is turbulence, and there nearly always is, our clients (hopefully) won't be nervous. Their portfolios will deliver them returns while helping them keep the volatility of their blood pressure to a minimum.

And there are other reasons to write these letters.

The letters allow me to scale my writing, while time doesn't scale as well. (I wrote about this before). After IMA clients read a letter, very few have any questions for me. The few that do get me on the phone or send me questions that I answer in the Q&A section of the next letter (their choice). I guesstimate that I spent about thirty hours on the phone last year talking to clients (less than 30 minutes a week). IMA has about two hundred clients. If I spent 30 minutes on the phone with each of them four times a year, I'd be spending at least 400 hours a year or 8 hours per week on the phone with them. That is time I couldn't spend on research.

I used to think that the difference between introverts and extraverts was their enjoyment of in-person interactions with others. Recently I've discovered that there is another important difference between them: Extraverts get recharged from interactions, while for introverts these interactions drain energy. Though I do enjoy social interactions, one hour on the phone consumes three hours of my energy (or the equivalent of six hours of writing, which is a relaxing, meditative experience for me).

Finally, I am so much smarter on paper than on the phone.

See, everyone wins!

The Winter 2020/21 letter that we just sent out to IMA clients was 27 pages long. Over the next few weeks I'll share excerpts from the letter with you. These excerpts will not focus as much on fish (stocks) as they do on the subject of fishing. In the past I'd rewrite excerpts from these letters as articles, but I feel that the relationship with my readers has evolved to a level where I don't need to do that.

Don't Be a Sophist

We need to pull the fancy outer layer off our problems and strip them to their bones.

VITALIY KATSENELSON

I discuss how to use a Stoic technique to help manage the emotions that come with the stock market.

Click to listen to a narration of this article

The market is up a lot; it is expensive. Should we be selling? This is the number one question we've been getting from clients. So, should we?

We'll give you several answers. We agree that the market is expensive. In fact, a few months ago we compared the euphoria and speculative mood of the market to the one in 1999. Back then, many stocks got so expensive they weren't being valued on earnings, but on eyeballs.

Today, just like then, some high-flying names don't have any earnings. The ones that do are valued on price-to-sales, because a price-to-earnings of 250 carries as little informational content as a 170 or a 500. Yes, the market is expensive and extremely speculative – but *we don't own the market*. We own a portfolio of individually analyzed and still significantly undervalued companies.

To frame this discussion, I'd like to share an excerpt from the book I am working on. Just between us, it will be called *Soul in the Game* and will come out sometime in late spring 2021, published by Harriman House. If you would like to read an early draft and help me hunt for typos, let Barbara know at pa [at] imausa [dot] com and she will send it to you in a few months.

> *In ancient Greece and Rome, parents took their kids to study oratory skills from teachers called Sophists (the word sophisticated has sophist as its root). Sophists focused on the art of persuasion through both emotion and reason, and kids were taught to argue both sides of an argument. Stoics, on the other hand, put the emphasis mainly on reason (not emotions) in their communications.*
>
> *The Sophist's oratory skill was like a spear; it was a powerful weapon that could be used for good or for evil, thus students needed the morality taught by philosophy to know where to point it.*

Stoics were extremely cautious about the Sophists – they thought the words you use to persuade others matter, since in persuading others you may impact your own thinking. In the attempt to persuade others through an appeal to their emotions, we use colorful metaphors; we dramatize the words we use. If we had two brains, one to talk to others and one to talk to ourselves, we'd be fine. But that is not the case; thus our words may turn on us and impact our own emotional state.

It is almost as though Stoics would not want to use the colors available in the rainbow to express their opinions but resort to only black and white. However, I see the value of their thinking. We need to examine the words we use when we communicate with ourselves. When something stirs up negative emotions inside us, we need to be careful when we describe the problem to ourselves. We want to make sure we are not being Sophists against ourselves.

The best way to do this is to write it out. When you lay each word on the paper, examine it. Instead of "My husband drives me insane," you write, "My husband says the following … that upsets me." (I am not quoting from my wife's journal; I am reading her mind.) Instead of "The stock market collapsed," write "The stock market declined X%." Epictetus said something along the same lines. Instead of saying "Our ship is lost far at sea; we'll never get home," he suggested we go with "We are at sea, and we don't know where we are."

We take fancy words, string them together, and add dramatic, superfluous colors. Instead of calling a dish Basel Honey Glazed Wild Alaskan Salmon, Marcus Aurelius might suggest we describe it as "the dead body of a fish, with herbs and honey." He writes, "Just in the same way we should act all through life, and where there are things which appear worthiest of our approval, we should lay them bare and look at their worthlessness and strip them of all the words by which they are exalted."

We need to pull the fancy outer layer off our problems and strip them to their bones. Instead of "my life is horrible," you create a list of things in your life that bother you, spelling them out as plainly as possible (don't use big, colorful words; leave those for the Sophists).

A client called me. Let's call him Todd, because that is his real name. He was somewhat confused on what to do. He explained, "Our stocks are up. The market seems to be crazy. There is rampant speculation everywhere. I am really concerned for our portfolio." I told him the above story about the Sophists and Stoic Philosophers. We agreed that instead of focusing on the market – an ambiguous organism with thousands of stocks – we should really zoom in on one stock at a time, and then we'd see that our portfolio is not full of insanely valued, speculative stocks that are used as casino chips by Robinhood traders. Rather, it's a diligently constructed collection of high-quality, significantly undervalued businesses (30- to 50-cent dollars).

I broke our portfolio down to "dead fish" basics, and we discussed our largest positions in thoughtful detail, just the way we would in a seasonal letter. Todd was relieved – the undramatic, black and white language of stoicism helped him see that there is a lot of value in our portfolio. Just as I see value in stoic philosophy when analyzing and valuing companies.

Let's Keep Humans At The Heart Of Hiring Practices

Businesses have never done as much hiring as they do today... and they've never done a worse job of it.

HARVARD BUSINESS REVIEW

The Financial Times recently published an article about my travails in recruiting. After sharing the article, I expand on what I learned about recruiting, teams, and culture since becoming CEO of IMA.

The *Financial Times* published an article about my travails in recruiting. I'll let you read the article first and then I'll come back with additional thoughts.

"LET'S KEEP HUMANS AT THE HEART OF HIRING PRACTICES"

The next time you apply for a job, how would you feel if the person doing the interview asked to see your Uber rating? It is the number you get from Uber, whose drivers score their passengers from 1 to 5 after drop-off, and a few weeks ago one US boss went on Twitter to say he had made it part of his hiring process.

"If you treat strangers with respect then you will treat customers and co-workers well too," wrote Vitaliy Katsenelson, chief executive of an investment firm in Denver.

"It seemed like a good idea," Katsenelson told me last week. He got the idea after noticing that Nassim Nicholas Taleb, author of the 2007 best-seller, *The Black Swan*, had included his impressive 4.9 Uber rating on his Twitter profile.

As it happened, Katsenelson had been looking for a new operations manager. An Uber score sounded like a smart, unbiased way to see what applicants were really like.

The woman he hired had a 4.89 rating, slightly higher than Katsenelson's 4.86 and much better than my dismal 4.65, which is worse than it sounds. Some drivers won't pick up anyone with a score below 4.6. But Katsenelson quickly discovered his Uber plan was flawed. Women told him their scores had dropped after they spurned Uber drivers' advances. Men who lived in rough neighbourhoods suffered a similar fate after trying to get dropped off nearer their front doors than reluctant drivers wanted to venture.

To his shock, he then learnt his assistant, Barbara, had the lowest score he had ever seen. This did not compute. She was, in his words, an incredibly kind, wonderful person. "I wish I had a whole company of Barbaras".

It turned out she hardly took Ubers at all and one time when she had ordered one, there had been some sort of mix-up that meant she never made it into the car.

Katsenelson quickly dumped the idea. "I thought I was so clever, but then I realised it's not a silver bullet."

Listening to him talk, I began to wish more companies shared his scepticism about using algorithms to hire people.

The traditional face-to-face job interview, a mainstay of assessing job applicants for at least a century, has morphed into a gruesome tech shadow of itself.

Recruitment is widely outsourced to companies that scour websites for potential hires. Candidates' online applications are scanned for key words and phrases hirers supposedly want to see. An array of digital tools using voice recognition, body language software and the like are used to allegedly predict good recruits.

I know all this because it has been so well documented by management experts such as the Wharton School's Professor Peter Cappelli.

As he wrote in Harvard Business Review not too long ago: "Businesses have never done as much hiring as they do today. They've never spent as much money doing it. And they've never done a worse job of it."

We have very little idea if these practices produce good hires. Cappelli reckons only about a third of US companies report that they check to see if their hiring processes secure good workers. So what should they be doing? Give snazzy but unproven tech tools a wide berth. Check past performance and crucially, test for basic skills. It is astonishing how often a business will demand drug tests but ignore the results of skill checks.

Ultimately, hiring outsiders is always going to be fraught. But I think Katsenelson was on to something with a ploy he used a few years ago to recruit an analyst. Determined to find someone who really cared about investment research, not just money, he devised a tediously time-consuming job advert. It asked candidates to list all the books they had read in the past 12 months; talk about the three books — and two people — who had influenced them most; provide a stock idea analysis and write a cover letter to say why not hiring them would be a massive mistake.

About 50 applications came in, only a dozen of which answered each question. But the successful candidate is still with the firm and for Katsenelson, "it worked out great". This tactic won't suit every company, or every job. But I bet it does better than the average algorithm.

ADDITIONAL THOUGHTS

As I wrote in "The Softer Side of Value Investing," as I matured as an investor and became CEO of IMA, I realized that people and culture play a significant role in the success of any business. I've been very careful about making sure that we hire the right people at IMA. Our process of hiring an operations manager took more than three months. I wanted to make sure that the skillset of the person we hired matched the job to be done, but just as importantly, I wanted to know that this person fit with and complemented IMA culture. We have a culture of great customer service, respect, and fun (life is too short).

I also learned that the interviewing process lacks honesty the same way first dates do – applicants tell you what they think you want to hear. Therefore, during interviews I spend as much time watching the body language of applicants as I do listening to what they have to say.

I really liked the intent of the Uber rating idea. It was supposed to be an additional, unbiased data point on one's behavior by people that provide you a service. What I discovered is that there are plenty of biases that influence the accuracy of that number, and it is heavily dependent on the frequency of rideshares. Simply put, it's a flawed indicator of someone's niceness.

The Uber rating was a great theoretical idea that could have provided valuable data. However, once that idea met reality, I realized its flaws. So I stopped using it and doubled down on less scientific methods like calling applicants' references.

As an investor I spend most of my time in scientist mode. Every stock we own has made it into our portfolio based on a lot of research that has spilled into a hypothesis (set of assumptions). But then life happens and puts this set of assumptions to the test. When the reality goes against our initial hypothesis, we hopefully have the mental flexibility to change our minds. Being in scientist mode is also important when you are running a business, as my hiring travails revealed.

P.S. Since we are on the topic of hiring people, here's what I wrote about our experience hiring an analyst: "Letter to a Young Investor."

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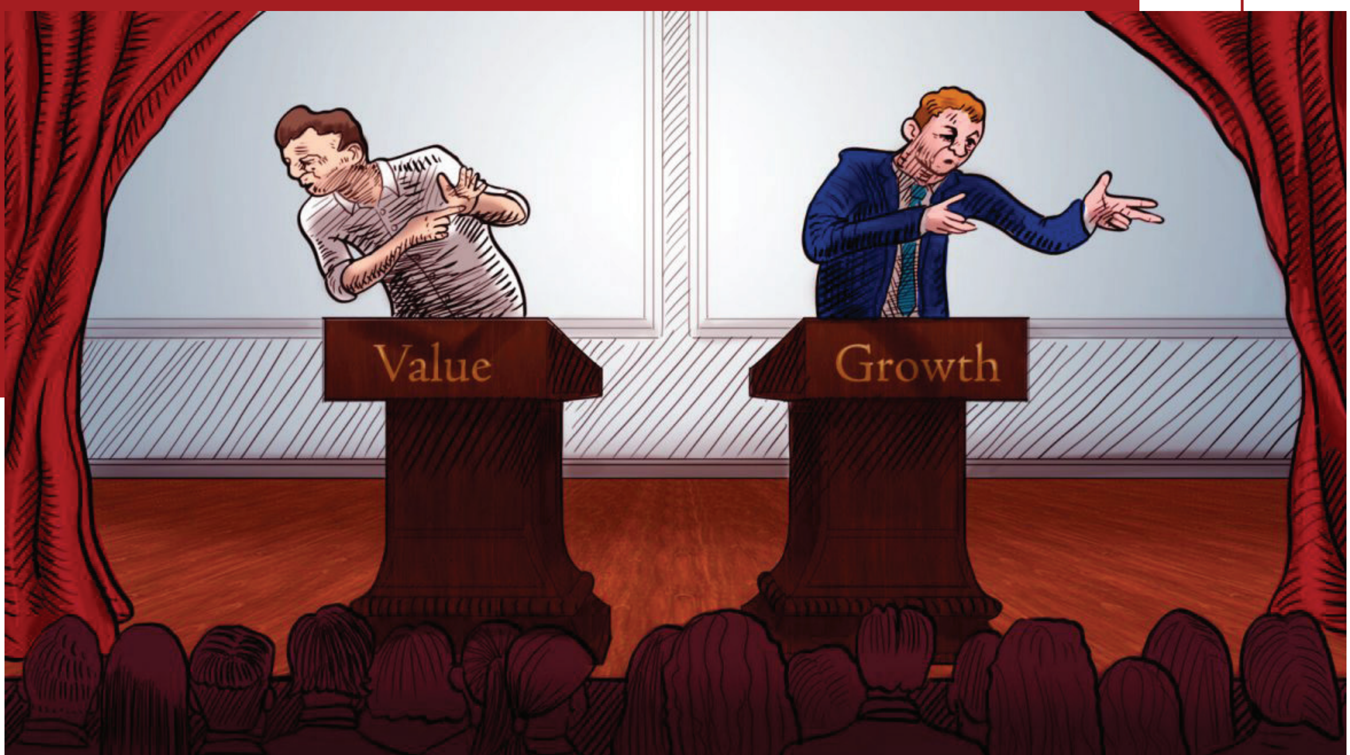
Painting by my father
Naum Katsenelson

Investing

Value & Growth Demagogues



Though I don't want to be a demagogue, period, if I had to choose sides today, I'd rather err in being a value demagogue.

VITALIY KATSENELSON

I have a problem with both value- and growth investing demagogues. While value demagogues tend to believe any company that trades at a P/E above the market average is too frothy, growth demagogues claim that price doesn't matter.

Click to listen to a narration of this article

The following was excerpted from our Winter letter to IMA clients.

I have a problem with both growth and value demagogues.

Growth demagogues will argue that valuation is irrelevant for high-growth companies because the price you pay for growth doesn't matter. They usually say this after a very extended move in growth stocks, where these investors look like gods that walk on water. They call value investors "accountants."

The price you pay matters (this is not a new message). As we've discussed in the past, if you bought great, high-growth companies near the end of the Nifty Fifty bubble in the 1960s or near the end of the dotcom bubble in the 1990s, it took more than a decade to break even (after first struggling through double-digit losses).

One company that comes to mind as I write this is Qualcomm. That stock went from $4 in 1999 to $80 – that's a 20x increase. Qualcomm is truly an incredible company (we own its shares, which we bought for the first time in 2015). It owns essential patents on wireless technology. Your mobile phone runs on Qualcomm's intellectual property. Every time a mobile phone is sold on any part of this large planet, Qualcomm collects a few bucks. An incredible and very profitable business. From 1999 the mobile phone market went through an incredible growth spurt – it's hard to find a market that grew faster globally. However, this did not stop Qualcomm stock from declining to $14 (an 83% drop) in the early 2000s. It took 15 years for Qualcomm to revisit its 1999 high, while its revenues went up 6x over that time.

If Qualcomm doesn't remind you of Tesla, it should – electric cars are the future. (I wrote a tiny book about it, which you can read here.) Tesla stock is up 8x in 2020; it has even been admitted into the exclusive S&P 500 Index club.

The stock is trading at an incredible 22x revenues, or some (meaningless) price-to-earnings multiple (the company is barely profitable). I discussed Tesla's valuation in the past, so I won't waste digital ink on it here, but I'd wager that the expected return for the stock over the coming decade looks incredibly unattractive. The price you pay for even an incredible high-growth company (whose product you love) matters.

Now that I've made a lot of friends in the growth demagogue camp, let's make some among the value demagogues.

Value demagoguery starts when value investors read Ben Graham's Intelligent Investor and the main point they get out of the book is that they need to buy statistically cheap stocks. That is like visiting the Louvre and only learning that its bathroom has soft hand towels. Or reading the Ten Commandments and the only thing you get out of them is how to count to 10. Value demagogues often miss the value investing philosophy embedded in Graham's book. I spelled out that philosophy in an essay, "The 6 Commandments of Value Investing" (click here to receive them in your inbox; or you can listen to it here).

The value demagogues also look at the high current statistical valuation of high-growth companies and ignore that this number is based on rear-view mirror earnings. They ignore that there is tremendous value in growth, and that value is unlocked when a growth company escapes its adolescence and enters maturity. Its costs start growing at a slower pace than its revenues, its margins expand, and its earnings skyrocket. This is why in our models we look at companies based on their earnings at least four years out. If we have a unique insight into the sustainability of a company's future moat and exploding total addressable market, we are looking out farther than four years and then discounting back to today.

What makes the analysis of some of the growth darlings more difficult this time is that their income is distorted (depressed) by investments (in customer acquisition, for instance) that are made through their expense line on the income statement.

Let me give you this example. Walgreens, when it was opening several stores a day during its high growth stage, was doing so through its balance sheet. It would buy land, build a store, and stuff it with inventory – all these activities happened on Walgreens' balance sheet. But a store is a long-term asset that will help Walgreens generate sales and profit for decades. Walgreens would depreciate the land and building over 30 years; thus, as an investor, you would only see 1/30 of the building's cost going through the income statement in any given year. Inventory would show in the income statement as cost of goods sold when they were sold. Costs in the income statement matched revenues they helped to generate.

When software-as-a-service (SAAS) companies acquire customers, the costs are expensed through the income statement, depressing earnings (they never touch the balance sheet). Though the customer may stick around for 10 years, the cost of acquiring that customer hits the income statement on day one (e.g., in the salesperson's commission). The faster you grow, the heavier the customer acquisition burden you carry.

Research and development (R&D) efforts also don't flow through the balance sheet but are expensed through the income statement. R&D is building an asset that will have a long-term life (just like a Walgreens' store), but almost all of R&D cost is expensed in the year it happens.

Modern accounting conventions were created for the industrial economy, which was heavy on physical, easy-to-identify, depreciable assets (stores, factories, etc.). Over the last two decades significant parts of the economy changed, but we are not going to wait for accounting conventions to change, so we need to change.

We don't want to be either value or growth demagogues, though it is easy to turn into one or the other. Our goal is to produce good returns for our clients (and ourselves since we own the same stocks) while sleeping well at night. Or, in other words, we try to maximize returns per volatility of our clients' blood pressure. We are constantly making a conscious and very deliberate effort to be neither type of demagogue. Our portfolio today looks a bit more eclectic than a traditional value portfolio. Over the years we've made gradual changes to our analytical process to capture value when it resides in growth, which allowed companies like Twilio, Uber, Twitter, and others to enter our portfolios.

Though I don't want to be a demagogue, period, if I had to choose sides today, I'd rather err in being a value demagogue. Traditional value (defined as slower-growth companies) has been underperforming growth for too long. Also, the pandemic has widened this gap significantly. Today the stock market cannot get enough of high-growth stocks (even adjusting for nuances in their accounting). We believe many are tremendously, if not insanely, overvalued.

Today, we see value in the more traditional (slower-growth) names. At some point this will change.

The world around us is changing at an accelerating pace. We should strike a delicate balance of learning and adjusting to changes but at the same time remaining true to who we are as value investors (I highly recommend you read Six Commandments of Value Investing, (click here to receive them in your inbox).

The Renaissance of Pipelines

Pipelines are undergoing a renaissance today, but it's not the one you think.

VITALIY KATSENELSON

At first, investors loved them. Then, they hated them. Now, investors have left them for dead. Oil and gas pipeline companies are anything but popular. But they are essential businesses, with rising free cash flow and substantial dividend yields.

Click to listen to a narration of this article

This is the final excerpt from IMA's winter letter.

Pipelines are undergoing a renaissance today, but it's not the one you think. The previous renaissance of shale oil and natural gas development was anything but a good outcome for this industry. Capital-intensive industries, contrary to common opinion, don't benefit from increased demand for their product. Increased demand attracts competition. In a capital-intensive business it is very difficult to increase your capacity just a little. These industries don't work that way, and here is why: Larger investments bring lower costs on a per-unit basis. But when everyone does this it also brings lower prices (revenues) per unit.

To make things more complicated, the pipeline industry is structured as master limited partnerships (MLPs). MLPs are mostly owned by retail investors who hold them to get one shiny object – yield. These companies generate enormous cash flows, while maintenance capital expenditures – basically, the expenses of maintaining their pipelines – are relatively small (10-20% or so of their cash flows).

To grow cash flows, once a company has an established pipeline network, it can do any number of things: It can raise prices for transporting products in its pipelines. It can make small investments to improve the interconnectivity of its pipelines, thus increasing the value of the pipelines to its customers, which also brings higher prices. It can send more products through its pipelines (of course, they are limited by capacity). There are probably a few other small things it can do, and we are sure these companies did them. A company can also do big things – build new pipelines, for instance. Improvements in oil and natural gas extraction technologies brought an enormous amount of petrochemicals to the surface, and they need to be transported.

Here is the problem. Since their investors were attracted to dividends, these companies would pay out most of their cash flows in that form, and whatever cash flows were left they'd put into new projects; but those cash flows were not enough, so… yes, they'd borrow a lot of money. But even borrowing was not enough, so they would pay large dividends and then issue shares (MLP units). They'd pay 6% dividends and then turn around and issue 3% of new shares. Retail investors were delighted to collect 6%, ignoring the fact that the pie now needed to be shared with 3% more shareholders (the stock price would decline 3%).

From 2008 to 2014 none of those things mattered. Investors infatuated with high and rising dividends drove prices of these companies higher in a straight line. This party ended in 2014, when lower oil prices exposed overcapacity in the industry.

That is not the renaissance we are referring to.

The renaissance of today is the one of cash generation. The pandemic and low commodity prices increased uncertainty in the industry, and pipeline companies stopped investing in new projects and have thus been generating enormous cash flows. In our conversations with these companies we learned that this trend did not start in 2020 but a few years back, as their shareholder base changed from retail to institutional investors. They generate cash flows and then decide what is the best use for the cash (after they pay a reasonable dividend).

We spent a lot of time analyzing pipelines in January 2020. Two companies stood out back then: Magellan Midstream (MMP) and Enterprise Products (EPD). However, at the time we decided to do nothing – they were not cheap enough. Ten months later, they were.

MMP is in a category of its own. It has by far the best capital allocation record in the industry – a higher return on capital and the least (almost no) share issuance. MMP focuses on transmitting refined products (gasoline, diesel, jet fuel). It has very little competition in its pipeline routes and is often a sole supplier. The beauty of the pipeline business, if it is run properly, is that it is mainly a fee-for-service business where the supplier often guarantees minimum revenues.

One concern we had with MMP was electric cars: They don't run on gasoline. We did a lot of modeling and realized that it will take a long time before gasoline goes away. Even if sales of electric cars increase, which we think they will, the number of gasoline cars on the roads will remain stubbornly high for a long time. Electric semi-trucks are a decade behind electric cars, and planes are… we don't know how far they are behind semi-trucks. Also, as demand for gasoline declines, pipelines will be able to raise prices (kind of like cigarette companies are doing today).

As of this writing MMP is a $43 stock or so. It is earning about $4 today and should earn about $5.50 in 2024. It pays us about $4 of dividends. As things come back to post-pandemic normal and its free cash flows grow, the company will either buy back stock or increase its dividend. Over the next four years we will collect at least $16 of dividends. MMP should be trading at least at 15x earnings or $75. It was in the low $60s at the beginning of 2020 (and the 2017 high was $80). We'd argue that high, sustainable, growing dividend payments are more valuable in a near-zero (during and post pandemic) interest rate environment. Combine this with dividends, and MMP is worth around $91 to us.

MMP is a 45-cent dollar.

Enterprise Products (EPD) is the largest pipeline company in the US. Its main focus is on natural gas. Size is important in this industry. Pipelines are networks that connect producers with refineries and transportation hubs. As prices vary at various points, flexibility of this network allows producers to send their commodities to the points where they'll get paid the most. Also, 89% of EPD's revenue is from fees for services (take or pay contracts). We like EPD's exposure to natural gas and natural gas liquids, because most of these products are used in manufacturing (plastics) and the generation of electricity.

EPD was not shy about spending money on new pipelines over the last five years, but neither was it shy about issuing new units (this was another reason for our initial hesitation about the company in January). EPD recently announced that it is slashing its capital expenditures to $800 million from $4 billion in 2019. EPD's free cash flow (operating cash flow less capital expenditures) is due to explode from $1.77 in 2020 to $2.50–2.75 in around 2022 or 2024.

Our confidence in EPD is boosted by the fact that a third of EPD units are owned by the Duncan family (Dan Duncan, EPD's founder, died in 2010). The Duncans have been a significant buyer of EPD stock lately.

EPD pays a $1.80 dividend, so over the next four years we'll collect at least $7.20 in dividends. The stock should be trading at 15 times free cash flows, or $37.50 or so. Add dividends, and over four years EPD is worth $44 to us, give or take.

EPD is a 43-cent dollar.

Inflation is here. But for how long?

I think about inflation on three timelines: short, medium, and long-term.

VITALIY KATSENELSON

Exploring the nuances of inflation, including when it may be coming, from where it might arrive, and how long it might be staying.

Click to listen to a narration of this article

For the last three weeks I've been working on our letter to IMA clients. My typical letters, where I discuss stocks in our portfolio and which I write four times a year, run about 30 pages long. This time, when I got to a natural stopping point, I was on page 22. But there was one small problem: I hadn't mentioned a single stock we own. I wrote about the economy, inflation, our strategy for investing in an inflationary environment, sideways markets, the craziness of today's markets, and cryptocurrencies. We called this letter "Summer Letter – Part One" (I know, very creative) and sent it out to our clients.

Since Part One discusses "how to fish" and the ocean, but not the fish, I'll share it publicly. I'll break it up into five digestible articles that I'll send out over the next five weeks. One caveat. I am *not* going to rewrite (sanitize) them into traditional articles. I'll leave them as they were, addressed to IMA clients. I apologize ahead of time; in some small part they'll be IMA portfolio-specific. I'll be honest, I just don't have the time or energy to rewrite them. I am currently working on Part Two of the letter that discusses individual stocks we own. After I am done with that I have to dive into finishing my book, which was supposed to be out last month.

I am really looking forward to summer. For all practical purposes the pandemic is over in our lives, at last for now. My 15-year-old daughter Hannah is going to a three-week sleepaway camp in the Chicago area. This is the first time Hannah has left home for more than a one night sleepover at a friend's house. The thought of not seeing her for three weeks is crushing me. I may go to Chicago in early July to pick her up and spend a few days in the Windy City, and may even do a reader get together.

Hannah has a very addictive personality. A few years ago she got addicted to reading, and last year she read 75 books. Before the pandemic she started playing volleyball. She practiced several hours a day, often on her own. She got really good at it. Unfortunately, Covid interrupted it. This January, after she watched *The Queen's Gambit*, she got hooked on chess. She plays nonstop. She has already played 550 games on Chess.com in just a few months. She also watches YouTube videos and solves puzzles endlessly. Chess is all she thinks about. A slightly sad fact: I have not won a game with her in months.

I recommended that Hannah read Josh Waitzkin's book The Art of Learning. After devouring it she stopped paying attention to her rating and started focusing on each game (process vs. outcome). She said this little tweak really improved her game.

Waitzkin was the real life kid from the *Searching for Bobby Fischer* movie. I listened to the book, ordered a paper copy, and will be reading it on our vacation in Vail next week. It's one of the best books on learning I've read (okay, listened to) in a long time.

INFLATION IS HERE. BUT FOR HOW LONG?

This letter is going to be long. I blame the word inflation, be it transitory or not, for inflating its length.

The number one question I am asked by clients, friends, readers, and random strangers is, are we going to have inflation?

I think about inflation on three timelines: short, medium, and long-term.

The pandemic disrupted a well-tuned but perhaps overly optimized global economy and time-shifted the production and consumption of various goods. For instance, in the early days of the pandemic automakers cut their orders for semiconductors. As orders for new cars have come rolling back, it is taking time for semiconductor manufacturers, who, like the rest of the economy, run with little slack and inventory, to produce enough chips to keep up with demand. A $20 device the size of a quarter that goes into a $40,000 car may have caused a significant decline in the production of cars and thus higher prices for new and used cars. (Or, as I explained to my mother-in-law, all the microchips that used to go into cars went into a new COVID vaccine, so now Bill Gates can track our whereabouts.)

Here is another example. The increase in new home construction and spike in remodeling drove demand for lumber while social distancing at sawmills reduced lumber production – lumber prices spiked 300%. Costlier lumber added $36,000 to the construction cost of a house, and the median price of a new house in the US is now about $350,000.

The semiconductor shortage will get resolved by 2022, car production will come back to normal, and supply and demand in the car market will return to the pre-pandemic equilibrium. High prices in commodities are cured by high prices. High lumber prices will incentivize lumber mills to run triple shifts. Increased supply will meet demand, and lumber prices will settle at the pre-pandemic level in a relatively short period of time. That is the beauty of capitalism!

Most high prices caused by the time-shift in demand and supply fall into the short-term basket, but not all. It takes a considerable amount of time to increase production of industrial commodities that are deep in the ground – oil, for instance. Low oil prices preceding the pandemic were already coiling the spring under oil prices, and COVID coiled it further. It will take a few years and increased production for high oil prices to cure high oil prices. Oil prices may also stay high because of the weaker dollar, but we'll come back to that.

Federal Reserve officials have told us repeatedly they are not worried about inflation; they believe it is transitory, for the reasons I described above. We are a bit less dismissive of inflation, and the two factors that worry us the most in the longer term are labor costs and interest rates.

Let's start with labor costs.

During a garden-variety recession, companies discover that their productive capacity exceeds demand. To reduce current and future output they lay off workers and cut capital spending on equipment and inventory. The social safety net (unemployment benefits) kicks in, but not enough to fully offset the loss of consumer income; thus demand for goods is further reduced, worsening the economic slowdown. Through millions of selfish transactions (microeconomics), the supply of goods and services readjusts to a new (lower) demand level. At some point this readjustment goes too far, demand outstrips supply, and the economy starts growing again.

This pandemic was not a garden-variety recession.

The government manually turned the switch of the economy to the "off" position. Economic output collapsed. The government sent checks to anyone with a checking account, even to those who still had jobs, putting trillions of dollars into consumer pockets. Though output of the economy was reduced, demand was not. It mostly shifted between different sectors within the economy (home improvement was substituted for travel spending). Unlike in a garden-variety recession, despite the decline in economic activity (we produced fewer widgets), our consumption has remained virtually unchanged. Today we have too much money chasing too few goods– that is what inflation is. This will get resolved, too, as our economic activity comes back to normal.

But.

Today, though the CDC says it is safe to be inside or outside without masks, the government is still paying people not to work. Companies have plenty of jobs open, but they cannot fill them. Many people have to make a tough choice between watching TV while receiving a paycheck from big-hearted Uncle Sam and working. Zero judgement here on my part – if I was not in love with what I do and had to choose between stacking boxes in Amazon's warehouse or watching Amazon Prime while collecting a paycheck from a kind uncle, I'd be watching *Sopranos* for the third time.

To entice people to put down the TV remote and get off the couch, employers are raising wages. For instance, Amazon has already increased minimum pay from $15 to $17 per hour. Bank of America announced that they'll be raising the minimum wage in their branches from $20 to $25 over the next few years. The Biden administration may not need to waste political capital passing a Federal minimum wage increase; the distorted labor market did it for them.

These higher wages don't just impact new employees, they help existing employees get a pay boost, too. Labor is by far the biggest expense item in the economy. This expense matters exponentially more from the perspective of the total economy than lumber prices do. We are going to start seeing higher labor costs gradually make their way into higher prices for the goods and services around us, from the cost of tomatoes in the grocery store to the cost of haircuts.

Only investors and economists look at higher wages as a bad thing. These increases will boost the (nominal) earnings of workers; however, higher prices of everything around us will negate (at least) some of the purchasing power.

Wages, unlike timber prices, rarely decline. It is hard to tell someone "I now value you less." Employers usually just tell you they need less of your valuable time (they cut your hours) or they don't need you at all (they lay you off and replace you with a machine or cheap overseas labor). It seems that we are likely going to see a one-time reset to higher wages across lower-paying jobs. However, once the government stops paying people not to work, the labor market should normalize; and inflation caused by labor disbalance should come back to normal, though increased higher wages will stick around.

There is another trend that may prove to be inflationary in the long-term: de-globalization. Even before the pandemic the US set plans to bring manufacturing of semiconductors, an industry deemed strategic to its national interests, to its shores. Taiwan Semiconductor and Samsung are going to be spending tens of billions of dollars on factories in Arizona.

The pandemic exposed the weaknesses inherent in just-in-time manufacturing but also in over reliance on the kindness of other countries to manufacture basic necessities such as masks or chemicals that are used to make pharmaceuticals. Companies will likely carry more inventory going forward, at least for a while. But more importantly more manufacturing will likely come back to the US. This will bring jobs and a lot of automation, but also higher wages and thus higher costs.

If globalization was deflationary, de-globalization is inflationary.

We are not drawing straight-line conclusions, just yet. A lot of manufacturing may just move away from China to other low-cost countries that we consider friendlier to the US; India and Mexico come to mind.

And then we have the elephant in the economy – interest rates, the price of money. It's the most important variable in determining asset prices in the short term and especially in the long term. The government intervention in the economy came at a significant cost, which we have not felt yet: a much bigger government debt pile. This pile will be there long after we have forgotten how to spell *social distancing*.

The US government's debt increased by $5 trillion to $28 trillion in 2020 – more than a 20% increase in one year! At the same time the laws of economics went into hibernation: The more we borrow the less we pay for our debt, because ultra-low interest rates dropped our interest payments from $570 billion in 2019 to $520 billion in 2020.

That is what we've learned over the last decade and especially in 2020: The more we borrow the lower interest we pay. I should ask for my money back for all the economics classes I took in undergraduate and graduate school.

This broken link between higher borrowing and near-zero interest rates is very dangerous. It tells our government that how much you borrow doesn't matter; you can spend (after you borrow) as much as your Republican or Democratic heart desires.

However, by looking superficially at the numbers I cited above we may learn the wrong lesson. If we dig a bit deeper, we learn a very different lesson: Foreigners don't want our (not so) fine debt. It seems that foreign investors have wised up: They were not the incremental buyer of our new debt – *most of the debt the US issued in 2020 was bought by Uncle Fed*. Try explaining to your kids that our government issued debt and then bought it itself. Good luck.

Let me make this point clear: Neither the Federal Reserve, nor I, nor a well-spoken guest on your business TV knows where interest rates are going to be (the total global bond market is bigger even than the mighty Fed, and it may not be able to control interest rates in the long run). But the impact of what higher interest rates will do the economy increases with every trillion we borrow. There is no end in sight for this borrowing and spending spree (by the time you read this, the administration will have announced another trillion in spending).

Let me provide you some context about our financial situation.

The US gross domestic product (GDP) – the revenue of the economy – is about $22 trillion, and in 2019 our tax receipts were about $3.5 trillion. Historically, the-10 year Treasury has yielded about 2% more than inflation. Consumer prices (inflation) went up 4.2% in April. Today the 10-year Treasury pays 1.6%; thus the World Reserve Currency debt has a negative 2.6% *real* interest rate (1.6% – 4.2%).

These negative real (after inflation) interest rates are unlikely to persist while we are issuing trillions of dollars of debt. But let's assume that half of the increase is temporary and that 2% inflation is here to stay. Let's imagine the unimaginable. Our interest rate goes up to the historical norm to cover the loss of purchasing power caused by inflation. Thus it goes to 4% (2 percentage points above 2% "normal" inflation). In this scenario our federal interest payments will be over $1.2 trillion (I am using vaguely right math here). A third of our tax revenue will have to go to pay for interest expense. Something has to give. It is not going to be education or defense, which are about $230 billion and $730 billion, respectively. You don't want to be known as a politician who cut education; this doesn't play well in the opponent's TV ads. The world is less safe today than at any time since the end of the Cold War, so our defense spending is not going down (this is why we own a lot of defense stocks).

The government that borrows in its own currency and owns a printing press will not default on its debt, at least not in the traditional sense. It defaults a little bit every year through inflation by printing more and more money. Unfortunately, the average maturity of our debt is about five years, so it would not take long for higher interest expense to show up in budget deficits.

Money printing will bring higher inflation and thus even higher interest rates.

If things were not confusing enough, higher interest rates are also deflationary.

We've observed significant inflation in asset prices over the last decade; however, until this pandemic we had seen nothing yet. Median home prices are up 17% in one year. The wild, speculative animal spirits reached a new high during the pandemic. Flush with cash (thanks to kind Uncle Sam), bored due to social distancing, and borrowing on the margin (margin debt is hitting a 20-year high), consumers rushed into the stock market, turning this respectable institution (okay, wishful thinking on my part) into a giant casino.

It is becoming more difficult to find undervalued assets. I am a value investor, and believe me, I've looked (we are finding some, but the pickings are spare). The stock market is very expensive. Its expensiveness is setting 100-year records. Except, bonds are even more expensive than stocks – they have negative real (after inflation) yields.

But stocks, bonds, and homes were not enough – too slow, too little octane for restless investors and speculators. Enter cryptocurrencies (note: plural). Cryptocurrencies make Pets.com of the 1999 era look like a conservative investment (at least it had a cute sock commercial). There are hundreds if not thousands of crypto "currencies," with dozens created every week. (I use the word *currency* loosely here. Just because someone gives bits and bytes a name, and you can buy these bits and bytes, doesn't automatically make what you're buying a currency.)

"The definition of a bubble is when people are making money all out of proportion to their intelligence or work ethic." – The Big Short

I keep reading articles about millennials borrowing money from their relatives and pouring their life savings into cryptocurrencies with weird names, and then suddenly turning into millionaires after a celebrity CEO tweets about the thing he bought. Much ink is spilled to celebrate these gamblers, praising them for their ingenious insight, thus creating ever more FOMO (fear of missing out) and spreading the bad behavior.

Unfortunately, at some point they will be writing about destitute millennials who lost all of their and their friends' life savings, but this is down the road. Part of me wants to call this a crypto craziness a bubble, but then I think, Why that's disrespectful to the word *bubble*, because something has to be worth something to be overpriced. At least tulips were worth something and had a social utility. (I'll come back to this topic later in the letter).

But.

When interest rates are zero or negative, stocks of sci-fi-novel companies that are going to colonize and build five-star hotels on Mars are priced as if El Al (the Israeli airline) has regular flights to the Red Planet every day of the week except on Friday (it doesn't fly on Shabbos). Rising interest rates are good defusers of mass delusions and rich imaginations.

In the real economy, higher interest rates will reduce the affordability of financed assets. They will increase the cost of capital for businesses, which will be making fewer capital investments. No more 2% car loans or 3% business loans. Most importantly, higher rates will impact the housing market.

Up to this point, declining interest rates increased the affordability of housing, though in a perverse way: The same house with white picket fences (and a dog) is selling for 17% more in 2021 than a year before, but due to lower interest rates the mortgage payments have remained the same. Consumers are paying more for the same asset, but interest rates have made it affordable.

At higher interest rates housing prices will not be making new highs but revisiting past lows. Declining housing prices reduce consumers' willingness to improve their depreciating dwellings (fewer trips to Home Depot). Many homeowners will be upside down in their homes, mortgage defaults will go up… well, we've seen this movie before in the not-so-distant past. Higher interest rates will expose a lot of weaknesses that have been built up in the economy. We'll be finding fault lines in unexpected places – low interest has covered up a lot of financial sins.

And then there is the US dollar, the world's reserve currency. Power corrupts, but the unchallenged and unconstrained the power of being the world's reserve currency corrupts absolutely. It seems that our multitrillion-dollar budget deficits will not suddenly stop in 2021. With every trillion dollars we borrow, we chip away at our reserve currency status (I've written about this topic in great detail, and things have only gotten worse since). And as I mentioned above, we've already seen signs that foreigners are not willing to support our debt addiction.

A question comes to mind: **Am I yelling fire where there is not even any smoke?**

Higher interest rates is anything but a consensus view today. Anyone who called for higher rates during the last 20 years is either in hiding or has lost his voice, or both. However, before you dismiss the possibility of higher rates as an unlikely plot for a sci-fi novel, think about this.

In the fifty years preceding 2008, housing prices never declined nationwide. This became an unquestioned assumption by the Federal Reserve and all financial players. Trillions of dollars of mortgage securities were priced as if "Housing shall never decline nationwide" was the Eleventh Commandment, delivered at Temple Sinai to Goldman Sachs. Or, if you were not a religious type, it was a mathematical axiom or an immutable law of physics. The Great Financial Crisis showed us that *confusing the lack of recent observations of a phenomenon for an axiom may have grave consequences.*

Today everyone (consumers, corporations, and especially governments) behaves as if interest rates can only decline, but what if… I know it's unimaginable, but what if ballooning government debt leads to higher interest rates? And higher interest rates lead to even more runaway money printing and inflation?

This will bring a weaker dollar.

A weaker US dollar will only increase inflation, as import prices for goods will go up in dollar terms. This will create an additional tailwind for commodity prices.

If your head isn't spinning from reading this, I promise mine is from having written it.

To sum up: A lot of the inflation caused by supply chain disruption that we see today is temporary. But some of it, particularly in industrial commodities, will linger longer, for at least a few years. Wages will be inflationary in the short-term and will reset prices higher, but once the government stops paying people not to work, wage growth should slow down. Finally, in the long term a true inflationary risk comes from growing government borrowing and budget deficits, which will bring higher interest rates and a weaker dollar with them, which will only make inflation worse and will also deflate away a lot of assets.

How We Invest In Inflation

Inflation and higher interest rates are joined at the hip.

VITALIY KATSENELSON

Finding investments to weather the storm. Strategies and ways to mitigate inflation risk, including investing in businesses with pricing power, capital intensity, and investing abroad.

Click to listen to a narration of this article

This is the second part of my summer letter to IMA clients. You can read the first part here.

Thoughtfully and humbly.

We need to recognize that inflation in the long-term is a probability but not a certainty. Macroeconomics is a voodoo science; it appropriately belongs in the liberal arts department. The economy is an incredibly complex and unpredictable system.

Here is an example: Japan is the most indebted developed nation in the world (its debt-to-GDP exceeds 260%, while ours is 130% or so). Its population is shrinking, and thus its level of indebtedness per capita is going up at a much faster rate than the absolute level of debt. Anyone, including yours truly, would have thought that this forest full of dry wood was one lightning strike away from a disastrous conflagration. And yet Japanese interest rates are lower than ours and the country has been mired in a deflationary environment for decades.

Admittedly, Japan has a lot of unique economic and cultural issues: Companies are primarily run for the benefit of employees, not shareholders (unproductive employees are never let go); there are a lot of zombie companies that should have been allowed to fail decades ago; and the Japanese asset bubble burst in 1991, when debt-to-GDP was only 60%. The point still stands: Long-term forecasting of inflation and deflation is an incredibly difficult and humbling exercise.

As investors we have to think not in binary terms but in probabilities. The acceleration of our debt issuance and our government's seeming indifference to it and to ballooning budget deficits raise the probability and the likely severity of inflation. At the same time, we have to accept the possibility that the economic gods are playing cruel games with us gullible humans and have deflation in store for us instead.

Inflation and higher interest rates are joined at the hip. The expectation of higher inflation will raise interest rates, as bond investors will demand a higher return. This in turn will result in larger budget deficits and more money printing and thus more borrowing and even higher interest rates.

Here is how we are positioning our portfolio for the risk – the possibility, not the certainty – of long-term inflation:

Valuation matters more than ever. Higher interest rates are an inconvenience to short-duration assets whose cash flows are near the present and devastating to long-duration assets. Here is a very simple example: When interest rates rise 1%, a bond with a maturity of 3 years will decline about 2.5%, while one with a maturity of 30 years will decline 25% or so.

The same applies to companies whose cash flows lie far in the future and who are thus very sensitive to increases in the discount rate (interest rates and inflation). Until recently they have disproportionally benefited from low interest rates. They are the ones that you will most likely find trading in the bubble territory today. But their high valuations (high price-to-earnings ratio) will revert downward. Value stocks will be back in vogue again. We have started seeing the rotation from growth to value recently.

Inflation will benefit some companies, be indifferent to others, and hurt the rest. To understand what separates winners from losers, we need to understand the physics of how inflation flows through a company's income statement and balance sheet.

Let's start with revenue. Higher prices across the economy are a main feature of inflation. We want to own companies that have pricing power. **Pricing power** is the ability to raise prices without suffering a decline in revenue that comes from customers' inability to afford higher prices or from the loss of customers to competitors.

Companies that have strong brands, monopolies, or products that represent a very small portion of customer budgets usually have pricing power.

If Apple raises prices on the iPhone, you'll curse Steve Jobs and pay the higher price. (A friend of mine curses him every time the iPhone frustrates him. I keep reminding him that Steve is no longer with us. Doesn't help.) Of course, if Apple raises iPhone prices too much and its products become unaffordable, consumers may just start buying iThings less often.

Tobacco companies have pricing power. I lived through a hyperinflation in Russia in the late 1980s and early 1990s, I was a smoker then. One day cigarette prices doubled. I experienced a price shock. I cursed at tobacco companies; cigarettes did not get any cheaper. A day later I was paying double again for my cigarettes. Smokers are very loyal to their brands, and cigarettes are an addictive product. We own plenty of these stocks, too. The same applies to beer and especially hard liquor. (If you think tobacco stocks are socially irresponsible investing choices, you are … just read my thoughts on this topic here).

What the pandemic showed us is that humans are adaptable creatures – you throw adversity at us, we'll indulge in angry outbursts but we'll adapt. The rate of change of inflation matters even more than absolute rate of inflation. If inflation remains predictable, even at a higher level, then businesses will plan for and price it into their products. If the rate of growth is highly variable, then there is going to be a war of pricing powers for shrinking purchasing ability of the end customer. We want to own companies that are on the winning side of that war.

Let's go to the expenses side of the income statement. Companies whose expenses are impacted the least by rising prices do well, too. Generally, companies with larger fixed costs do better.

But.

It is important to differentiate whether the capital intensity of a business lies in the past or in the future. A business whose high capital intensity is in the past benefits from inflation. Think of a pipeline company, for instance (we own plenty of those). Most of its costs are fixed, and they have been incurred in yesterday's pre-inflation dollars. The cost of maintaining pipelines will go up, but in relation to the total cost of constructing pipelines these costs are small. However, companies that operate pipelines have debt-heavy balance sheets, which can become a source of higher costs. Pipeline companies we own have debt maturities that go out many decades into the future. They'll be paying off these debts with inflated cash flows.

I've seen studies that looked at asset prices over the last few decades and declared "These assets have done the best in past inflations." Most of these studies missed a small but incredibly important detail: The price you pay for the asset matters. If we are entering into an inflationary environment today, it is happening when asset prices are at the highest valuation in over a century. (This was not always the case during the period covered by these studies.)

For instance, one study showed that REITs have done well during past inflations. This may not be the case going forward. Aside from its being a very broad and general statement (not all REITs are created equal), low interest rates brought a lot of capital into this space and inflated valuations. Investors were attracted to current income, which was better than from bonds, and they paid little attention to the valuations of the underlying assets. Buying REIT ETFs may do more harm than good.

I cannot stress this point enough: Whatever landscape is ahead of us, we are entering into it with very high valuations and an economy addicted to low interest rates.

We have to be very careful about relying on generalized comments about past inflations. We need to be nuanced in our thinking.

WE GET ASKED ABOUT GOLD AND CASH

Gold: We don't have a great love for gold. We have a position through options as a hedge. We discussed it in the past in great depth, so I won't bore you with it here.

Cash: I am basically referring to short-term bonds, which seem like the most comfortable asset to be in today. However, their ability to keep up with inflation has been spotty in the past. It is okay in the short term but likely to be value-destructive in the long term. Our view on cash has not changed: In a portfolio context cash should be a residual on other investment decisions. In our portfolios cash is what is left when we run out of investment ideas.

INVESTING OUTSIDE OF THE US

The US government was not the only one borrowing and paying people to stay at home. But the US has done it to a much greater degree than others. Most importantly, we are not slowing down our spending (and thus borrowing), which will likely lead to a weaker dollar. If nothing else, a declining dollar makes foreign securities more valuable in US dollars. The probability of a stronger dollar is low.

But there is more.

The next decade will likely belong to ex-US investing. If you invested outside the US over the last decade, your returns were overshadowed by the gigantic outperformance of the US markets. Today the US is the most expensive developed market. Take Europe, for instance; most European stocks are still trading below 2007 highs. UK stocks trade at a half of the valuation of US stocks.

Our approach to investing is very simple: We are diehard value investors looking for high-quality companies that are significantly undervalued and run by great management. We do not change into flamboyant value-indifferent investors when we cross the border. International investing just gives us a greater palette with which to paint our investing canvas.

We've been doing ex-US investing for a long time. Today, about a third of our portfolio is in international stocks. In a few months we are going to roll out a new ex-US portfolio (some stocks from this portfolio will spill into our core value and dividend portfolios, but not all).

If you thought we had a silver bullet and easy answers, we don't. I know what I am about to say is going to fall on deaf ears, especially since we are in an apparently never-ending bull market. But *as steward of our clients' capital, our most important objective is survival (avoiding permanent loss of capital and maintaining purchasing power) in both inflationary and deflationary environments.*

Last decade this did not matter. Risks were only figments of our imagination, as money printing by the Fed, which was trying to fix a lot of sins and became the biggest sin of all – significantly distorting the price of money and thus the economy. But as Charlie Munger said, "If you are not confused about the global economy, you don't understand it."

A suddenly appearing iceberg is life-threatening to a speedboat (or cruise liner), but it is just an unpleasant inconvenience for an icebreaker. Our goal is to have a portfolio of icebreakers. We are playing a different game – we are not racing against the speedboats. We take comfort in knowing that, while the speedboats may outrace us for some time, they are bound to eventually hit an iceberg and sink. One iceberg that we have an eye on today is inflation (though we are prepared for deflation, too.)

Curmudgeon on Cryptocurrency

Cryptocurrencies are a clear and present danger to the US dollar.

VITALIY KATSENELSON

I share a story about when four separate people asked me about "investing" in cryptocurrencies, as well as my thoughts on Bitcoin and other crypto-assets.

Click to listen to a narration of this article

This is part 3 of the summer letter I wrote to IMA clients; it was also published in Barron's.

In mid-April I picked my 15-year-old daughter Hannah and her friend Sarah up from school and took them to Barnes & Noble. Sarah found out that I "do stocks" for a living and immediately asked me about crypto. She wondered what cryptocurrency she should buy and if she should open a Robinhood account.

I'll tell you about the advice I gave her in a bit. But a few days later I got three calls in one day from my wife's side of the family – from my sister-in-law (a pharmacist) and my wife's cousins (both are barbers). They were all asking me about crypto. I told them, you don't ask my advice on which number to put your chips on when you play roulette in Vegas; cryptocurrencies fall into the same category.

No matter what asset class you are discussing, it feels a bit "toppy" when people far removed from investing start asking you for advice about it, all at once.

I feel like an old curmudgeon writing this. I know "I don't get it." Crypto lovers look at me as if I am defending silent movies and treating "talkies" as unwelcome, short-term imposters. Curmudgeon I am.

When we discuss crypto, we need to separate blockchain technology from the so-called currencies. Though I have yet to see a mainstream application of blockchain, I get a feeling they are coming. However, just because a technology is useful, has a lot of applications, and is widely accepted doesn't automatically mean that you can use it to create a genuine currency.

Here is an example. Venmo, which is owned by PayPal, is a very useful technology that many Americans use weekly or even daily. The benefits of widespread usage of Venmo, however, accrue to PayPal's shareholders and don't lead to appreciation of the US dollar or whatever other currency it transacts in.

When we talk about cryptocurrencies we have to make clear which one. Many consider Bitcoin their god and savior. However, there are thousands of these "currencies" out there, with dozens created every week.

Until recently Bitcoin looked like a clear winner; even Elon Musk was touting it, and Tesla bought $1.5 billion worth of it. Then Musk also shared with us his love of Dogecoin – a joke of a currency (literally, it was created to mock cryptocurrencies), and Dogecoin exploded in price. A few weeks later Musk realized that Bitcoin is "Beanie babies powered by coal." Because of Bitcoin's decentralized nature, solving useless math problems to mine more bitcoins consumes more electricity than Argentina. Musk announced that until Bitcoin starts consuming less energy, Tesla will not be accepting it as a payment for cars. If you are an ESG-oriented pension and don't want to own Exxon ("evil Big Oil"), I want to see how you justify owning Bitcoin.

Arguably, Bitcoin is worse for the environment than internal combustion engine cars if you adjust for CO2 production in relation to societal utility (at least cars get you places). For the energy cost of processing one bitcoin, VISA can process 810,000 transactions, about 370 times faster.

I've spilled a lot of ink explaining that one of the biggest assets the US government has in its arsenal is the US dollar being the world's reserve currency. Control over our own currency gives politicians the ability to make promises and not keep them, by constantly running budget deficits and printing and borrowing money to pay for these promises. We are able to run trillion-dollar deficits because the US government has a dollar-printing press. The US government will not give it up without a fight. We've started wars over less.

Cryptocurrencies are a clear and present danger to the US dollar. There is a very high probability that the US government will outlaw the use of cryptos as currencies. Sounds far-fetched? The US government did this in 1933 with gold. That was less than 100 years ago. India is threatening to ban Bitcoin. South Korea already did.

I am sympathetic to some cryptocurrency investors, especially after seeing what we are doing with our fiat currency. However, for most people they are just speculative vehicles. My wife's relatives pay little attention to the US Government's or Fed's balance sheets. They are interested in bitcoin for one reason only – it is going up. Cryptos present these "unique" opportunities for people to pour their life savings into bits and bytes on servers far far away with a hope that they'll magically turn their lives into paradise on the beach.

When you go to the casino you are not cashing out your life savings and borrowing from your mother-in-law, unless you are a degenerate gambler. You don't do that because the casino doesn't try to masquerade as a place where you invest. If you have an ounce of common sense, you know you are in a casino, a place where people gamble, the air is pumped in, you hear the unending ring of slot machines, and you can't readily find an exit. A reasonable person will only take as much money to Vegas as he can afford to lose.

Cryptocurrencies are a different beast. You buy them on platforms that resemble your brokage account, where (hopefully) you invest. Also, you're not gambling with casino chips, you are buying "currencies." Suddenly, crypto is competing not with your Vegas purse but with your 401(k). This domain confusion is dangerous. My advice on crypto has been consistent: Gamble with as much money as you can afford to lose. But remember, even when you are winning – actually, especially when you are winning – you are not investing, you are gambling, and thus approach it as a trip to Las Vegas, not a visit to your 401(k).

Now to the advice I gave to Sarah (my daughter's 15-year-old friend). I told her, first of all, don't open an account on Robinhood. This platform has merged the worst that social media and the casino have to offer into one interface. You are too young to gamble. If you'd like to invest, then you have to accept that it's not a get-rich-fast but rather a get-rich-slow activity. Once Sarah heard "get rich slow," I think she lost interest in whatever advice I had to offer. Luckily we arrived at Barnes & Noble, so she did not have to go on listening to this curmudgeon.

I'll leave this discussion with a quote by one of my favorite thinkers, Nassim Taleb: "[Investing/speculating in cryptocurrencies is] the idea that a collection of people would get rich at the expense of society for the sole privilege that the world is adopting their currency and not another."

P.S. I want to do a small follow-up to my article above. I received many emails from readers explaining to me that I had ignored the revolutionary nature of blockchain as a technology. I did not. I am actually fascinated by what blockchain may be able to accomplish. The more I learn about it, the more I realize that Bitcoin was a revolutionary invention as a technology, but far from a perfect one. There are many other strong rivals that are faster, more energy efficient, and smarter (programmable), which are trying to unseat it. This is why there are now thousands of "currencies" (technologies) out there with new ones coming weekly.

I have found that learning about them is fascinating; each one has a different philosophical and technological approach. But again, I look at them as technologies, not currencies. I found this interview with Charles Hoskinson, creator of Cardano and co-creator of Ethereum (both are cryptocurrencies/ technologies) very interesting.

Sideways Market

Sideways markets happen not because the stock market gods play an unkind joke on gullible humans but because of human emotions.

VITALIY KATSENELSON

I go over why we may be entering a sideways market (I wrote two books on this subject), as well as how to invest in them.

Click to listen to a narration of this article

I started writing my first book, *Active Value Investing: Making Money in Range-Bound Markets*, in 2005 and finished it in 2007. I published the second, an abridged version of the first (*The Little Book of Sideways Markets*), in 2010. In both books I made the case that there was a very high probability that we were in the midst of a secular sideways market – a market that goes up and down, with a lot of cyclical volatility, but ends up going nowhere for a long time.

Sideways markets happen not because the stock market gods play an unkind joke on gullible humans but because of human emotions. Historically, sideways markets have always followed secular bull markets. At the end of secular bull markets stocks become very expensive – their valuations (P/Es) get very high. Sideways markets are just a payback for all the fun and returns stock investors enjoyed during secular bull markets.

In 1999, after 17 years of incredible returns, the mother of all secular bull markets ended with valuations we'd never seen before. For this reason, in my first book I argued that the sideways market that started then might last longer than past ones. In the Little Book I went a step farther with the benefit of hindsight – it was written post-Great Recession. I argued that the economic growth rate going forward would be lower than it was in the past, and thus this sideways market might last even longer than I originally suspected.

Both books provided a framework for how to think about paths that might lie in our future.

Fast-forward a decade. The market we've been in was anything but sideways. Was I wrong? Yes.

What I failed to see was how the Great Financial Crisis would change the role the Fed would play in our economy, that it would continue to buy our debt while the economy was expanding. Also, I was blindsided by our government's changed attitude toward debt (the US debt-to-GDP was at 60% in 2005, at 100% in 2019, and is 130% today). Most importantly, if you had told me that as that our debt pile was growing our interest rates would decline to near zero, I wouldn't have believed you.

This brings me to today.

In modern stock market history, since the 1890s, we've entered into sideways markets when market valuations were very high (check!) at the end of a long-lasting (secular) bull market (maybe; we'll only know in hindsight, but it's hard to deny that we've had one hell of a run). Price to earnings, not earnings growth, was the largest source of stock market appreciation (check! Stocks are making new highs because of the pandemic and the budget deficits. Think about that.) There was a lot of euphoria about stocks as they became a national pastime (check! Though now they are sharing the spotlight with crypto.)

As euphoria deflates, valuations stop expanding. Investors become disillusioned, bored with stocks. Price to earnings stagnates and then goes into a long-term compression cycle, from above average, through average, to below average. (It then spends plenty of time below average, turning investors away from stocks). Any gains you get from earnings growth are offset by price-to-earnings compression.

Today, stock market valuations are at an all-time high. Rising interest rates and inflation may serve as chilling factors to price-to-earning expansion; after all, declining interest rates were instigators of the price-to-earnings expansion on the way up.

I've written two books on this topic and don't have a burning desire to write another one here; however, here are our Active Value Investment Principles (straight from my books):

Be an active value investor. Traditional buy-and-forget-to-sell investing is not dead but is in a coma waiting for the next secular bull market to return – and it's still far, far away. Sell discipline needs to be kicked into higher gear.

Increase margin of safety. Value investors seek a margin of safety by buying stocks at a significant discount to protect them from overestimating the "E."

In this environment that margin needs to be even more beefed up to account for the impact of constantly declining P/Es.

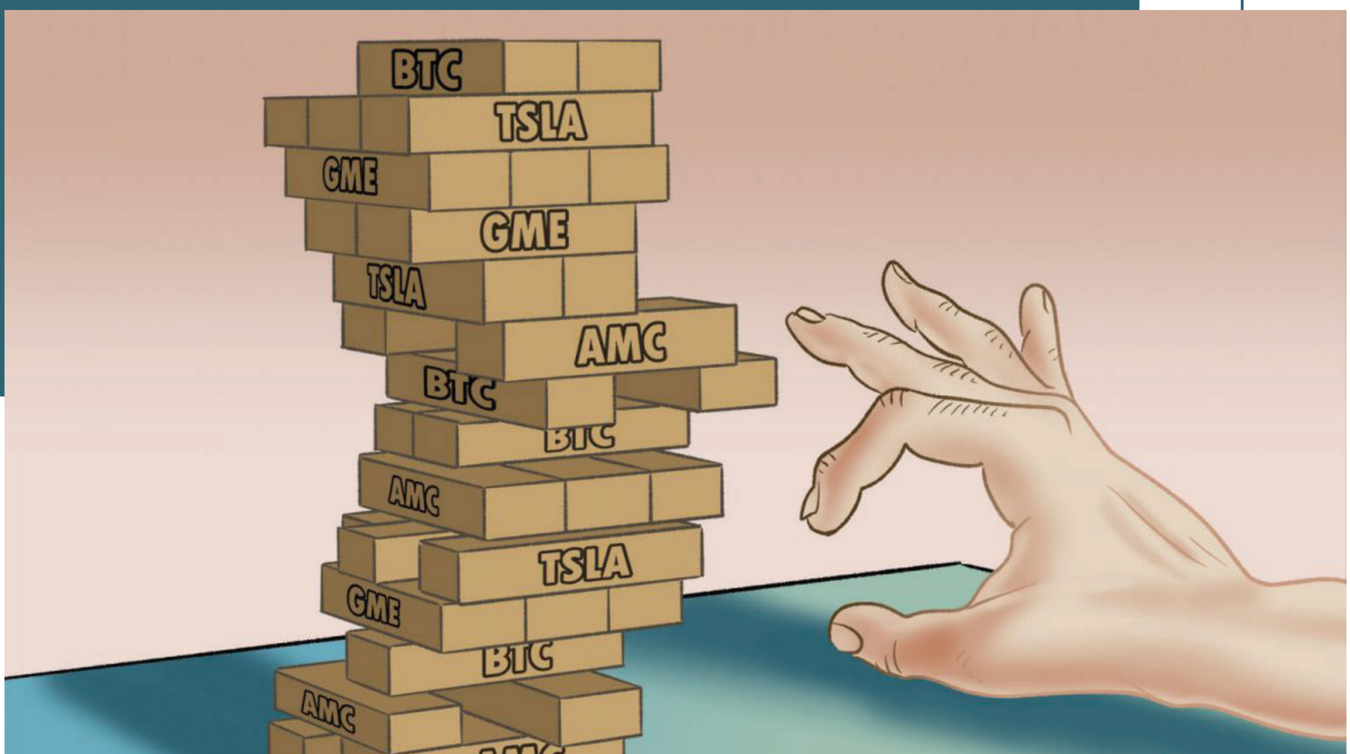
Don't fall into the relative valuation trap. Many stocks will appear cheap based on historical valuations, but past bull market valuations will not be helpful again for a long time. (I cannot stress this point enough.)

Don't time the market. Though market timing is alluring, it is very difficult to do well. Instead, value individual stocks, buying them when they are cheap and selling them when they become fairly valued.

Don't be afraid of cash. Secular bull markets taught investors not to hold cash, as the opportunity cost of doing so was very high. The opportunity cost of cash is a lot lower during a sideways market. And staying fully invested will force you to own stocks of marginal quality or ones that don't meet your heightened margin of safety.

Invest globally. "The larger the pool of stocks you can choose from, the higher the bar – the opportunity cost – that a new stock has to overcome to make it into the portfolio."

Fool's Gambit



As a professional money manager if you don't play the fool's gambit then you are taking career risk.

VITALIY KATSENELSON

In investing, there are many "games to play". There are a lot of ways to try to make money in the market, and not all of them are good, rational, or productive over the long term.

Click to listen to a narration of this article

This is an excerpt of the summer letter I wrote to IMA clients.

Today the stock market is in a bubble; this is not a secret to most market participants. Most investors are ignoring it and just infatuated with the ride. They are playing *Fool's Gambit* – waiting for a greater fool to buy their over-valued stock from them. And why not, greater fools have been showing up in droves for years. Low interest rates inflated the prices of all assets forcing everyone to take greater and greater risks.

Then there is pure, unadulterated greed. This market bubble is filled with this "get rich fast" attitude and the fear of missing out; all bubbles are. This time the market has been further deformed by social media, which seems like an enormous amplifier and arguably prolonger of that behavior, bringing what seems an endless supply of incremental buyers (bigger fools).

Companies like GameStop make Tesla's valuation look rational (Tesla's valuation is anything but rational, as I wrote before, it discounts a temporal wormhole into the future). But at least Tesla is a company of the future. GameStop is a struggling retailer of video games where the future – digital downloads – make its business model obsolete one download at a time. As of this writing it is valued at $17 billion dollars.

Initially GameStop's ascent may have started as financial nihilism by "have nots" trying to blow up the haves ("greedy hedge funds") that were short the stocks. Short sellers left GameStop stock months ago.

Today GameStop's stock is completely divorced from the underlying business it is supposed to represent. If the company never files another financial report shareholders won't notice or care. It is just a meme, a speculative gambling instrument used by one fool in search of an even greater fool. Though it may seem that the supply is endless, at some point you are going to run out of fools. You just don't know when.

Today the market is filled with people who want to get rich fast. **You cannot use logic and reason with a person who wants to get rich fast.** The allure of winning a stock market lottery overnight is too strong.

This speculative behavior doesn't stop with main street.

As a professional money manager if you don't play the fool's gambit then you are taking career risk. God forbid, you dare to hold cash or don't buy stocks that you believe are overvalued, but which are going up today and may even go up tomorrow, but could also collapse when the music stops.

Not playing this game is a non-decision decision for us. It is an easy choice because clients entrusted us with their life savings, all the money they are ever going to make. After you look them in the eyes and understand the gravity of what you are doing, playing fool's gambit stops being a choice. As you look through your portfolio, you'll clearly see that we don't play fool's gambit. This is why we are blessed with the clients we have and are very diligent in *not* accepting clients whose approach is antithetical to our investment principles.

MARKET TIMER'S GAMBIT

Rational people not drunk on greed, who are fine with getting rich slowly, may want to avoid this market altogether. They may play *Market Timer's Gambit*. Their argument (on the surface) is very logical. It goes like this: "I am going to stay on the sidelines for now and will go in after the market dips".

We are very sympathetic to this view. However, there are two problems with this strategy. First, market irrationality can last a long time. And second, though it sounds good in theory, in practice it is very difficult to execute.

Here is an example: Let's say you went 100% in cash waiting for the market to correct.

You waited for a long time and then the market declines 10%. You feel slightly vindicated, but the market really just settled to where it was a few months ago.

You have a decision to make: Get in or wait? You are of course prudent, and the market is declining, so you decide to wait.

The market is down another 10%. You feel a bit more vindicated. Now you feel rewarded for your patience and for the last few years of return you've missed out on.

But your gut tells you if the market declined 20% and it can go down lower. You wait.

You were right. The market declines another 10%. Economic news is ugly. The market decline may send the economy into a recession. Or the economy is already in a recession.

Now you are worried. You decide to wait.

The market declines *another* 10%. This cash now feels so dear you don't want to part with it. You feel like you've got this figured out. You tell yourself you'll invest when the news gets better.

The news is not getting better. But a strange thing happens. The market has a few strong days. Commentators call them a dead cat bounce, expecting further declines. These few strong days are followed by a few more. Suddenly the market has retraced the last 20% of the decline. You feel bad that you didn't invest two weeks ago (at the now "obvious") bottom.

I can continue but I won't. You get the point.

Once you are completely out, it is incredibly difficult psychologically to make a binary decision to dive back into the market. I've met quite a few people that have stayed out of the market since 2000 and are still waiting for their chance to get in. Just imagine the psychological rollercoaster they went through and the returns they left on the table.

Even if you got the market timing right once, putting it into a repeatable process is impossible. In addition to getting the timing of the economy right, you have to time the stock market response to the economy. I know many people who timed the market successfully once; I don't know any who've done it twice.

ONE STOCK AT A TIME

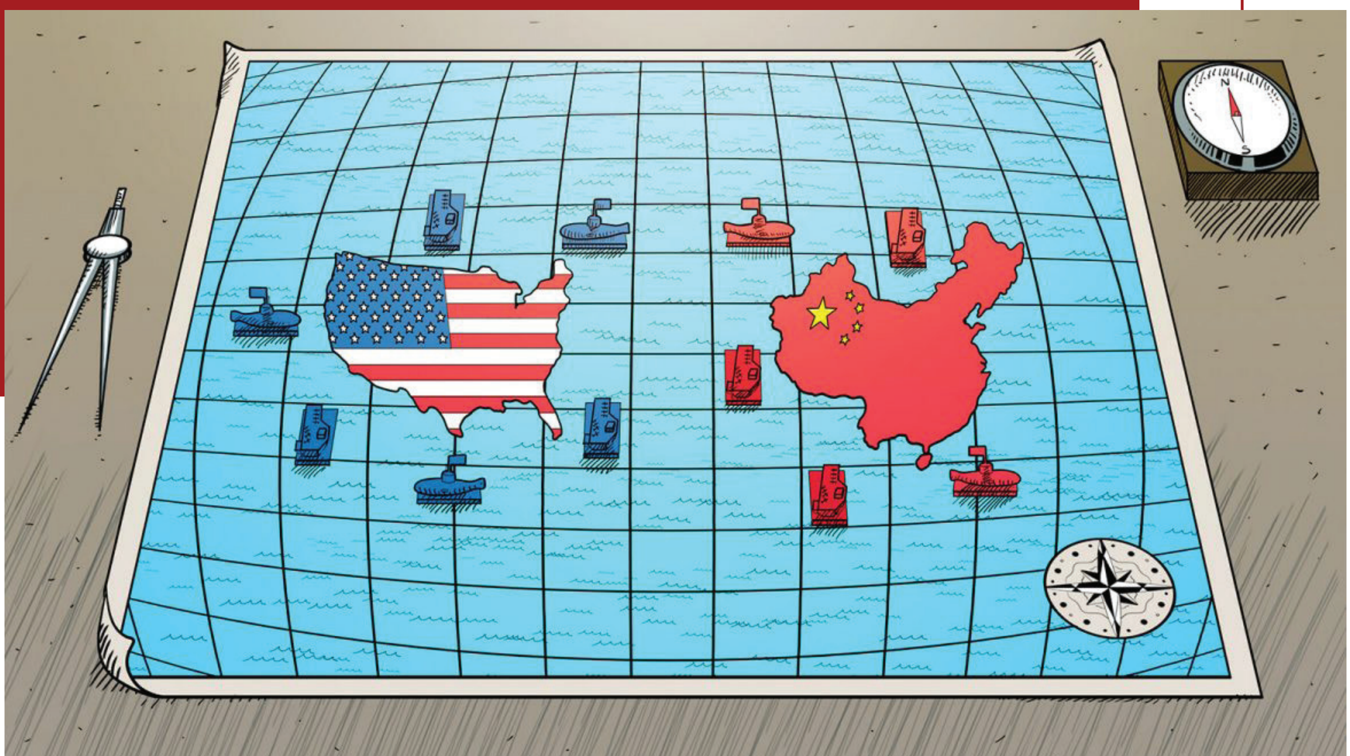
Investing in the stock market doesn't need to reside in the binary extremes of Fool's Gambit and Market Timer's Gambit. There is a different game available: *One Stock at a Time*. That is the game we play.

Even in this insanely overvalued market not all stocks are overvalued and in search of a greater fool. Armed with patience, a long-term time horizon and our time-tested value investing process, we patiently look for high quality companies, run by great management, that are significantly undervalued (i.e., have a margin of safety). This process is not fast and furious and won't get you rich quickly. It requires a lot of mundane work and turning over a lot of rocks. We read company financial filings, talk to management, competitors, build our own financial models, debate these investments among ourselves and with our global network of investors.

We only need 20 to 30 stocks – there are tens of thousands of stocks globally. When we cannot find enough stocks that meet our stringent investment criteria our cash balances go up and then they'll decline as we find new stocks. We don't time the market; we value individual stocks, buy when they are cheap and sell when they are dear.

Let's just sum it up. The market today is a $1 bill trading for somewhere close to $2 or more. Many stocks in the market today are $1 changing hands for $4, $6, $20. But *we don't own the market; instead we have humbly assembled a portfolio of $0.30 to $0.60 dollars.* One stock at a time.

US and China: In the Foothills of Cold War (Updated)



The resurgence of nationalism had started to create cracks in attitudes about global trade before the pandemic.

VITALIY KATSENELSON

In this article, I update my views about the US and China, and include my original article going over the risks posed by tensions between the two nations. I also discuss and share an update on IMA's investment in defense stocks, in light of the current geopolitical climate.

Click to listen to a narration of this article

This article is even more relevant today than when I wrote it. It seems that the movement of the geopolitical tectonic plates has only become more pronounced. A year ago, my Cold War observation seemed a bit ahead of its time; today it is on everyone's mind. Note how Russia and US tensions have taken a back seat to tensions between the Western world and China. This became even more apparent when Australia cancelled its submarine deal with France to buy its diesel submarines and chose to go with US nuclear submarines. The US submarines came with US strategic and military cooperation. Australia is not worried about Russia; its number one geopolitical threat is China.

China is going through significant changes. I have conflicting thoughts on what is going on there. On one hand, it seems that China is playing chess while the US is playing tik-tac-toe. It has been more strategic in its decision making. It suddenly gobbled up Hong Kong. It is slowly expanding its Belt and Road Initiative, indebting countries that lie in its way. China has slowly but surely become a drug dealer where the rest of the world, including corporate America, has gotten hooked on its crack. Data point: Witness American actor John Cena apologizing, in Chinese, for calling Taiwan a country. China is becoming more dominant and authoritarian every day.

On another hand, the Chinese economy is suffering significant decay. The collapse of Evergrande, one of China's largest property developers, with $300 billion in liabilities (including unfinished cities of apartments) is unlikely to be a one-off issue but is symptomatic of one of the largest bubbles in modern history. China has been delaying the bursting of the bubble to avoid social unrest. It has been doing it for so long that folks like yours truly got bored writing about it. But all Ponzi schemes end in tears and so will this one.

In addition, China has a demographic problem, a rapidly aging workforce that has resulted from the one child policy. Even though it has cancelled the policy, China's low birth rate has not budged.

OCTOBER 2020

Over the last six months we have skewed our portfolio more towards defense companies. We have done this intentionally. The world appears less safe today than at any time since the Berlin Wall came down. After 9/11 the world was united to fight terrorists. Even Russia – our Cold War foe – reached out to help the US fight the terrorists who attacked us.

Fast-forward two decades. We live in a drastically different world.

The resurgence of nationalism had started to create cracks in attitudes about global trade, especially in the US, before the pandemic. The pandemic has just widened those cracks as it exposed fragilities in global just-in-time supply chains and unearthed a helpless feeling of discomfort when we realized that we rely on the kindness of strangers to manufacture such simple items as face masks. Bringing manufacturing back to the US (or at least diversifying it away from China) is now about a lot more than jobs; it is an issue of national security.

Globalization led to shared interests; localization leads to an us vs. them mentality.

China's economic ascent, though based on a shaky foundation of debt and the biggest real estate bubble the world has ever seen, nevertheless presents a fresh challenge to US global dominance. That ascent has continued much longer than any rational person could have imagined. That is what you can get when you have an authoritarian regime controlling the economy, with the ability to borrow in its own currency. At some point this will not end well, but that is a topic for another time.

Graham Allison, American political scientist, wrote the book *Destined for War: Can America and China Escape Thucydides's Trap?* Thucydides was the Greek general and historian who chronicled the Peloponnesian War in 400 BC. He wrote, "It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable."

Allison draws a parallel between the rise of Chinese global power and the rise of Athens that Sparta perceived as a threat to its power, leading to war. The Thucydides trap leads to conflict because of a change in the status quo:

There is an established, dominant nation, confronted by a new contender to its dominance.

The dominant nation got used to spreading its values and writing the rules for the rest of the world. The contender believes it can write its own rules and doesn't need to follow by the rules of the old "has been" power. The dominant nation perceives this change as a threat. Any gain in strength of the contender nation is at the expense of the dominant nation.

The US (maybe naively) thought that as China developed, an infusion of market-based economics would lead to democratization of the country and an inevitable embrace of Western values. However, the opposite happened: It led to a stronger China, which doubled down on authoritarianism. China has five times the population of the United States, and today it is the largest economy in the world (measured by purchasing power parity, adjusted by cost of living).

Allison chronicled sixteen situations that involved Thucydides traps. Twelve spilled over into war.

In the past it required far more imagination to see the conflict between the US and China turning into war. However, today we find ourselves already in the middle of a technological cold war with China. And it is a war, not a friendly competition of tech companies battling for market share. It is a zero-sum game, us vs. them, where governments are putting a lot more than their thumbs on the scale of competition; they are removing the scale completely. They are doing whatever they deem is in their nations' best interests.

Robert Spaulding, retired US Air Force brigadier general, served as US Defense Attaché to China and is the author of *Stealth War: How China Took Over While America's Elite Slept*. He says, "What oil is for Saudi Arabia, data is to China." The Chinese government uses data to exert control over its citizens and may use it to impact other nations – the US perceives it as an existential threat. Cloud computing, 5G, and the amassing of data through the deployment of these technologies is at the core of this fight.

Let's zero in on 5G for a minute. The transition from 4th-generation (4G) wireless to 5th-generation (5G) is about a lot more than just the ability to download Netflix movies in seconds rather than minutes. 5G is a transformational technology that in coming years may turn our global society into either a utopian or a dystopian sci-fi movie. 5G uses much wider wireless spectrum, drains a fraction of the battery power, and has lower latency. The combination of these factors will result in a hundred- if not thousand-fold increase in internet-connected devices. Streetlights, trash cans, cars, cameras… cows; all will be connected through the wireless grid.

Here is one example from 2020 that popped up as I was writing this. Amazon has announced that you'll be able to pay for goods at its Amazon Go stores by scanning your hand. In other words, you'll no longer need your smartphone. Your personal data will change its main residence from the personal comfort zone of your smartphone to the cloud.

We are a few years away from it, but the amount of data created by the 5G network will increase exponentially. It will transform the internet of smartphones to the internet of things, where smartphones are just a small fraction of those things. And the potential for abuse of this power to monitor and control people will grow exponentially, too. We know that China is already the world leader in the antidemocratic applications of technology.

The US underestimated China for a long time, but no more.

So back to the tech cold war.

The US fired the first shot when it went after one of the most important technology companies in China – Huawei (one of the largest contributors of technology to 5G). At the US's request, the Canadian government arrested the company's CFO (daughter of the founder) in Vancouver, and she is potentially facing 30 years in prison for selling equipment to Iran. (You don't have to be a disgruntled cynic to see that the Iran sanction violation was used as an excuse here.)

Then the US put restrictions on the US companies providing chips and chip-making equipment to Chinese tech companies. This action alone is like shutting off the oxygen to the Chinese tech economy, and thus the Chinese economy as a whole. China will not sit by idly. It will retaliate. In the meantime, this was another reminder to China that it cannot rely on the continuity of American technology, so it is going to be spending as much as it needs to become self-sufficient in semiconductors and software.

In 2014 China announced its own version of the Manhattan Project: It allocated \$200 billion to achieve parity with the US in semiconductors. (Actually, the cost of the Manhattan Project in today's dollars was about \$20 billion.) I used to think that it would be impossible for China to catch up in semiconductors, no matter how much money it had to lose, because it doesn't have the knowhow that the global leaders (Samsung, Intel, Nvidia, Qualcomm, Micron) have accumulated over the decades of research. I am no longer sure that is true, especially after we cut off the supply of chips to Huawei.

Today China looks at this issue as an existential threat; and therefore, as a powerful but wounded animal, it will do whatever it must to survive. This is war. China never valued the intellectual property of others; it will steal intellectual property from other chip companies to catch up. Here is one example. Chinese engineers (plural!) were found guilty of stealing secrets from Micron. This is not good news for American tech companies that have gotten used to exporting to China (the understatement of the century).

Just as the Cold War of the 20th century had two gravitational poles, with satellite countries revolving around each pole, we'll likely see US/Western Europe/Japan and China gravitational technological poles. The UK has already followed the US's lead and banned Huawei equipment from its communications network.

This is not the behavior of friends. Henry Kissinger said that "We are in the foothills of a Cold War." We are on a trajectory that if left unchanged could lead to greater conflict. The US government closed the Chinese consulate in Houston, claiming China had violated the Espionage Act. China retaliated by closing the US consulate in Chengdu.

Then there is the TikTok fiasco, which is still unravelling. The US government fears TikTok's unchecked presence in the US, the data it may collect about US consumers, and what it will do with it. This is understandable. However, the way the US has dealt with the issue will be perceived as unconscionable by both China and, more importantly, the rest of the world.

The US government gave an ultimatum to TikTok get out of the US or be sold to a US-based company. But then President Trump demanded that whoever buys TikTok must pay the US government "key money" (a commission). In other words, since this "key money" will lower TikTok's purchase price, TikTok is basically paying the US government for… I'm not sure what. This is extortion. Mobsters do this, not the US government.

Actually, other countries, including China, do this. Apparently, it is done in commercial real estate, as well. But we are the shining beacon of democracy; we are the United States of America. We should be doing the opposite; we should make sure that this sale process is fair and above board.

Anyway, our treatment of TikTok will only escalate the US-China conflict. We just lowered the bar, which was already incredibly low. Be less outraged when

China does something similar to a US company (Apple or Qualcomm). Being a global technology company and doing business in China will come with a new set of risks.

It is hard to imagine a "hot" war between two nuclear nations. But though the US and Soviet Cold War did not result in direct confrontations, there was plenty of fighting through proxies (Vietnam and Afghanistan immediately come to mind).

From today's perspective it is difficult to see the US and China relationship getting better. US and Chinese interests are becoming less aligned, and from today's perch nothing short of an alien invasion seems likely to align them). I'm not sure if the occupant of the White House will really make a difference at this point. He/she may avoid escalation, or increase it. JFK's genius during the Cuban Missile Crisis was that though he listened to his advisors, he did not let the crisis escalate into a war by making a lot of what might have seemed to be small, incremental decisions that, independently, were relatively benign but that taken together would have led irreversibly to a nuclear shooting war.

There is an interesting dichotomy between the hawkishness of what I wrote above and the fact that China and the US are still deeply integrated. This buys us time for the relationship to improve.

Here is an unpleasant but accurate analogy: The US-China relationship is like a very bitter marriage with a lot of young children. The parties are skirmishing, but they are waiting for the kids to get out of the house before they go to "war" with each other.

But the divorce will come, and both sides are preparing for it. The kids-going-off–to-college moment for the US and China will have to mean economic independence from each other. While China is beefing up its semiconductor industry, the US is noodling on how to bring factories back to the US.

President Trump recently signed an executive order making it a strategic priority for the US to mine rare earth minerals. Despite their somewhat deceptive name, these not-so-rare minerals are crucial to the production of electronics. Today, however, 80% of them are imported from China. Rare earth minerals are another kid that has to go to college before the parents split up.

This brings us to defense stocks – they are the "lawyers" in our divorce analogy. They will be the primary beneficiary of any divorce, and the greater the tension between the couple, the more money they make.

The US spends $750 billion a year on defense. China is a not-so-distant second at $250 billion. Its defense spending almost doubled over the past ten years and is unlikely to slow down anytime soon. It is difficult for us to see defense spending declining; it will likely continue to march higher. When you look at US defense spending data over the last 70 years, despite the public perception that Republicans love defense and Democrats, well, not so much, defense spending has actually been quite apolitical – the external environment (self-preservation) has determined our spending on defense.

The US and Europe are likely going to continue to beef up their spending preparing not for the war that may come tomorrow, but the one decades into the future. Also, irrespective of who wins November election, the European allies will likely feel that they need to be more self-reliant on defending themselves. They'll be likely increasing their defense spending no matter what their underlying economy is doing.

OUR PORTFOLIO OF DEFENSE STOCKS

We have assembled a global (US and European) basket of defense stocks. They have less sex appeal than the internet-connected bike or the latest software-as-a-service darling, but we believe the virus provided us an opportunity to pick up these companies on the cheap. We were offered a welcome asymmetry of outcome. These companies are so cheap that we should make money with them if the China–US relationship normalizes. If, god forbid, tensions escalate, they'll skyrocket. We are not hoping for that scenario, but we're preparing for it.

Some of their stock charts look like these companies are about to have a date with their maker. Don't believe those charts. They are a perfect example of how the virus has inconvenienced businesses but not really changed them. These companies make stuff – be it fighter planes, submarines, aircraft carriers, or tanks. Social distancing does not remove the demand for their products but makes producing them temporarily harder.

These companies needed to adjust. They did. They went to multiple production shifts. Their efficiency temporarily decreased. Their contracts with their respective governments are usually structured as percent of completion. They finish 20% of the submarine and the government sends them a check for 20% of the agreed price. We are oversimplifying but hope you get the point. These milestones got pushed up by the virus a few quarters into the future. The companies will incur some extra short-term costs, but their long-term fundamentals are not impacted by the virus. Also, the virus does not make their business path-dependent – they are still very profitable and cash flow-generative businesses that can honor all of their obligations from their cash flows.

Defense companies have another thing in common – they are terrific businesses. They are either monopolies or operate in a cozy competitive (oligopolistic) environment. For instance, in the US – Huntington Ingalls and General Dynamics make submarines, each has 50% market share. Barriers to entry and switching costs are enormous, they are further complicated by security clearance required for their employees which are extremely difficult to obtain.

The market today is going bananas for subscription as a service businesses; well, these are truly subscription as a service businesses – they are building, servicing, and upgrading aircraft carriers, ships, submarines, planes, and training armed forces for a customer whose check will never bounce. In addition to that, they have long-term contracts and thus revenues flow till the end of times. These businesses have a good return on capital, very stable margins and usually very conservative balance sheets. And finally, today, because they got *inconvenienced* by the virus, we are buying them at bargain basement valuations.

Additional Thoughts (October 2021): Since I wrote this article, we opportunistically increased our exposure to defense companies. EU countries are waking up to the reality that the US has become a more inward-looking ally, and they are likely going to be increasing their defense spending. The UK has already boosted its defense spending by 10% in 2020.

I shared our thoughts on defense companies here.

Beloved Country. Unloved Hedge. (Updated)

The problem with arrogance is that it changes your behavior.

VITALIY KATSENELSON

My thinking on gold, the US Dollar, our national debt and our reserve currency status has not really changed much since August 2020, except that at IMA we have been increasing our exposure to foreign companies whose business is not tied to the US. We still have a small hedge in gold – I am as unexcited about it as I was when I wrote this article.

Click to listen to a narration of this article

My thinking has not really changed much, except that we have been increasing our exposure to foreign companies whose business is not tied to the US. We still have a small hedge in gold – I am as unexcited about it as I was when I wrote this article. Our chaotic and quite frankly embarrassing escape from Afghanistan has made me even less optimistic about our political leadership and the dollar.

AUGUST 2020

I usually love writing. I get up early every morning, make a cup of coffee, put on my headphones, and look forward to discovering what my subconscious will surprise me with.

Not this time.

I hated every minute I spent working on this article.

There are many reasons for this.

A few times, as I wrote, I got close to a line I don't like to cross – the politics line. I rarely discuss politics even with my friends. I have occasional political discussions with my kids (I try to show them all sides). I don't allow broadcasts of political debates in IMA hallways. They don't have the intellectual rigor we require in our research. They bring unwanted toxicity, resolve nothing, and nobody's mind ever gets changed.

I block most political discussions from my daily life and focus on things that have a shelf life longer than an overripe banana (things like books).

But writing this piece (client letter) was particularly painful because it made me think more about the negative changes that are happening to the country I love.

Why write it, then?

I am not writing this to vent my frustration (I scream into my pillow for that) or to provide a recipe of what must be done (you've got TV talking heads for that). I really didn't want to write about our national failings, but I have a pragmatic reason for doing so: As the world around us changes, we need to keep making changes to our portfolio. The coronavirus has compressed years of changes into months. It may be the straw that broke an aging, overconfident camel's back.

BELOVED COUNTRY. UNLOVED HEDGE.

I remember reading in January about the virus infecting China and catching myself thinking "This is a China problem; these viruses don't come to the US." Today as I consider this line of thinking I realize it is insanely naïve, ridden with arrogance, and very dangerous.

If I was the only one infected by such thinking, I'd take a mental note not to do it again, or maybe I'd be lying on the couch sharing it with my shrink, not writing about it. But this arrogant thinking has infected the whole country and most importantly our government. I am not talking about our virus response, or the tensions between liberty, commerce, and public health. I am talking about something else.

This arrogance was not built up out of thin air.

The US truly has so many advantages the rest of the world does not. It is flanked by two oceans, and it has two friendly neighbors, the polite one in the north and the fun one in the south. It has an abundance of fertile ground to feed itself and enough other natural resources to be independent from the rest of the world. It has not fought a war on its own territory with a foreign power in over two hundred years.

It is the world's largest democracy (measured by GDP; India is the largest by population). It is the cradle of technological innovation – every piece of technology that sits on my desk has its roots in the US.

It is for these reasons that the US dollar became the world's reserve currency.

America's competitive advantages are rooted in its geography, but the reason the dollar became the global reserve currency is that the US had the world's largest, strongest (steadily growing and conservatively financed) economy and a stable political system (the US Constitution is a big help here).

Let's zoom in on this point for a minute. Despite your ability to touch the green US dollar in your wallet, it is just a piece of paper that is worth something only if you and everyone around you believes in it. After World War II, the world believed in it.

People basically looked at the places where they lived and at America, and many of them concluded that the US was the safest place to keep their savings. They didn't have to worry that if they put their money in the US dollar it would lose its value. The dollar was not going to be diluted by hyperinflation or burned up by a foreign or civil war. The political system was stable and strong, and people didn't have to worry that at some point they wouldn't be able to take their money out of US banks and bring it home.

However, currency is a very nebulous concept. It's a story, and one that is not rooted in nature; it is completely based on mass perception.

This brings us back to arrogance.

The problem with arrogance is that it changes your behavior. You start believing that you are very special for reasons that are not grounded in reality. You start believing that bad things happen only to other people and nations because they are not as special as you. You can do anything you want – borrow and spend as much as you like – and nothing bad will happen to you. This behavior in turn starts to undermine the core reasons why people trusted your country and currency to begin with.

This is exactly what is now happening to the US. In 2020 the ratio of our debt to the output of the economy (debt to GDP) is likely going to exceed 120% (and might be as high as 130%). You can blame the virus for some of that, but the national debt had been going up steadily every single year. We ran huge budget deficits in bad times and in good times, long before the virus came on shore.

In 2000, only 20 years ago, our debt was $6 trillion – a 30% debt to GDP. It was $14 trillion in 2010 and $23 trillion in 2019, increasing $1 trillion a year while the US economy was booming. Or maybe that is why the US economy was booming. We were charging a trillion a year, year after year, on our national credit card to buy things and to engineer this growth. By 2019, ten (!) years after the Great Financial Crisis, the Fed was still running quantitative easing.

In 2019 debt to GDP was over 100%, eclipsing the EU's ratio of 86%.

(Yes, the capitalist US was more indebted than the "socialist" EU). We have not acutely felt that debt burden, because interest rates declined over the last two decades.

Then the virus arrived.

The US has spent 12% of GDP (so far) to keep the economy afloat during the shutdown – twice as much in terms of GDP as the rest of the world, four times as much as the largest European countries, three times as much as Japan.

Our debt has skyrocketed by another … maybe $6 trillion – too soon to tell. The Fed already owned $2.5 trillion of our government bonds in 2019, and now it owns $3.7 trillion of our fine paper and is a buyer of our corporate bonds and ETFs. Stocks are likely to be next.

Credit rating agencies have already put our AAA-rated debt on "negative watch," signaling a possible downgrade. Countries like the US that borrow in their own currency don't default on their debt, at least not by failing to make payments. Instead, we'll "honor" our obligations through massive money printing, which could bring massive inflation and tank the US dollar (who wants to own a currency that buys less and less?). God help you if you reached for yield and loaded up on long-term bonds (a trade that minted money for the last 30 years). Long-term bonds will be widow-makers.

But our large debt pile is only part of the story. In the largest economy in the world, the staunchest advocate of free markets, the cost of money (arguably the most important commodity) is set by a dozen economists. (Think about that when you hear the US calling another nation a manipulator of its currency.)

In 2020 the social fabric of our society is tearing apart. It is our tribe against their tribe. Every time you think the toxicity of our politics cannot get any worse, it does. Unlike in the country that came together during World War II or 9/11, this time the coronavirus has pulled us further apart. It doesn't look like the outcome of the 2020 elections will change that, and so the inertia of the last 20 years will persist.

Our foreign policy. Nobody knows what it is. The only time we hear about it is when we bicker with our neighbors and allies, bomb some country in the Middle East most Americans cannot find on a map, ratchet up tensions with China, or for the nth time slap sanctions on Russia.

The world used to look at the US as the global leader, as a moral compass. Let me put it this way. If Martians landed on the Earth today and took a careful look at our behavior, I don't think they'd conclude that we are the shining light of democracy.

This is incredibly difficult to write, but bad things don't just happen in other countries; they can happen here too. The US response to COVID-19 is a visceral reminder of that. We'd like to believe that the US is special, and it is special to us, but the laws of physics are not suspended here, and neither are medical and economic principles.

Though the US dollar is unlikely to lose its reserve currency status in the immediate future – for no other reason than that there are no better alternatives (every contender has problems of its own) – the strength we've seen over the last decade will likely fade in the rear-view mirror.

The virus has accelerated trends already in place – it has hastened the beginning of the end of globalization. Globalization was a tailwind to the US dollar in its role as the central medium of global exchange, and deglobalization (localization) has the opposite effect. We are also wading (and are already knee deep) into a cold war with China (a topic for separate discussion). We are waging a technological cold war with them and vice versa.

The dollar's decline may mean higher prices, higher inflation (we are a net importer), and higher interest rates (the Fed will try to squash interest rates, until it cannot).

In our portfolio we are already partially positioned for this shift, by owning foreign stocks – a weaker dollar means their earnings will go up in the US dollar terms.

But there is another thing we can do – buy gold.

That's something we have resisted doing for a long time. (I expressed my thoughts on gold here in October 2019.) There are so many reasons why I don't want to like gold: I have no idea how much it is worth (it doesn't have cash flows); it is a medieval relic; it has no productive value – it just sits in the vaults of central banks or stashed under mattresses.

Gold is hedging us against two scenarios: a weaker US dollar and the debasement of all currencies – the dollar declines but so do other currencies. Dollar outflows will be looking for homes. Some will flow into euros, British pounds, and Swiss francs, and some into gold – an incorruptible asset class (central banks and politicians cannot create more gold).

In the past our justification for not owning gold was that we'd rather own good companies, and we'll continue to do that. Gold will become just another position in our portfolio – an unloved hedge.

Despite the somber voice of this letter. The US is not turning into Zimbabwe anytime soon. Yes, we'll have challenges, but we'll get through it. The British Pound was the world's reserve currency for over a century, until the dollar unseated it about seventy years ago. The United Kingdom is still thriving today even despite going through a messy divorce (Brexit) with its European neighbors.

Yes, the US will have challenges, but we'll adapt to them. At IMA, we'd just like to do it early.

Inflation Update: Not Transitory Yet!

A perfect storm is formed by seemingly small factors.

VITALIY KATSENELSON

Today we are experiencing a perfect storm of inflation. A perfect storm is formed by seemingly small factors. Each one on its own may not be particularly significant, but once combined they result in an event that significantly exceeds the sum of all parts. I provide an update on my previous two inflation articles, and the risks I see on the horizon in the next few quarters.

Click to listen to a narration of this article

Inflation is a very interesting, important, and constantly evolving topic. I wrote several articles on inflation this year. This article is an update to previous articles I have written on this topic; the framework I described in the original articles is still intact. However, as time passed and we got more data, I've had new thoughts, which I'll share with you first. If you have not read those articles, I suggest you read them first and then come back to this update (links at the bottom of this update).

UPDATED THOUGHTS, OCTOBER 2021

Here are somewhat random thoughts on inflation.

Today we are experiencing a perfect storm of inflation. A perfect storm is formed by seemingly small factors. Each one on its own may not be particularly significant, but once combined they result in an event that significantly exceeds the sum of all parts.

Inflations are always caused by too much money chasing too few goods.

Let's explore both sides, starting with "too much money."

In the eye of the pandemic, during mandated shutdowns, the government dropped money from helicopters, trillions of dollars, to anyone who could fog a mirror. This happened while (and because) big parts of the economy that are normally large cost items in consumers' budgets – travel, entertainment, restaurants – were shut down. When your income doesn't change or arguably increases and your expenses decline, your pile of savings grows. Thus, despite a global pandemic, consumers' pockets were stuffed with cash, resulting in very healthy demand as the economy reopened. Consumer savings were also helped by the freeze on student loan payments and the eviction moratorium.

Most of the action today is happening on the "too few goods" side.

The global economy is an incredibly complex machine that needs to be in a state of constant flow. Once you stop parts of it and interrupt the flow, it takes time and a lot of effort to get it humming again.

Here is one example that highlights what happens when the normal flow of the economy gets interrupted.

Shipping containers: They are one of the most important technological inventions of the 20th century. They are the molecules in the blood vessels of the global economy. Their standardized size allows goods to move effortlessly on different modes of transportation (trucks, trains, ships) across the world. (I highly recommend you read the book *The Box.)*

There is a container shortage in the US today. Why?

There are many reasons: As the US production shut down during the pandemic and the Chinese economy was humming, we were consuming goods and not sending anything back to China. Containers got stuck in the US ports. But that was just the beginning. Today, containers are stuck at the end destinations and not brought back to shipping hubs due to the shortage of truck drivers. Ports are slow to unload ships due to labor shortages, work disruption due to Covid, and equipment shortages. Therefore fleets of ships loaded with containers are waiting to be unloaded, and this leads to even more container shortages, effectively taking supply out of the market. Companies suffering from post-traumatic stress syndrome caused by inventory shortages are in turn hoarding containers in order to store extra inventory in them.

The global supply chain is very complex. Few manufacturers produce every single part that goes into their finished products. They rely on dozens, and often hundreds, of manufacturers, many of whom have parts and raw materials stuck in the container bottleneck. Today your ability to produce goods is as strong as the weakest link in your supply chain.

Containers are just one example of many that illustrate disruptions on the supply side. In many ways and in many places, the result of Covid was effectively a reduction in the supply of … just about everything.

The one disruption that really puzzles me is the labor shortage. There are millions of jobs going unfilled today. I hear stories of Starbucks stores being closed due to a lack of workers. Every service that has a heavy labor component has gotten worse – be it restaurants, ridesharing, or pharmacies.

For a while we had an easy explanation: We were paying people not to work. So, they did what we asked them to do. However, I would have thought that after we stopped paying them to binge on Netflix, they'd come back to work. This has not happened as much as I thought it would, *yet*.

I have theories on why that is happening. Again, it is likely a sum of many factors, not just one. I can only partially agree with the rhetoric "I decided not to work as I hated my job and my pay," a litany we often see repeated today in the press. You can only do this for as long as you have savings. Eventually you'll starve. Before the pandemic, Americans, especially those in low-paying service jobs – the core of labor shortage – did not have big savings. Many lived paycheck to paycheck. The pandemic has helped many to increase their savings, but eventually they will chew through them. Hunger and living out in the cold are great motivators to get a job, which will lead to normalization of the labor market.

This is my main theory explaining the labor shortage today. But there are other theories, too: early retirement by baby boomers, migration of the labor force, newly minted Bitcoin millionaires who don't want to work, folks who sold houses in states with expensive real estate and moved to cheaper ones and are now sitting on nice nest eggs.

As a side note, all this newfound wealth (savings) has also made its way into … you guessed it, the stock market, cryptos, real estate, NFTs, and anything else that can be bought and sold. As the final elements of the stimulus roll off, people will either need to go back to work, or sell assets to pay for expenses, and speculative markets will run out of greater fools. At that point, the money will return to its rightful owners, and rational thinking and conservatism will be rewarded again.

The bottom line is that we have strong demand and are producing relatively few goods and services, and thus we have inflation on our hands.

As I discuss in the articles below, wages are the largest cost in the global economy, thus as higher wages roll through the economy, they alone will be the highest contributor to rising prices. I just received a note from our payroll administrator: She told me that her software provider raised prices, so she is raising prices for her services by 20%.

I know it doesn't feel like it, but inflation is both a feature and a bug of the normalizing economy. Higher prices signal to suppliers of goods and labor that we want more of what you've got. Higher container leasing prices will make storing inventory in them expensive and also increase production of new containers. Higher wages will bring truck drivers back on the road again.

The next … I don't know how long (six months?) will be tough. But I am optimistic, because capitalistic impulses are programmed deeply into our human DNA. I know people have been cancelled for less, but I applaud our selfishness. Yes, we are selfish creatures, and this selfishness is what is going to save us. Millions of tiny selfish decisions in the pursuit of personal profit maximization will return things back to … not normal, but a new normal.

This new normal may be different from the pre-pandemic one. In many ways better, in some worse. A lot of "good" and "bad" is really subject to our personal interpretation of what the pandemic really became: an accelerator of the future. We'll work from home more, go to the office less. We'll order more things and food online. Our travel for leisure may not change much, but business travel will be competing with Zoom calls. The global economy will continue to go through deglobalization; more manufacturing will move away from China and back to the US, Europe, and what we consider as "friendlier" countries. Inventories will become a bit less "just-in-time."

Long term, the present labor shortage will likely result in more automation – equipment never sleeps, talks politics in the office, or asks for a raise or healthcare benefits. As an example, as a small business, IMA is investing in more automation and streamlining our internal processes, and we don't even make widgets. I don't want to rely on fickle labor markets. I get a feeling we are not unique.

In addition to higher interest rates – a risk I describe in articles linked below – the most immediate economic risk I worry about today is inflation turning into stagflation. Higher prices result in significant reduction in consumption. We have positioned our portfolio accordingly.

Well, I have added a lengthy update to already lengthy articles. Here is my advice to you: Instead of straining your eyes, you can strain your ears and listen to the following articles. I'm providing links to my pieces on the inflation landscape (read, listen) and how we invest in inflation (read, listen).

The Softer Side of Value Investing

The culture in most companies, especially small ones, comes from the top.

VITALIY KATSENELSON

Culture matters. I share how I evolved from an analyst purely focused on numbers to an investor and CEO focused on people. Using two stories from IMA's own past, I recount how running the business made me a better investor.

Click to listen to a narration of this article

I have been with IMA since August 1997. I started as an analyst, then transitioned to being a portfolio manager and CIO. Then in 2011 I became IMA's unofficial CEO and in 2013 official CEO. The most important lesson I've learned running IMA is the importance of people and culture.

As a young analyst I did not have much appreciation for people and did not really think about IMA's culture. I have a feeling this is true for most young analysts. When you are starting out, you are focused on things that are quantifiable – return on capital, return on equity, various growth rates and valuation metrics. You can look backwards and analyze numbers and then you can model them going forward.

Even when you mature as an analyst and start spending time on the company's competitive advantages, you are still thinking about abstracts like the firm's distribution strategy versus its competitors, the stickiness of customers, the size of the potential market, etc.

I don't want to dismiss the importance of these factors. But as I started to manage people, after many painful experiences I realized that the success of IMA as an investment manager and a business was tied to people – human capital. Great employees push you forward; not so great ones drag you down.

Then there is culture. Let me tell you two stories.

In 2008, Michael Conn, IMA's co-founder, was CEO of the company. IMA's operational folks were reviewing investment management agreements, comparing them to the fees that were actually encoded in our portfolio management (billing) system. They found that one account was mistakenly miscoded. IMA had been overcharging a client for 20 years. The difference in any particular quarter was not grotesque, but over the 20-year period it had added up to a large sum. Let me remind you that this happened during the financial crisis; the market was quickly melting down.

Once the operations folks brought this problem to Mike, he said, there is only one thing to do, let's calculate the interest accrued over this time period and refund the client the fee with interest. Mike called the client and apologized for the mistake. The fee was refunded. That was it.

And then there is another story.

When I took over running IMA we had no marketing strategy. Mike's original partner, Merv, was the marketer. IMA's marketing went away when Merv retired in the early 1990s. I was running the firm and I had to come up with a marketing strategy. My education was in finance, not in marketing. I experimented a lot.

Let's pause and fast-forward. Today we do only very passive marketing and no sales. People subscribe to my articles. When the need to hire a money manager arises, prospective clients reach out to us (this usually happens after they've read my articles for years). We ask them to read our 31-page brochure. We don't employ a salesperson. I am a horrible salesman and hate selling. Only after they read this brochure, I'll get on the phone with them and answer their questions for about 20 minutes. That's it.

When I became CEO back in 2013, one of my not so brilliant ideas was to do cold calls. I was not going to do cold calls myself; I hired an assistant, Slavcho, who lived in Macedonia. His task was to call prospects and ask if they want to have a call with me.

I thought Slavcho might face some awkward conversations – "Hi, my name is Slavcho, would you like to schedule a call with Vitaliy?" Too many Eastern European names in one sentence. I asked Slavcho, how would you feel about going by "Steve" instead. He didn't care. In fact, he kind of liked Steve.

One day Slavcho calls me and says "Vitaliy this guy John is going to call you. I told him that I was born in Macedonia and moved to San Diego ten years ago. I went to college in LA and then moved to Denver." I was confused. I couldn't understand what was happening. Slavcho said, "Well, you didn't want people to know that I live in Macedonia, so I created a cover story."

I was shocked and embarrassed. This was a wakeup call for me.

What had just happened was completely on me. I had inadvertently asked my subordinate to lie. My little white lie almost created a culture of deception at IMA. I told Slavcho that from now on he could use his real name and if anyone asked, just tell them the truth. (I ended the cold calling idiocy a few months later).

In contrast, Mike's behavior taught everyone at IMA a lesson of integrity. Not just when it's convenient but when it hurts. (Mike had to forgo his paycheck during the financial crisis.) My inadvertent behavior threatened to turn good people into liars. The little things management does matter. As a parent I learned that my kids pay much closer attention to my actions than to my words. I don't want to be condescending and compare employees to kids. But I was an employee once. I paid more attention to what the management did than what it said. Yes, management actions matter a lot more than their words.

Warren Buffett told a story about an insurance company where people were screamed at by senior management when they brought bad news. They stopped bringing bad news. Nothing good happened to that company.

The culture in most companies, especially small ones, comes from the top. People emulate the management (rather than just the founder and CEO). Culture is what people do when no one is watching. It is the mutually agreed set of principles that aligns everyone's behavior. But it is much more than that. It is a positive, negative, or inert charge. A positive charge makes the sum of individuals in the company exceed their mathematical sum. It is synergistic. A negative charge, caused by a sluggish bureaucracy or internal power struggles, causes friction and ultimately harms business performance. An inert charge neither adds nor subtracts.

And there is one more thing – incentives. During the 2021 annual Berkshire shareholder meeting Warren Buffett was asked if Berkshire would insure Elon Musk's trip to Mars, to which Buffett replied, "Sure; it will depend on price." Then he thought some more and added, "There will be one price if Musk is on board the ship, and another if he is not." It is programmed into our genes to put our self-interest above that of others. It would be impossible for Elon Musk to care more about the safety of a ship taking strangers to Mars than about one carrying him and his family.

If you have great people and a healthy culture and add proper incentives, a company is unstoppable. When management owns a lot of shares in the business, they will behave like owners; they'll have skin in the game. They won't do acquisitions or overpay for them just to grow the size of the company. Their interests will be aligned with those of the other shareholders.

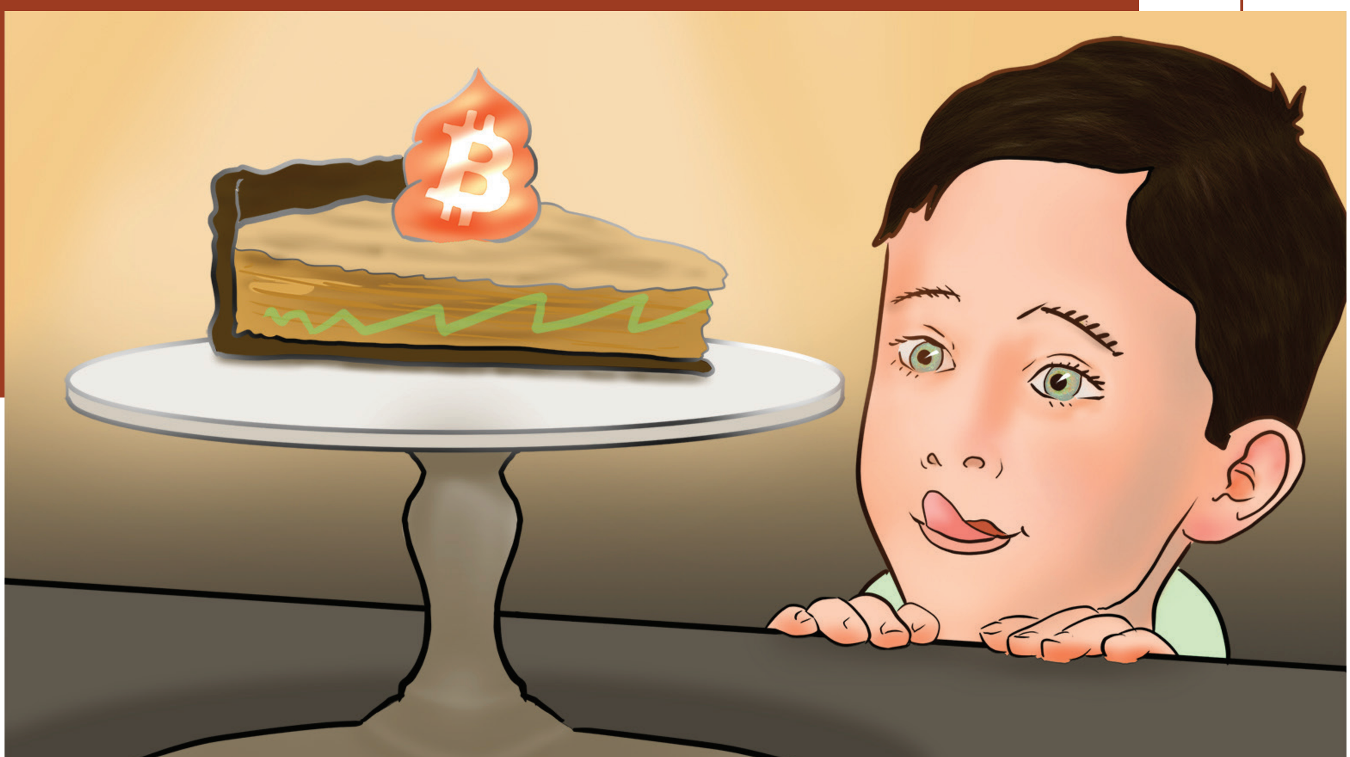
Being CEO of IMA made me a better investor. Today, when we analyze companies, in addition to doing everything else we've done before, we also think a lot about the management that runs them, their culture, and incentives. In fact, if I look at my biggest investment mistakes in the past, most of them have one thing in common: bad management.

Life is so much easier when companies you own have a great culture and are run by top-notch, properly incentivized management teams with skin in the game.

Life is definitely too short to own companies run by bad management. Warren Buffett said that he'd like to own "businesses that an idiot could run, because one day they will be." I can definitely see this being true in the past. I am not sure if it is true today. The rate of change is much different today.

Some businesses can definitely withstand more abuse by management than others. But there is no business great enough that it can withstand endless abuse by management. I am thinking about Microsoft as I am writing this. Under Steve Ballmer, Microsoft's culture decayed. Toxic HR policies turned the internal culture within the company into a version of the Hunger Games. Microsoft was setting cash on fire with mindless acquisitions. Microsoft's business was so strong (it was a monopoly) that Ballmer didn't kill it, but we don't know where Microsoft would be if the new CEO hadn't changed the company's course and revitalized its culture. Companies with wide moats are not impervious to destruction by management; it just takes longer for them to die.

This Holiday, Will Mr. Market Eat Too Much Pi?



We own businesses that are priced, not valued, by Mr. Market thousands of times a day

VITALIY KATSENELSON

There happens to be a cryptocurrency, one of thousands, that is also named Omicron. I still cannot grasp the logic behind it, but that cryptocurrency was up 900% on the day the South African variant was christened. There must have been a trading algorithm or a lot of bored investors looking for the next gamble, to drive something seemingly worthless up 900%.

Four times a year I write a letter to IMA clients. These letters are long; the most recent Fall letter is 27 pages. I try very hard to bring IMA clients into our thinking about the economy, investing, stocks and decisions we've made in their portfolio (in this essay I explain the reason for their length.) Over the next few months, I'll share with you excerpts from the Fall letter. I believe the relationship with my readers has evolved over the years such that we don't need to sanitize and rewrite these excerpts into essays: I'll leave them in the raw, original, more honest form. Enjoy!

THIS HOLIDAY, WILL MR. MARKET EAT TOO MUCH PI?

Mr. Market was less than kind to our portfolio over the last few months, and especially the last few weeks. I cannot tell you how *little* it worries us what Mr. Market thinks about our stocks at any particular point in time. We love* our portfolio even if the Mr. Market doesn't fancy it today.

Also, before we take Mr. Market seriously, let us tell you about the rationality of Mr. Market lately. The World Health Organization (WHO) names each variant of the Covid virus by going to the next letter of the Greek alphabet. After Delta, which is currently the most predominant variant of the virus ravaging the world, there must have been nine others that were not important enough because we never heard of them. Why nine? Because when the latest variant of concern was found in South Africa, it emerged that the letter *Nu* was supposed to be applied to it. But *Nu* sounds a lot like new. WHO didn't want to confuse people, so it skipped to the next letter in the Greek Alphabet, which is *Xi* – oops, that's the Chinese supreme dictator. So, for the sake of global political stability, that letter was skipped, too.

Α Alpha (al-fah)	Β Beta (bay-tah)	Γ Gamma (gam-mah)	Δ Delta (del-tah)	Ε Epsilon (ep-si-lon)	Ζ Zeta (zay-tah)
Η Eta (ay-tay)	Θ Theta (thay-tay)	Ι Iota (eye-o-tah)	Κ Kappa (cap-ah)	Λ Lambda (lam-dah)	Μ Mu (mew)
Ν Nu (new)	Ξ Xi (zz-eye)	Ο Omicron (ome-cron)	Π Pi (pie)	Ρ Rho (roe)	Σ Sigma (sig-mah)
Τ Tau (taw)	Υ op-silon (op-silon)	Φ Fie (fie)	Χ Chi (k-eye)	Ψ Psi (sigh)	Ω Omega (o-me-gah)

This brings us to *Omicron*, the name of the latest variant.

This is where this story gets a bit more interesting.

There happens to be a cryptocurrency, one of thousands, that is also named Omicron. I still cannot grasp the logic behind it, but that cryptocurrency was up 900% on the day the South African variant was christened. There must have been a trading algorithm or a lot of bored investors looking for the next gamble, to drive something seemingly worthless up 900%.

That is the drunken Mr. Market that is pricing our stocks today.

I am going to repeat what you will find me saying several times in the letter: We own businesses that are priced, not valued, by Mr. Market thousands of times a day. We have done a lot of work on each company in the portfolio, and through diligent research we have reached the conclusion that each is worth more than the price it is changing hands at today. Are we going to be right about each and every stock? Of course not. This is a numbers game. But we use a time-tested methodology centered on common sense and the cash flows these businesses generate. Also, this is not our first rodeo. We'll go on making small tweaks, taking advantage of Mr. Market's manic-depressive moods, at least when it comes to anything that generates cash flows.

Of course, we could change our investment process and load up on the cryptocurrency called Pi Coin, which happens to take its name from the letter in the Greek alphabet that follows *Omicron*. But I think we all agree we should stick to our knitting, buying high-quality businesses that are significantly undervalued. (Anyway we already loaded up on pie during Thanksgiving.)

Our advice – enjoy this holiday season. Spend time with your loved ones; don't look at your portfolio. Let us worry about it – after all, we own the same stocks you do.

We wish you joyful and safe holidays.

*I shared a draft of this letter with some close value investing friends. A few of them politely pointed out that I should not use the word "love" to describe my views towards the portfolio. They are right. Love is almost by definition an irrational emotion. Our view towards stocks we own are not an affection or emotion. In fact, we work relentlessly to extricate emotion out of our process. We look at ourselves as scientists (we would wear white coats to work if we thought we would get away with it and not constantly spill coffee on them).

Our opinion on any company we own is just a thesis that will be validated or invalidated by time. We'd like to invalidate them before time does. So "love" is not the word that I should use to describe what we think of our portfolio, it is a flawed shortcut for saying – we own high quality, significantly undervalued companies that are run by good, sensible management teams.

Value investing is at the core of how I analyze stocks.

Learn its principles in 6 simple hands-on steps:

> The 6 Commandments of Value investing
> (A free 8-email series)

Music

Painting by my father Naum Katsenelson

Music Throughout My Life

Painting by my brother Alex Katsenelson
Prints available on ArtistUSA.com

I am wondering what music will define 2021 for me.

VITALIY KATSENELSON

At the beginning of each year, I sit down and reflect on the year that closed, looking for lessons to be learned and opportunities for improvement. I plan out what I personally want to achieve and set goals for IMA.

One thing I do for no practical reason but for pure enjoyment is try to figure out which composer and which music had the most impact on me in the year that just passed.

This year I was the most impacted by… actually, I have a better idea – I'll go through the music that was important to me one year at a time me in chronological order.

I must warn you, we are about to embark on a very lengthy journey. I suggest you digest this very long list slowly. I'll specifically link each piece to only one of my favorite performances (that is a lot of fun and pressure on yours truly).

Let the fun begin.

The early 1980s belong to *Rachmaninoff's Piano Concert No. 2* and *Tchaikovsky's Piano Concerto No. 1*. I feel like this music came to me with my mother's milk. This is what my parents listened to and these pieces were probably my introduction to classical music.

1988 was the year of "Barcelona," a single released by Queen's Freddie Mercury and Spanish soprano Montserrat Caballe.

1989 was the year of Fritz Kreisler. My "American" aunt – my father's younger sister who immigrated to the US in 1979 – visited Russia for the first time since she'd left and brought me a Walkman and one tape – Kreisler's "Liebesfreud."

1992 belonged to Rachmaninoff's *Rhapsody on a Theme by Paganini*. Nicolo Paganini wrote 24 capriccios – short, technically challenging pieces composed for violin that tend to have less appeal for listeners than for performers.

Rachmaninoff, in turn, created a musical masterpiece for piano and orchestra (think of this as Rachmaninoff's 5th concerto) based on Paganini's work – a piece that appeals to both listeners and performers.

I remember listening to it when I went on my first date in America. I'd been in the US only a few months; I didn't speak English; and my date didn't speak Russian. It was an odd experience, but we listened to this piece together.

1993 was Rossini's "Stabat Mater." By this time we had already immigrated to the US, and my "American" aunt's first present to our family when we arrived was a CD player and a "Stabat Matter" CD featuring Luciano Pavarotti.

1994 was the year of the Three Tenors – Luciano Pavarotti, Placido Domingo, and Jose Carreras. I first heard them perform at the opening of the FIFA World Cup in 1990 in Rome, but I was not ready for their music. However, their 1994 World Cup performance in Los Angeles stuck with me. Their comradery, mutual admiration and respect for each other comes through in spades in this clip.

1995 belongs to Max Bruch's *Violin Concerto No. 1*. Best Buy used to have a CD rack of $1.99 CDs where it sold recordings by Eastern European orchestras. My CD collection, which has since been donated to Goodwill thanks to Spotify, was dominated by those CDs.

This was also the year that Queen released their 15th and final album, *Made In Heaven*, recorded months before Freddie Mercury's death in 1991. The day Freddie died in November 1991 was one of the saddest days of my life; but this album, to me, was made in heaven.

1996 was the year for Rachmaninoff *Concerto No. 3* – it was the year when the movie *Shine* with came out, which featured this concerto. This concerto still holds a special place in my heart. I've listened to every performance I could find. Ironically, Rachmaninoff himself playing this concerto is my least favorite, it is too fast.

1997 belonged to two operas, Puccini's *Madam Butterfly* and Verdi's *La Boheme.* This was the year when I fell in love with opera as a classical music genre. (I wrote about how I got into opera here).

1998 was the year of *Warsaw Concerto*, by Richard Addinsell. He composed it for the British movie *Moonlight Serenade*. The director wanted to use Rachmaninoff's 2nd piano concerto but could not due to copyright restriction.

The director commissioned Addinsell to write a concerto in Rachmaninoff's style, which is why this piece sounds so much like Rachmaninoff's 2nd and 3rd concertos.

In 1999 I was smitten by Edward Grieg's *Piano Concerto No. 1*. This was Rachmaninoff's favorite concerto. He adapted many parts of it in his own concertos.

2000 was the year of Chopin's first and second piano concertos. I was in the piano concertos phase of my life. (I go repeatedly through phases from piano to violin concertos to symphonies and then to operas.)

In 2001 it was time for Eugene D'Albert's *Piano Concerto No. 1* – D'Albert, born in Scotland, is arguably the most underrated composer of the 20th century.

In 2002 I was obsessed with Saint-Saens piano concertos, all of them. I had a Two-CD set with Pascal Roget performing them. I listened to them nonstop. Now they all blend into one long piano concerto, and that is the way I like to listen to them – nonstop.

The first decade of the century somehow is a blur, except that 2005 was definitely the year of Oscar Peterson. He made jazz accessible to people like me. "You Look Good to Me" and "Hymn to Freedom" are the pieces that stand out of from that year. But there is one more that is extra special to me: "Just a Gigolo." I drove Jonah to daycare – he was 4 – and that was "our" music that we listened to in the car. It was a decade mostly occupied with operas.

Pietro Mascagni composed 15 operas, but today he's known only for one: *Cavaleria Rusticana*. The overture to this opera was in *Raging Bull*, the Martin Scorsese movie starring Robert DeNiro. To this day my favorite performance is in a movie by Italian director Franco Zeffirelli, with Placido Domingo and Elena Obraztsova.

Pagliacci, by Ruggero Leoncavallo, is one of the most-performed operas today. Though Leoncavallo also wrote other music, during his lifetime and today he is known only for *Pagliacci*. Again, my favorite performance is in Franco Zeffirelli's movie with Placido Domingo.

Somewhere in that decade, I think it was 2006, I watched *Callas Forever*, a film about Maria Callas directed, you probably guessed it, by Franco Zeffirelli. Maria Callas was Greek-born, one of the most gifted sopranos of the 20th century. Zeffirelli and Callas were friends. This movie is a fictionalized story about Callas that is loosely based on Zeffirelli's interactions with the diva. It features music from Bizet's *Carmen*. My favorite aria in *Carmen* is "*La Fleur*" ("The Flower"). This was the first time I encountered the out-of-this-world "Casta Diva" aria from Bellini's *Norma*. And then there was Puccini's *Tosca*. My favorite aria from *Tosca* to this day is "Te Deum" – one of the most dramatic, darkest arias.

A little factoid. Callas, while married, had an affair with Aristotle Onassis, the Greek shipping magnate, who was also married. Later they both got divorced but never married one another. Later, Onassis married Jacqueline Kennedy (JFK's widow).

2011 was the year of *Tchaikovsky's Symphony No. 4* – I visited Australia and heard this symphony for the first time.

2012 was Tchaikovsky's again, as I was overwhelmed by his *Symphony No. 6*, his last.

In 2013 it was Tchaikovsky's *Evgeniy Onegin*. I went to see it with my then-12-year-old son Jonah at a movie theater, in a performance by Anna Netrebko and the Metropolitan Opera.

2014 was the year of Sibelius, more specifically his *Symphony No. 5*. I vividly remember when I heard it for the first time: I was boarding a plane from Denver to Miami, and Spotify randomly started playing the finale of that symphony. I kept replaying that finale throughout the flight to Miami.

2015 was the year of Bach's *Piano Concerto in D minor* – and the year of Bach. Bach is the composer that you "arrive" to later in life (at least that was the case for me); his music lacks the drama that young souls seek. I still listen to this concerto when I need to summon my writing muse.

In 2016 there were two Franzs, Liszt and Schubert. They were complete opposites – shy, introverted Schubert and bigger-than-life showman Liszt. Schubert was incredibly underappreciated during his lifetime and died in poverty. Liszt was bigger than Elvis and Frank Sinatra combined in his day. Schubert's *Symphony No. 8* is the piece that I could not stop playing. Liszt's *Sonata in B Minor* is a symphony for one instrument – piano. And then there was a piece that unites both Franzs, Liszt's transcription of Schubert's *Wanderer Fantasy*.

2017 was the year for Tchaikovsky piano concertos – *Concerto No. 2* (especially part 2) and *Concerto Fantasia*.

2018 belongs to Edward Grieg, *Piano Concerto No. 2*, the concerto Grieg only sketched out but did not complete.

2019 went to another piano concerto, Dmitry Shostakovich's *Piano Concerto No. 2* (2nd movement).

This brings us to 2020 – which belonged to Antonin Dvorak.

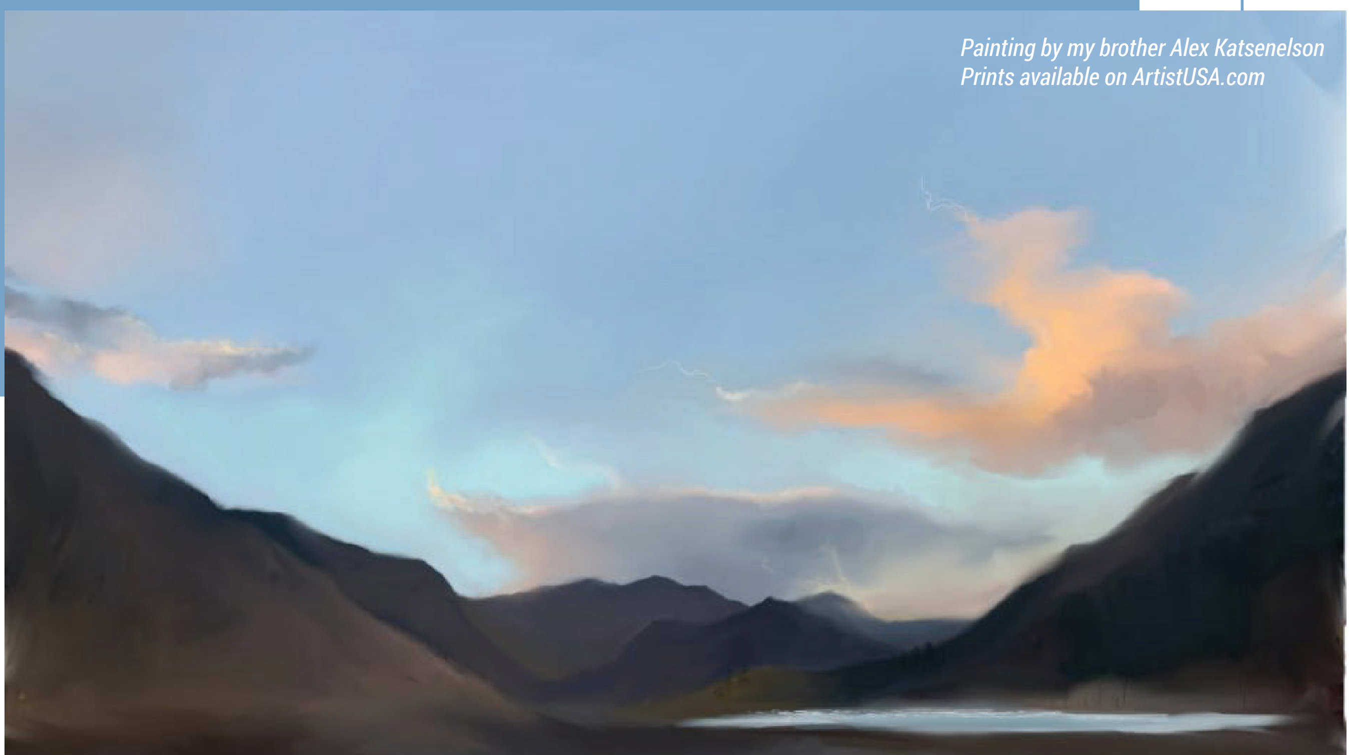
Dvorak's *Cello Concerto in B minor* became my favorite cello concerto. Dvorak, a Czech composer, wrote this concerto in New York City in 1894. I'd argue it is more American than Dvorak's *New World Symphony* (which is supposed to be his "American" symphony). If you listen to it carefully, you'll hear Western melodies, with wagons moving over the prairie. The performance by Jacqueline Du Pre is near and dear to my heart.

Then in December 2020 I stumbled onto Dvorak's *Serenade for Strings*, which he composed in less than two weeks in May 1873. I listened to it nonstop for a month.

I cannot talk about *Serenade for Strings* and not mention another piece that also became a dear favorite of mine in 2020: Tchaikovsky's *Serenade for Strings*.

Fleshing out this list for you has spilled into an incredibly rewarding, nostalgic, and therapeutic experience for me. It has also made me realize yet again how important music has been to me throughout my life. It is the texture underlying and accompanying many experiences. Now I am wondering what music will define 2021 for me. All I can tell you is that it has started out with Tchaikovsky's *Piano Concerto No. 3*.

How Do You Introduce Someone To Classical Music



Painting by my brother Alex Katsenelson
Prints available on ArtistUSA.com

Start with the music that is the most accessible.

VITALIY KATSENELSON

How do you introduce someone to classical music? You start with the music that is the most accessible, with the music that hits you over the head right away. The one that gets you hooked and won't let you go.

For me that was Rachmaninoff's *Piano Concerto No. 2* part 2, or the first bars of Tchaikovsky's *Piano Concerto No. 1*.

Falling in love with classical music is a path-dependent process. If you accidently listen to a piece that hits you over the head, you'll reach out for more. Unlike pop music, classical music is complex (I am generalizing about both genres). This complexity often makes it difficult for someone who did not inhale classical music with his or her mother's milk to get into it.

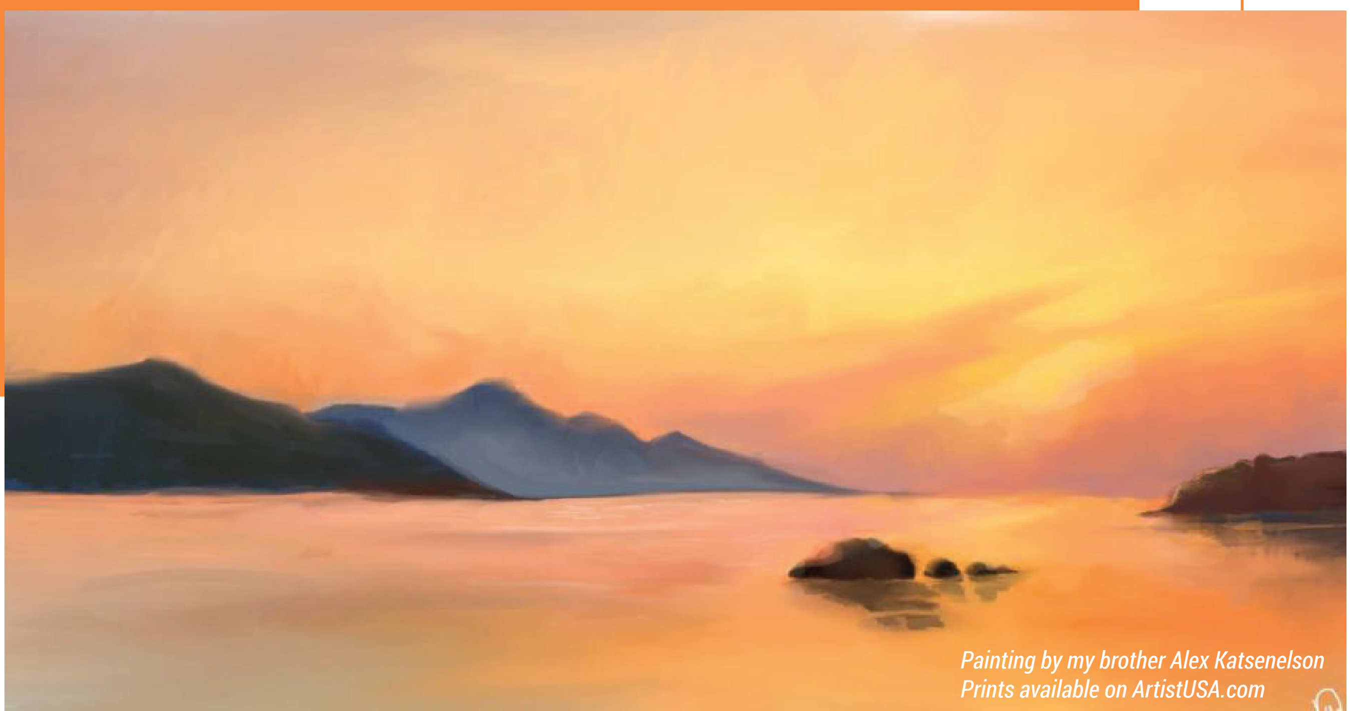
There is only one way to overcome that complexity – keep listening to the same music multiple times. With every listen you start hearing connections that you did not hear before. In fact, I recommend not to go to a live concert unless you've listened to the music performed at the concert a half dozen times beforehand.

It seems that over the years I inadvertently stepped into two public missions in life: to proselytize my love for both value investing and classical music. In my attempt to achieve the latter, I have created a playlist that I ambitiously call "The Gateway Drug to Classical Music – Piano Edition." This playlist features only piano. (I'll create other playlists in the future.) I used three criteria to select pieces for this playlist: (1) piano is the lead instrument; (2) I have to love the piece; (3) It has to be accessible from the first listen and hopefully hit the listener over the head with its beauty. I struggled with the last criterion the most. I've listened to these pieces so many times that I only need to hear the first few bars and I know how they'll sound. I put the ones that I had the most confidence in up front.

Also, the pieces on the list are usually excerpts from longer pieces. So if, for instance, the second movement of Rachmaninoff's *Piano Concerto No. 2* touches you, then listen to the full concerto a few times.

I am sharing two playlists – the original I created on Spotify and the YouTube version (which I exported from Spotify). I'll keep updating the Spotify playlist, since that is the service I use daily.

Alexander Siloti – A Hidden Russian Gem



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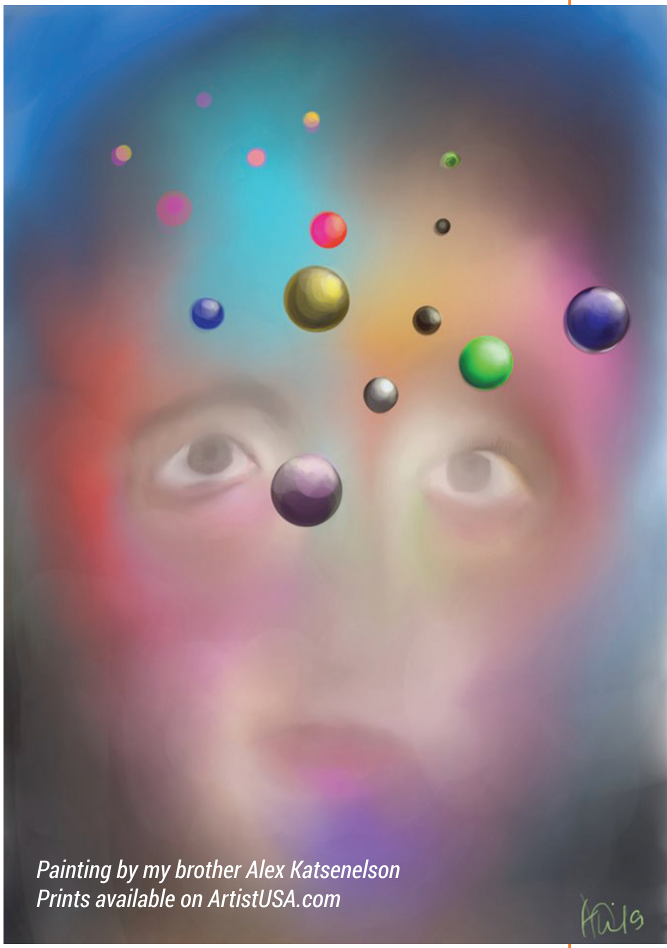
He is little known today, but there must have been something special about Siloti.

VITALIY KATSENELSON

Alexander Siloti

In this series of articles, we'll explore one of the most underrated figures in classical music, Alexander Siloti (often spelled *Ziloti,* which is an accurate transcription from Russian). He is little known today, but there must have been something special about Siloti: Tchaikovsky, Rachmaninoff, Stravisnky, and Liszt all dedicated music to him.

I'll divide our exploration into several parts. In this piece we will discuss Siloti and Rachmaninoff.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Siloti was born in Kharkiv, Ukraine (then Imperial Russia) in 1863. He studied at the Moscow Conservatory under Tchaikovsky. He had such great potential as a pianist that in 1880 Russia sent him to Weimar, Germany to study under the king of piano himself, Franz Liszt. Liszt did not charge for his classes, but the Russian government paid for Siloti's room and board and even gave him 10,000 rubles for gambling! (I hope my son, Jonah, a student at CU Boulder, doesn't get any ideas and will not start asking me for an allowance to play Draft Kings). Siloti studied under Liszt for six years until Liszt's death in 1886.

We need to pause to explain the significance of Siloti's studying with Liszt. The piano went through a significant transformation in the late 18th and early 19th century. Just as Elon Musk accelerated the transition from internal combustion engine to electric cars, Franz Liszt was the driving force that accelerated the transition of the piano from an instrument used for private performances in living rooms to a powerful orchestra of one whose sound fills large auditoriums. Liszt helped to transform the piano into a more robust instrument that could handle a much greater range of music – and tolerate more abuse from the enthusiastic pianist!

Liszt changed the way piano sounded by developing new playing technique and writing much more challenging and ambitious music for piano. He rewrote “old” music for the new instrument, transcribing Wagner’s operas, Beethoven’s symphonies, etc. Liszt’s piano started to sound like its own orchestra. I am just scratching the surface here. If this topic interests you, I wrote a more in-depth essay on Liszt and the evolution of the piano, which you can read here.

Back to Siloti. After studying under Liszt, Siloti taught for three years at the Moscow Conservatory. One of his students happened to be none other than his first cousin, Sergey Rachmaninoff. Rachmaninoff was born 1873, so he was ten years younger than Siloti (he was only thirteen when Liszt died). We will never know for sure, but can make an educated guess that Siloti was the likely link that connected Liszt to Rachmaninoff. Because of Siloti, Rachmaninoff’s piano concertos are very Lisztonian. They are incredibly technical and demanding of the performer and squeeze out every ounce of the piano’s might. Neither Liszt’s nor Rachmaninoff’s piano music was technically demanding just to tax the pianist. The increased difficulty was the price to pay for richer, bigger-than-life sound.

Let’s listen to the cadenza (solo part) from Rachmaninoff *Piano Concerto No. 3* (one of my favorite concertos). Note that you are listening to just one instrument – a piano that sounds like a full orchestra. Click here to listen.

And then listen to Liszt’s *Sonata in B Minor* (minutes 7–9). You’ll be reminded of Rachmaninoff, as the piano goes from being a lyrical instrumental instrument to suddenly erupting into an orchestra. https://youtu.be/w65QgjWHNDA?t=407

Now when you listen to Rachmaninoff’s 3rd piano concerto you can thank Russia for giving Siloti 10,000 rubles to go gamble in Germany and study under Liszt and then transfer his knowledge to his talented cousin Sergey. Click here to listen.

Tchaikovsky and Siloti

Last time we discussed Siloti and Rachmaninoff. Today we are going to explore Siloti in connection with Tchaikovsky's *Piano Concerto No. 1.*

At first Tchaikovsky was Siloti's teacher in Moscow Conservatory; but later in life Siloti became his friend, a performer of his music, and even a proofreader and contributor to Tchaikovsky's music.

Tchaikovsky was a symphonist; the piano was just another instrument to him. It is important to note the difference between a symphony and a concerto. A symphony may have solo passages, but it is really written for the whole orchestra. Concertos are written for a solo instrument (piano, violin, cello…) *and* the orchestra.

As we discussed last time, Siloti studied under Liszt and was highly influenced by him. In a Lisztonian piano concerto, the piano makes its own stand; it plays a dominant role in the concerto and is not afraid to go against the orchestra. Liszt never lets you forget that the piano is the hero of the story (the concerto). Tchaikovsky did not have the same affection for the piano, and thus he lessened the piano's role in his concertos.

Tchaikovsky consulted Siloti on the technical role of the piano in his concertos. This is where things get more interesting. Tchaikovsky's piano concertos that we listen to today are not the versions that Tchaikovsky wrote.

Let's explore Tchaikovsky's first piano concerto. Most of us think of this concerto and remember the powerful, larger-than-life, piano chords during the opening bars. This is not what Tchaikovsky wrote. His version was gentler, with the piano complementing, not competing with, the orchestra. In fact, that is the version Tchaikovsky conducted just days before his death.

After Tchaikovsky's death Siloti rewrote parts of this concerto and made the introduction more Lisztonian, giving the piano a more leading role. Siloti's version is what you hear performed today in most concert halls.

I'll share two performances, both with Mikhail Pletnev at the piano.

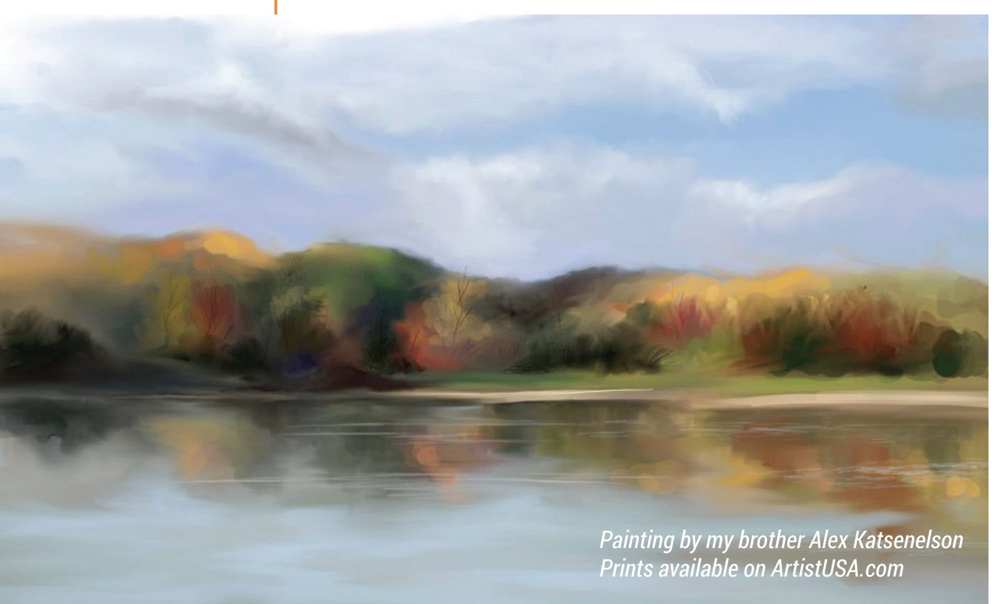
Tchaikovsky's original version—click here to listen.

Siloti and Tchaikovsky's Piano Concerto No. 2

Tchaikovsky wrote that though his second concerto was "troubled," he still liked it far more than the first. But Tchaikovsky was not happy with the piano part of his second piano concerto. He wrote, "The Second Concerto is also impossible in its current form. … It contains many blunders of mine, but the number of mistakes in the parts is, in a word, disgraceful. I have endured many torments with this concerto at rehearsals."

He allowed Siloti to revise the concerto. Siloti made most of his cuts to the second movement, where the concerto went from a focus on the piano to a triple concerto, with the piano joined by cello and violin. Tchaikovsky appreciated Siloti's effort but did not agree with his cuts and edits.

Nevertheless, the version of the concerto that is mostly performed today is Siloti's version, which was published after Tchaikovsky's death. I must confess that I find beauty in both versions and I like them equally. We'll listen to both.



Painting by my brother Alex Katsenelson
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Original, uncut version—click here to listen.

Siloti and Bach's Prelude in B Minor

This is a continuation of my series of articles about Alexander Siloti. (I have to warn you, this note is full of trite realizations.)

It took me a while to realize that some people are great at creating and some are terrific at editing the creations of others. Often creators are not good editors and editors are not good creators. Few are good at both. Tchaikovsky was a great creator but still needed the help of editors. He often relied on his friends to polish his wonderful masterpieces. I have mentioned that Siloti helped him with the piano parts in his piano concertos. Also, after Tchaikovsky's death Siloti took it upon himself to "improve" Tchaikovsky's piano concertos, making them even more Lisztonian.

We usually glorify creators, but editors are lost in the footnotes of history. However, editors may add a lot of value to original work and may even transform it.

Painting by my brother Alex Katsenelson
Prints available on ArtistUSA.com

I have not been able to find any original music by Siloti, but he had a great talent for "editing" (transcribing) the work of others. Let's take Bach's *Prelude in B Minor.* Silotti took *Bach's Prelude in E Minor,* changed the key from E to B (made it a bit darker), tweaked a few things, and created a completely new, wonderful piece of music.

Maybe originality is overrated.

As I listen to Bach's original version and Siloti's transcription I see incredible beauty in both. Here is another revelation (I warned you): As I have gotten older, I have realized that I don't have to like one thing more than another. I may find beauty in both. As trite as it sounds, this little discovery was liberating. Listen to both pieces and perhaps you'll see what I mean. Click here to listen.

Bach – Siloti Siciliano

This prelude was originally composed for flute by Bach. Alexander Siloti transcribed it to piano. I'll share both flute and piano versions with you.

Click here to listen.

Painting by my brother Alex Katsenelson
Prints available on ArtistUSA.com

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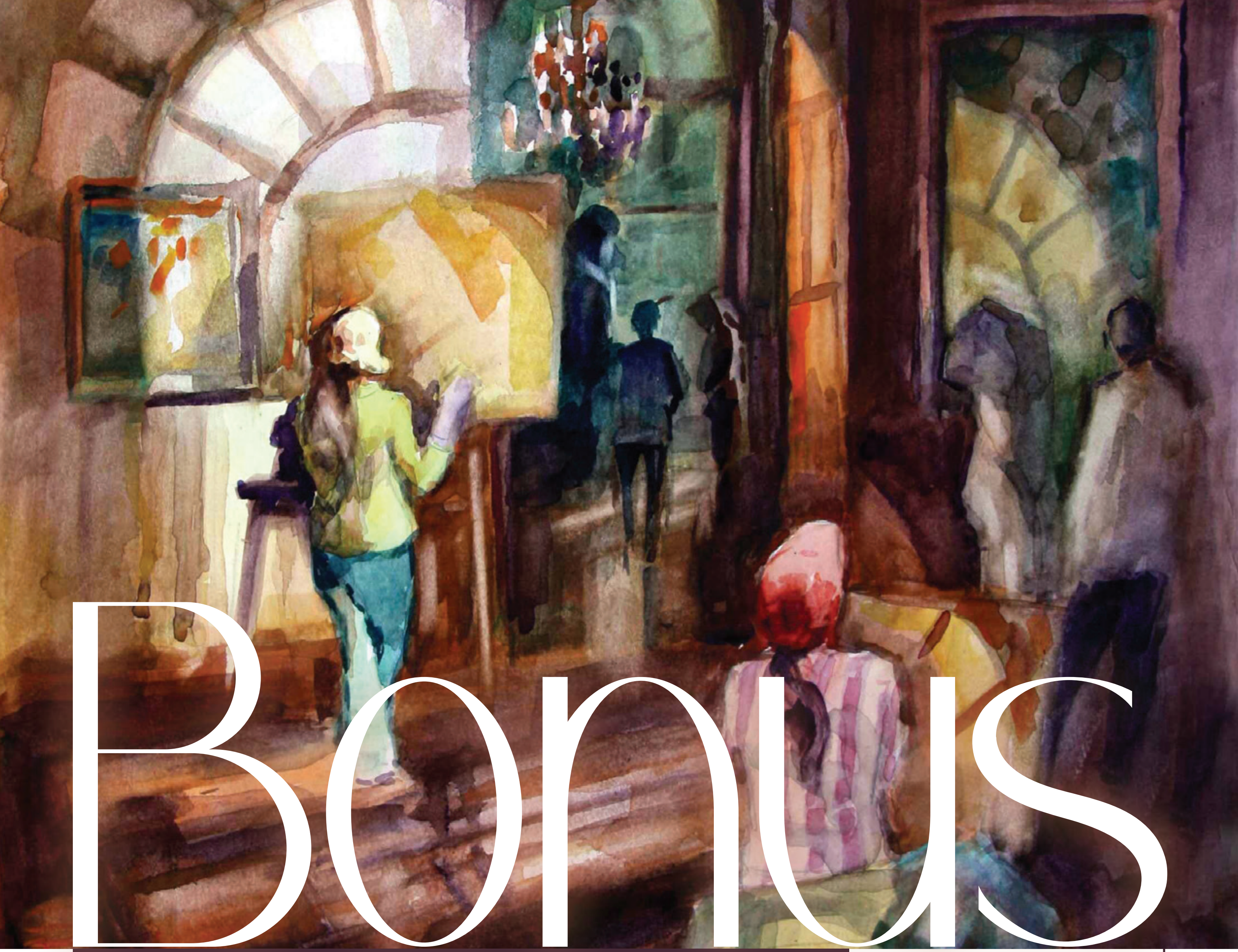
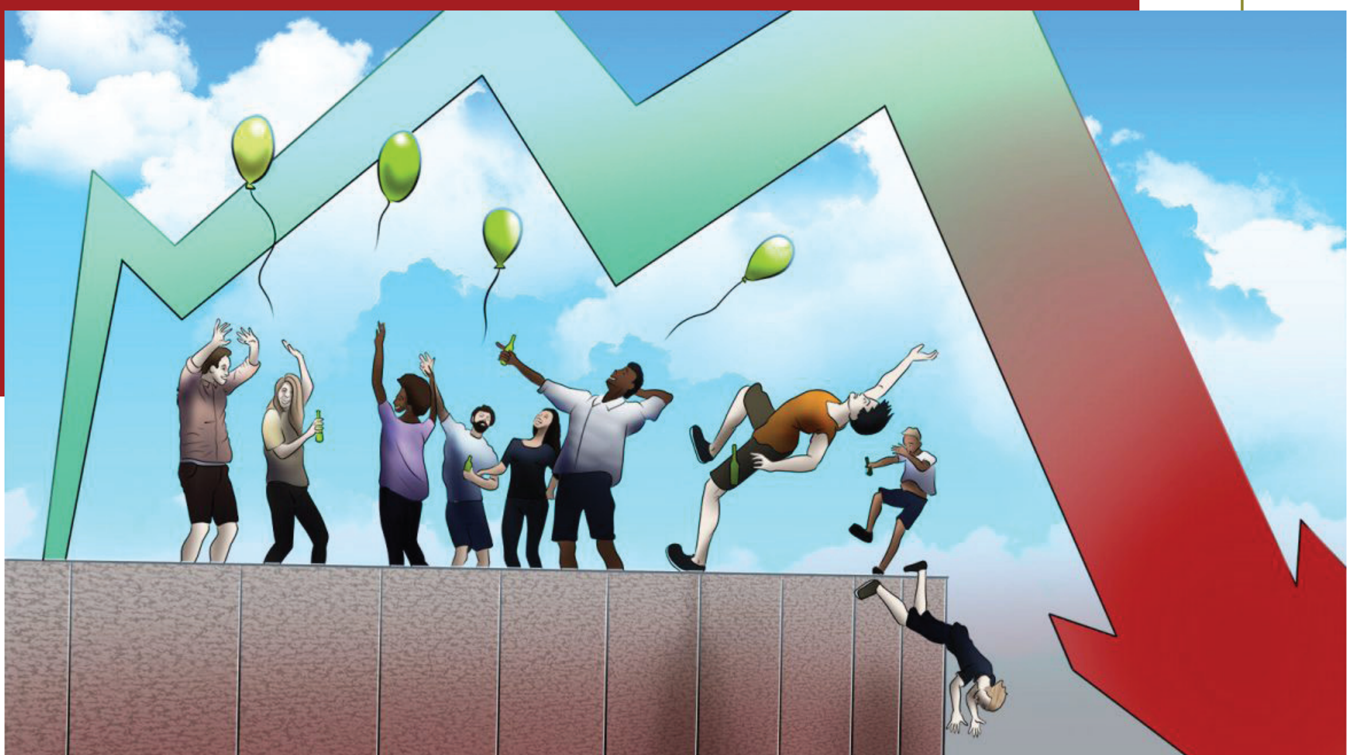


Bonus

Painting by my father Naum Katsenelson

2020: Party Like It's 1999?



Growth stocks are incredibly expensive. Value stocks have underperformed growth stocks for the last ten years.

VITALIY KATSENELSON

This article was originally written in 2020, but it still rings true today. Party like it's 1999 – this was the theme of our IMA annual meeting in 2019. This...

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Party like it's 1999 – this was the theme of our IMA annual meeting in 2019. This is how the stock market feels to us today. No, there are no dot-coms, though temporarily we had dot-cannabis and dot-fake-beef bubbles which got popped. Near zero interest rates, abundant liquidity, and a perceived absence of risk (and fear) turn money into a crude instrument of bubble creation. This is why the stock market is experiencing a lighter version of the previous millennial lunacy.

Growth stocks are incredibly expensive. Value stocks have underperformed growth stocks for the last ten years. The last time this underperformance was this extreme was... wait for it... 1999.

Historically, value stocks have outperformed growth stocks by a significant margin. But they have gone through painful bouts of underperformance in the past.

Value stocks have however shown some signs of life lately. (We are whispering – we don't want to tempt the stock market gods).

Growth stocks have outperformed for several reasons. Low interest rates favor the bird in the bush (distant future cash flows) not the bird in hand (high current cash flows). Negative interest rates paradoxically make $100 ten years in the future more valuable than $100 already in your pocket. (Yes, chew on this.)

Investors in search of yield have driven the prices of just about everything skyward, and especially anything that has even the superficial appearance of a bond. We are talking about dividend-paying stocks (the likes of Coke and Kimberly Clark), which are treated as bond substitutes. Anything that resembles a services stock is trading at a dot-comish valuation. These companies have enviable recurring revenues, of which they trade at a 20-25x multiple, and investors cannot get enough of them. (Not earnings, revenues.) This is another example that bubbles are just a good thing taken too far (in this case a great thing).

Passive investing through index funds and ETFs benefits expensive companies, as they have a much larger slot in the indices that are put together based on market capitalization. This will end in tears: An ever-rising stock market and investor feelings of safety, either through owning iconic brand stocks or diversification by means of index funds or ETFs, results in complacency and thus underappreciation of the risk embedded in the Average Joe's portfolio.

If economic growth continues to march along at the current rate and valuations go on expanding, then the market terrain will continue to be smooth. A race car (a more aggressive strategy) will finish the race faster than a four-wheel-drive (all-terrain) vehicle. But **if the investing terrain turns rocky, the race car won't even finish the race, while the all-terrain vehicle plows on through.**

The problem is that we have no idea what terrain lies ahead of us, so we'll always err on the side of durability over speed.

We are not excited about the stock market or the economy; but **we don't own the stock market, we own high-quality companies acquired at cheap to fair valuations.** Most of our companies (with one or two exceptions) are non-cyclical. We hold plenty of cash, and where we can, we hedge. So no, this is not your garden-variety portfolio, but we believe we are prepared for whatever future terrain we find ourselves in.

We feel a bit like sober, not-so-popular kids with eczema at a party where everyone else is drunk on the spiked punch and having a great time. We may feel a little envy right now, and – let's be honest – we are not having a great time. The more commonsensical and rational you are, the less fun you have been having at this party.

But the party will end (they always do), and we are going to be the designated drivers getting our dates safely home. When the music stops and it's time to go home, the drunk kids will be carried out and suffer giant hangovers. Just sayin'.... That's what happened in 2001 and countless other times in history, and it will happen this time, too. We just don't quite know when.

Time for an All-Terrain Investment Portfolio

As investors today we feel something like a traveler preparing to drive across an unknown continent. A look in the rearview mirror tells us we should pick a race car,...

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As investors today we feel something like a traveler preparing to drive across an unknown continent. A look in the rearview mirror tells us we should pick a race car, and if the road continues to be as it has been, then our trip may be fast and uneventful. But what if the road that lies ahead is rocky, full of holes and maybe even strewn with giant boulders?

A sports car will not get past the first potholes. What we need is a four-wheel-drive, all-terrain vehicle. This monster will not have the speed or the sex appeal of the shiny red convertible, but it will complete the journey. Its position at the finish line will depend entirely on one unknown — the road ahead. If it is a smooth, unbroken route, then our Land Cruiser will be left in the dust by the Ferraris and Maseratis. It will complete the journey; it just won't be the first to cross the finish line. But if my prediction is correct, you're going to be mighty glad to be in the ATV — you might even end up at the head of the pack.

On the surface the U.S. and global economies appear to be growing, and though the growth has been slow, it has been steady. My concern is that demand for goods has been highly inorganic, engendered by quantitative easing and unsustainable budget deficits. I've spilled gallons and gallons of digital ink on this subject in past columns.

Today, I want to focus on how to prepare for the consequences of this engineered, inorganic growth. Investing is a forward-looking endeavor. **Investors need to build a portfolio for the economy that lies ahead, not the one in the rearview mirror. Unfortunately, the view of the road before us is murky at best.** History is not very helpful either, as the QE experiment has never been attempted at its current magnitude. **For a potentially Mojave Desert–like countryside, you're going to need an ATV. Paraphrasing Warren Buffett, "To finish first, first you need to finish."**

When it comes to stocks, let me explain what “all-terrain” means in practical terms. To do this I need to explain **my firm’s three-dimensional analytical view of stocks: quality, valuation and growth.**

The valuation (the worth of the business) and growth (earnings growth and dividends) aspects have a dual purpose: They serve as a source of returns and as protection against losses. If you pay 50 cents for a company that is worth $1 — a 50 percent margin of safety — and the stock goes up to $1, that is the valuation dimension working as a source of returns. On the other hand, that 50-cent investment can tolerate a lot of bad news before you lose money — that is margin of safety working to protect you against losses.

The growth dimension protects you against the clock. A company that is growing earnings and paying dividends is compensating you for your time. ” Dividends tangibly enrich your P&L on a quarterly basis. Earnings growth increases the value of the firm over time — if earnings double, that aforementioned 50 cents turns not just into $1 but into $2.

Now, how about the quality dimension? A traditional definition of a quality company checks off these boxes: a significant competitive advantage, high return on capital (which usually accompanies a competitive advantage), good management (skilled at both running the business and allocating capital) and, last but not least, a solid balance sheet. **However, there is a simpler test for what constitutes a quality company. It is one that you would be comfortable owning for five or ten years, even if the stock market were closed.**

Of course, in an environment where the true cost of money is unknown (due to central banks’ machinations) and global growth has become a Frankenstein-like creation (thank your local central banker again), the valuation and growth dimensions have lost their tangibility for lower-quality companies. You thought you were buying a $1 company for 50 cents, but in the absence of quality, valuation can degrade much faster than your margin of safety and $1 can turn into 20 cents in a New York minute.

I would like to zoom in deeper on what may appear to be a small analytic shift that we’ve been making at my firm, though it’s one we think is very significant: **We became dogmatic about quality. It is now an uncompromising filter in our analysis. If a company doesn’t pass our quality filter, we simply stop — the company is dead to us, and we don’t bother with**

the valuation and growth dimensions. Passing the quality test doesn't mean a company is a buy, but it earns a stock the right to be examined for valuation and growth.

Quality is the superstructure of the all-terrain company — and portfolio: They must be able to survive anything thrown at them by the global economy.

These Simple Tips Can Make You a Better Investor

The stock market is not your friend. Instead, the market awakens a dangerous emotion — fear.

VITALIY KATSENELSON

The stock market is not your friend. Instead, the market awakens a dangerous emotion — fear. Often we are too fearful to invest in stocks, or, having taken the plunge,...

Click to listen to a narration of this article

The stock market is not your friend. You want to approach it the same way the American president should approach a one-on-one meeting with the Russian president – be respectful but cautious. He might smile at you and say all the right things, but despite the diplomatic niceties, your interests might or might not be aligned.

The stock market awakens a dangerous emotion – fear. It is sitting dormant in us all, awaiting an excuse to wake up. When stocks are going up we may find ourselves engulfed in the fear of missing out (which is so predominant in our society that we even have an acronym for it – FOMO). When we are consumed by FOMO our time horizon magically expands. We tell ourselves we are long-term investors and our risk tolerance is infinite. Risk of decline? Our chest puffs out and we say “bring it on!”

And then when the market actually declines, a very different fear pays us a visit – the fear of loss. The invincible hero who conquered the FOMO moment shrivels to a husk of his former self when the fear of loss emerges. The puffy chest collapses, and so does the time horizon, shrinking from “years and years” to months, days or minutes.

These two fears are not compatible with successful investing and have a zero-sum relationship with rational decisions. The more you are dominated by these fears the less rational you are.

I know I shouldn’t resort to a formula this early in the letter, but think of the total skill set of an investor as a multivariate equation in which all our skills are combined: the ability to value companies, to interpret financial statements, to understand and apply macro- and microeconomics, to be an independent and creative thinker, etc.

And then that grand sum must be multiplied by your ability to remain rational. Think of your ability to remain rational as a number between 0 and 1. If you are totally rational, you are a 1.

If you let the emotions generated by the last tick of the market seep into your investment process and dominate your buy and sell decisions, then it won't really matter what the sum of your other skills is. That sum will be multiplied by a big fat zero, and thus your total skill level as an investor will be exactly that – yes, zero. You'll be doing what the average investor does – buying high and selling low.

Thus, rationality is one of the most important qualities I'd be looking for in a money manager. Recent market volatility – a code word for when the market doesn't just go up but also declines – makes the rationality discussion even more pertinent.

Staying rational is a very proactive, not a reactive, journey. We deliberately structure our life and design our investment process to protect us from the toxicity of the market. The more you let the stock market into your life unguarded, the more your rationality slips from one toward zero.

Here are some of the things we do to move our rationality dial towards 1.

DON'T LOOK CONSTANTLY AT YOUR PORTFOLIO.

Next time you notice the price of a stock you own move up or down, think about the factors that may be influencing that move. Stocks are priced but not valued every day. They are owned by people who have very different time horizons. You'll have mutual funds and hedge funds whose clients often have the patience of five-year-olds. They are getting in and out of stocks based solely on what they expect them to do in the next month or six months – a rounding error of a time period in the life of a company that lasts decades.

Some buyers and sellers are not even humans but computer algorithms that are reacting to variables that have little or nothing to do with fundamentals of the company you invested in – these players have a time horizon of milliseconds.

You will also have folks who are buying and selling a stock based on the pattern of its chart. Not that they don't know what the company does; they will tell you they don't care what it does. For them it's just a chart with this squiggly line crossing that squiggly line.

Then there are folks who spend more time researching the next movie they are going to see than the stock they're about to buy. Some of them buy a stock after reading a single article on the internet, while many others buy on the advice of their brilliant neighbor Joe, the orthodontist.

And there is the latest craze – passive investing. This one is a bit personal and requires a small detour.

Interest rates are the foundation of the discount rate (also known as the required rate of return) that we use to convert future cash flows into today's dollars. Think of the discount rate as being composed of two layers: the foundational layer – the risk-free rate (the interest rate, let's say, on the 10-year Treasury) – and a risky layer that should compensate you for additional, asset-specific risks.

When central banks artificially changed the price of money by buying trillions in government and corporate bonds, they made the Soviet planned economy look like child's play. Instead of messing with little stuff like setting prices on shoes and sugar – the kiddie stuff that tens of thousands of Soviet central planners were playing with – a few dozen capitalist "free market" central bankers set the price of the single most important commodity, the risk-free rate, which is at the core of most economic decisions and the valuation of *all* assets.

Valuation of companies whose earnings lie far, far in the future benefits dramatically from falling interest rates, while the valuation of companies whose earnings are not growing as much and are concentrated in the present and near future doesn't enjoy that benefit.

A similar dynamic happens in the bond market: Bonds with short maturities (similar to value stocks) are impacted a lot less by declining interest rates than long-term bonds (similar to growth stocks).

So active managers that have even a modicum of discipline in their stock selection get fired, and the money flows into index funds that indiscriminately buy what is in the index. What is in the index, you may ask? Most popular indices today are constructed based on companies' capitalization. Thus, companies that have done well lately (the FANGs), get a much greater portion of new capital – in fact the FANGs are 10% of the S&P 500 Index. So "high-duration" companies are benefiting from both low interest rates and the "dumbness" of the indices.

However, as investors who hold long-term bonds in 2018 are discovering, rising interest rates hurt. We don't know what interest rates will do in the future. But today the US government is running a trillion-dollar budget deficit at a time when the economy is growing 5%. What do you think the deficit is going to be when growth slows down or turns negative during a recession (yes, those things do happen). To make things worse, these deficits add to the $21 trillion of US debt, which doubled over the last ten years while the government's interest payments didn't change (thanks to low interest rates). Higher, maybe even much higher, interest rates are not unlikely going forward.

If you own the S&P 500 (or long-term bonds), you implicitly think one of several things is true: (1) interest have a zero or insignificant probability of going up, (2) I'll be able to get out in time, or (3) I have a life-sized statue of John Bogle in my living room, and I have very, very, very long time horizon.

Back to various actors who are responsible for daily ticks of your favorite stocks. If you are a fundamental investor, you are not just buying stocks, you are buying fractional ownership in businesses.

You spend hundreds of hours on research, you read company financial reports; you talk to management, competitors, customers, suppliers. You build a financial model that looks years into the future to value a business and also try to kill it. If after you've done all that, you find yourself glued to the computer screen watching the price change tick by tick, you are basically giving credence to the idea that what a company is worth should be decided by algorithmic funds, the guy who reads charts but cannot even spell the name of your company, Joe the neighbor, and an ETF with the IQ of a Halloween pumpkin. (I don't want to insult everyday pumpkins here.)

In short, the less time you spend looking at your portfolio, the more rational you are going to be.

TURN OFF THE TV

We rarely turn on business TV in our office. Stock market movements throughout the day are completely random. The same actors that are influencing the up and down ticks of individual stocks are driving market movements. I feel for TV producers who must provide a continuous narrative to this randomness.

Business TV presents additional dangers to your rationality: It reprograms you to think about the stock market as a game. In encouraging you to play that game, it puts you at risk of nullifying all the research you've done as you let your time horizon dwindle from years to minutes.

It also holds the danger of stripping from you the humility that is so needed in investing. Business TV guests who provide their opinions on stocks have to project an image of infallibility (the opposite of humility). Again, I understand them – they are there to market themselves and their business, and thus they must project the image that they have an IQ of 200 on every possible topic.

You are never going to hear from them the words that are the essence of investing: “I don’t know.” This is dangerous, because it may cause you to stop thinking about investing in terms of probabilities and make you believe that you can be an expert on everything.

If you start thinking that the future has only one path, you may ignore other paths and thus other risks in your portfolio construction. If you tell yourself that you’re an expert on every company, then your circle of competence has no boundaries and your overconfidence may take you to places (and into investments) where you have no place being.

Also, since “I don’t know” is not part of their vocabulary, business TV guests will confidently answer questions that should never be asked, such as “What will the economy and stock market do next?” If you have been investing long enough, it is hard to not develop opinions (hunches) about what the stock market and economy will do next. However, we work diligently to extinguish these hunches from our investment process, because they lack repeatability.

If you get the next leg of the stock market or economy right, that’s just dumb luck – nothing more and nothing less. Economic and stock market behavior, especially in the short term, are very random. God forbid your recent forecasting success goes to your head, because your ability to predict what will come next is not much different from your predicting the next card to be turned up in blackjack.

BE AN INVESTOR.

We used to identify with our self-proclaimed “I am a long-term investor” brethren. However, over time this term has morphed to mean “I am a buy and hold (never sell) investor.” Also, the term *long-term investor,* in our view, is a bit redundant, since there is no such thing as short-term investing in the stock market. If you are *investing* in stocks, then your time horizon should automatically be long-term, otherwise you are just a trader deceiving yourself into thinking that you’re an investor. However, investing is not just about the *holding* time horizon (the ability to hold). The *analytical* time horizon is just as important.

To us, being investors means having an attitude with which we look at stocks and how we process information. We buy businesses that happen to be listed on public exchanges, but our attitude toward them would not be much different if they were private. We view all news, be it quarterly guidance (whether it's "great" or "disappointing"), upgrades or downgrades by analysts, or any headline crossing our screens in the context of one question: How does it impact the value of the business?

This perspective is liberating, because you start to process the news flow very differently. You begin to filter out the noise of the everyday news dump. Quarterly earnings stop being about "beating" or "missing" guidance. Yes, this simple question, "How does it impact the value of the business?" filters out 90% of the noise and puts us on a solid investment footing.

This Is What Happiness Feels Like

It's dark outside, and my wife and three kids are safely asleep. This is what happiness feels like.

VITALIY KATSENELSON

My daughter Hannah had her bat mitzvah this Sunday (see below). It was one of the most important days of her life. For a Jewish girl it ranks somewhere close…

Click to listen to a narration of this article

My daughter Hannah had her bat mitzvah this Sunday (see below). It was one of the most important days of her life. For a Jewish girl it ranks somewhere close to getting married or having a firstborn.

You really don't know what true emotions are until you become a parent. As I am writing this at 5 am, I have headphones on and I'm listening to Beethoven's *Moonlight Sonata*. It's dark outside, and my wife and three kids are safely asleep.

This is what happiness feels like.

I know that in two hours they'll wake up. We'll have breakfast and I'll drive them to school. Jonah (my sixteen-year-old) will be bargaining with me about what music we'll listen to – classical will not be his first choice. Hannah will be on Jonah's side. Mia Sarah (my almost-4-year-old) will offer her preference, which is always the same: "Wheels on the Bus Go Round and Round." We'll compromise. Jonah has a learner's permit, and he'll be driving us through a beautiful park. I'll hug and kiss them, drop Jonah off at high school, Hannah at middle school, and Mia Sarah at preschool.

I am overwhelmed with emotions just writing this. This is all finite. One day they'll all be grown up. The house will be empty and days like today will be distant happy memories. I never want days like this to end. I really don't want my kids to grow up, and bat mitzvah is another reminder that they are! Someday I will no longer be hugging and kissing them in the morning and driving them to school.

Yes, and as you can imagine, the stock market, QE, Bitcoin, and whatever else I usually write about somehow seem so trivial and unimportant right now.

In my speech at Hannah's bat mitzvah I wanted to express my love for her and tell her something meaningful about becoming bat mitzvah. Expressing my love for her was easy; the latter part was difficult, as you'll see.

I am the Spielberg wannabe in my family. I am the one making family movies for big occasions (birthdays and anniversaries, etc.). A dozen years ago I somehow stumbled into this role, probably because no one else wanted it. Mr. Spielberg should not be worried about being dethroned by me anytime soon, but I really enjoy putting these fancy slideshows together – they send me down memory lane as I pick photos and videos – and I get to pick music!

Making a movie for Hannah's bat mitzvah was a highly emotional experience as well, as I got to relive her first twelve years through pictures and home movies.

Here is Hannah's bat mitzvah video:

Dear Hannah,

When I think of you, the word that instantly comes to mind is sunshine. Since you were very little, you always smiled. I'd wake you up in the morning, and no matter how early it was, you'd open your eyes and smile at me. Always.

You started skiing when you had barely turned four. You had no fear. No hesitation. You only had one speed – forward. Of course skiing came with its own sets of challenges for me. I kept losing you at Keystone or Vail.

If your Mom knew how many times I lost you, she'd have learned to ski and started skiing with us.

I just choose to look not at how many times I lost you but at how many times I found you.

When I lost you the first five times, I panicked. You were so little and these ski resorts are so large. I had a full head of hair when we started skiing, but after the first season, not so much.

When you went missing you wouldn't panic or cry. You'd ask someone for a phone and call me. Laughing, without a worry in the world, you'd say, "Dad, I am here."

You have always been happy within yourself. Wherever you go you bring sunshine with your smile.

This internal happiness is very rare.

Stay this way.

I was thinking what Jewish advice to give you today. I was a bit conflicted. I grew up in Soviet Russia, where there was no religion. I am not just talking about Judaism. From the time I was seven years old I was taught in school that “religion is the opioid of the masses.”

Until I was eighteen I thought that being Jewish was a nationality. And in Russia it was not a good one.

My parents and grandparents were not religious – both my grandfathers were scientists. My father is a scientist. I realized that I have a unique perspective on religion. I’ve been looking at the Jewish religion as an outsider looking in. So here it comes.

What does it mean when a child, a girl, becomes Bat Mitzvah? Since I grew in a very Jewish but also a very not religious family, I had to look the subject up. I went straight to the source of all modern wisdom: Wikipedia.

“Bat Mitzvah according to Jewish law is when the girl becomes responsible for her own actions… bears her own responsibility for Jewish ritual law, tradition and ethics.”

Let me tell you what this means to you in theory. I want to stress the word theory.

1) Now you are eligible to be called to the Torah. Since Mom takes you only to orthodox synagogues where only men are called to the Torah, this is unlikely to happen.

Of course, if you really want to be called to the Torah, just say a word and I’ll drive you a reform synagogue. Even if it is on shabbos.

2) You have a right to be legally married, at least according to Jewish law.

I think what the sages really meant is that you now have the right to be married to books and to learning.

Also, knowing your Mom, for whom PG-13 really means PG-21, you'll make one Jewish boy really, really happy after he finishes dental school; and you'll become anyone your gentle heart desires to become, as long as people call you Hannah Katsenelson, MD or Hannah Katsenelson, CFA.

As a Katsenelson you carry the torch of your ancestors. They all had an insatiable thirst for knowledge and learning that doesn't stop with college graduation.

My father, your Granpa Naum, already a PhD, went to university to study English when he was 76 years old. His mother (my grandmother) Emily (we gave you your middle name after her) studied English and took singing lessons well into her 70s. My father's father, my grandfather Volodya, translated scientific papers from other languages well into his 80s. And this is just my father's side of the family…

You learn for as long as your heart beats.

3) Until today, according to Jewish law, Mom and I were responsible for your actions.

Again, according to almighty Wikipedia, "Traditionally, the father of the bat mitzvah gives thanks to God that he is no longer punished for the child's sins."

Maybe other fathers have to do that; I don't.

The only sin I can think of that you committed is being a better skier than your father. A 12-year-girl old being a better skier than 44-year-old man in his prime. This is just wrong.

4) Now you have a duty to follow the 613 laws of Torah. This is really the topic I want you to think about.

I want you to think of being Jewish as three things: tradition, religion, and philosophy. Where one starts and another begins is often hard to tell.

Here is what I suggest you do. Take religion like Americans have learned to take our current president –seriously but not literally. There is an incredible amount of wisdom in the Jewish philosophy.

However, when you have 613 rules (mitzvahs), it is very easy to get lost in the trees and not see the forest. The rest of the world is struggling to keep 10 commandments; Jews have got 603 more to follow.

As an outsider looking in, I can see how following all these rules can be overwhelming and can often turn into a meaningless journey driven by fear.

Just as you skied without fear, don't do anything in life out of fear.

I love that Jewish religion and philosophy encourage you to question everything.

That is why there are three synagogues for every two Jews. We all need a synagogue we don't go to.

Question everything. Look for meaning. If you accept all 613 commandments, do it by choice, not because you feel you have to.

Finally, in your life you're responsible not just for yourself and your future family but for your brother and sister. And since Jonah and Mia Sarah are in the audience, this message is to you as well. Your siblings should always be the most important people in your life. Always.

Hannah, my sunshine, I know that when you grow up (which according to Jewish law starts today) you are going to become what you already are – an incredible, kind, thoughtful, human being who is going to keep lighting up everything around you with your presence.

Mom and I very proud of you.

Mazel Tov

How Franz Liszt Revolutionized Piano and Classical Music

Liszt did not create the new hardware, but his technique released the power of the new instrument.

VITALIY KATSENELSON

Franz Liszt was a Hungarian composer and pianist. I don't think you can talk about Liszt without talking first about the evolution of the piano.

Click to listen to a narration of this article

The piano you see today in concerts hall or in private homes was not always like that. Though the earlier instrument had a similar shape and had a keyboard, its interior plumbing was completely different. In fact it was called a harpsichord – think of it as a harp (wooden frame with stretched strings) with a keyboard.

Around 1700 the harpsichord gradually transformed into a pianoforte, which had the same look as the harpsichord, but instead of the strings being plucked they were hit by little leather-wrapped hammers. The frame that held the strings was still wooden, and the strings were held at low tension. This is the instrument used by Mozart and the young Beethoven. The sound of the pianoforte is different from the sound we accustomed to hearing today: it is lighter, and the instrument did not have a double escape mechanism and thus could not repeat sounds rapidly – it speaks instead of signing. Each note is very clear and distinct, and the pianoforte has still not completely lost the sound of the harpsichord. Think of Mozart's piano concertos or sonatas, which were written for pianoforte.

Mozart died in 1791, just as the fortepiano (or simply, piano), the instrument we are all familiar with, was starting to emerge. But from the late 1700s to the early 1800s the piano underwent a significant transformation. This transformation had a major impact on the music that was composed; and, in a musical feedback loop, composers impacted the instrument. Beethoven was one of the early adopters and beneficiaries of the piano's evolution and played an important role in the evolution of the instrument. At one point he had broken 78% of the strings in his piano. He complained to the piano manufacturer that pianos wore out very fast.

The biggest differences between the pianoforte and fortepiano (the modern piano) are, first, that the frame the harp strings are tied to is not wooden but metal; the low-tension strings have been replaced with high-tension ones; the instrument has a range of two additional octaves (14 extra white keys); and the hammers are covered with tightly compacted felt instead of leather. These changes transformed a delicate instrument into an incredibly powerful beast that can replace an orchestra but that at the same time retains the gentleness of its ancestors.

This brings us to Franz Liszt (1811-1886). Liszt was born sixteen years before Beethoven's death. He was a child prodigy and a virtuoso pianist. He was the first rockstar of Europe – he was Michael Jackson before Michael Jackson was Michael Jackson.

As luck would have it, on a trip to Paris, Franz Liszt stayed in a hotel right across the street from Erard Piano – a trailblazing piano maker that invented the double escapement movement that sped up the piano and significantly reduced the limitations of previous generations of pianos. Erard was also the first piano maker to fit pedals under the piano.

As the story goes, young Franz wandered into the Erard store and started playing on one of the instruments. Mssr. Erard smitten by the boy's genius and also recognized a unique marketing opportunity. He made an endorsement deal with young Franz, providing pianos for all of Liszt's performances. Liszt went on a three-year tour, giving several performances a day. No town was too small – he loved the attention and the applause. However, this tour was suddenly interrupted by his father's untimely death.

In 1832 Liszt attended a concert of the Italian violin virtuoso Niccolo Paganini. The violin had undergone its most dramatic improvements two hundreds years before the piano did, and it was a mature instrument by that time. After Liszt heard Paganini he remarked, "What wonderful things might be done with the piano if its technical possibilities were developed as those of the violin have been by Paganini." He decided to become the Paganini of piano. For three years he stopped appearing in public and practiced non-stop (putting in Malcom Gladwell's 10,000 hours).

Liszt invented solo recitals – before Liszt it was unheard for an artist to give a solo performance (doing so was probably perceived as immodest). Liszt changed the way the piano is positioned on the stage, placing it to the right of the stage and opening the lid toward the audience.

To me – and this is the extremely uneducated opinion of an amateur classical music aficionado – Liszt pushed the boundaries of what was possible on the now-evolved, much more powerful instrument, where the player's technique was the only limitation. To do this he had to write his own music for the new instrument and vastly improve performance technique.

Imagine that Intel had just created a new processor that was 100 times better than the old ones, and let's say Microsoft wrote a new operating system that vastly improved the capabilities of that new processor. But to truly shine the new system would need new programs. The old ones might still run just fine, but to truly showcase the new box's abilities, it would need to be loaded with brand new apps.

Liszt did not create the new hardware, but his technique (the new operating system) removed a lot of limitations and released the power of the new instrument.

To me, Liszt's *Sonata in B Minor* is the new software. Liszt made a solo piano sound, at times, like a full orchestra – something that I don't think had been done before him (though I'd be happy to be proven wrong). Liszt's contribution to classical music is incredible and immeasurable. It spans much further than his amazing music, because Liszt showed the likes of Brahms, Rachmaninoff, Grieg, and many others what the piano could do.

Letter from the Value Investing Mental Asylum or How I Embraced Stoics

The vicious cycle will continue until it doesn't.

VITALIY KATSENELSON

Albert Einstein defined insanity as "doing the same thing over and over again but expecting a different outcome." I can relate to this on some level. I share with you why I am not writing this from a mental asylum. I found solace in Stoicism.

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A year ago, I called the stock market mood "partying like it's 1999." I was off by a year. Last year was missing the necessary euphoric speculation, which ironically arrived in the middle of a pandemic that engulfed the world.

Just as history doesn't repeat itself but rhymes, so does stock market behavior. Though there are a lot of similarities between 1999 and 2020, there are differences, too.

In 1999 the market was flooded with dotcoms, "new economy" companies that traded at astronomical valuations, were losing money, and had unproven business models. Today we have a lot of "new economy" companies, too, which either offer software as a service or do something in the cloud. Unlike in 1999, these companies generate cash flows. Just like the dotcoms of 1999, they are growing fast.

Most appear to be real businesses, but it is not always clear how sustainable their competitive advantages are. This is paramount when the market expects super-high growth rates to continue decades into the future.

Here is one example: Zoom – a clear beneficiary of the pandemic. It is a real company. The pandemic turned its name into a verb. But there are zero switching costs from Zoom. Could Google, Facebook, or some startup displace it? Too early to tell. In the meantime, Zoom is trading at half the market capitalization of AT&T or Verizon.

In 1999, the stock market plunged into a speculative frenzy. Day trading became the past time of everyday folks. At least in 1999 you had to wait to place trades until you got home or to the office. Today, you can even trade (gamble) from the comfort of your own bathroom on your smartphone, with the Robinhood app, which resembles a casino slot machine. (I'll talk about Robinhood separately.)

Clear, flashing signs of speculative behavior became apparent recently when Apple and Tesla stocks went up 50% or more in the days after they announced stock splits. Apple has created more value for its shareholders by announcing a stock split in 2020 than by coming out with new products. Tesla's market capitalization has exceeded the market cap of all US, European, and Japanese car makers combined.

Here is the rub, though: Stock splits create zero (no!) economic value. Let's say there is a publicly traded pizza. It has 16 slices and each slice trades for $1. So the price of the whole pie –its market capitalization – is $16 ($1 times 16). Let's say this pizza observed Tesla's and Apple's positive experience with stock splits and decided that it wanted to be cut into 32 slices instead of 16 – a two for one slice split. So if you owned one slice that was worth $1, now you own two at $0.50 each.

However, after our pizza announces its two for one slice split, investors get excited about new "cheaper" slices and push the price per slice up 50% from $0.50 to $0.75. Pizza weight and size and number of calories have not changed, but "investors" (I use this word loosely here) are suddenly willing to pay $24 ($0.75 times 32) for the same pie they paid $16 for a day earlier. This sounds ridiculous as I write, and probably to you as well. But this is exactly what has been happening with Tesla and Apple shares.

(I really hope Papa Johns and Pizza Hut executives are not reading this; I don't want to give them any ideas here.)

This speculative phase may have been triggered by a combination of low interest rates which have resulted in low margin rates, the decline of retail trading commissions to zero, pandemic stimulus money, and/or boredom from lockdown.

In any case, just as in 1999, stocks that have been rising are the ones that continue to rise. Speculators ride the wave of what worked lately. There is another factor that helps these stocks: call options on individual stocks, as traders gamble to leverage their bets on rising stock prices. According to the CBOE, the volume of single-stock contracts is up 80% in August over a year ago. Investors' euphoric bets on call options creates a skew in the options market: – A significant imbalance develops between calls and puts, which usually balance each other out.

Thus, every time someone buys a call option, a counterparty on the other side (a market maker) has to buy stock in the open market to hedge its exposure. As the stock price goes higher, the counterparty's exposure to the stock increases and it has to buy more stock, which in turn drives the stock price up. Higher stock prices lead to higher stock prices. You can watch this video, which explains the dynamics of the process.

This vicious cycle will continue until it doesn't.

In addition, an elephant has waltzed into a relatively small room: Masayosi Son's Softbank.

Softbank distorted prices in the venture capital market with its $100 billion Vision Fund in 2018 and 2019. Now, it appears Softbank is using $5 billion to bet on rising prices of the FAANG stocks.

This is the most speculative behavior we've encountered since 1999, though it doesn't mean that this is the peak of speculation. I don't know how long this stage will last. It could last three months or three years. One thing I am sure about is that this is not the new normal or the forever-state of the market. Behavior that is driven solely by speculation and divorced from fundamentals is not sustainable and thus will end, usually in tears.

This begs another question: The Fed just announced three more years of near-zero interest rates. Does that mean this party will continue for another three years? Here is what I know: Every bubble has burst. Every single one! It is, however, much easier to spot "irrational exuberance" than its duration. Just ask Alan Greenspan, "the Maestro," who used the term "irrational exuberance" to describe the enthusiasm that was already building in 1996 and burst four long years later.

In a speculative phase, everyone who is buying overvalued stocks is counting on a greater fool to buy even more overvalued stocks for higher prices in the future. At some point the stock market runs out of greater fools. It's that simple.

Japan is a special country with an incredibly special culture. It rebuilt after WWII and seemed unstoppable. It was conquering the world, scooping up prime real estate in Hawaii, California, and even New York's Times Square in the '80s and early '90s. Japan's domination seemed to have no end in sight – until the Japanese asset market collapsed under its own weight. The ensuing perennial low and negative interest rates did not save Japanese stocks. Similarly, the US market was oh so bubbly in the late '90s, and some even argued that it would never again go anywhere but up – and then it ran out of greater fools.

Here is another thing that happened in 1999: Growth stocks become priceless and value stocks became worthless. This started to happen again last year, and in recent months the gap has widened considerably.

Growing (but not fast-growing) businesses were left for dead in 1999. As growth and dotcom stocks were going up, value stocks were declining. It was extremely demoralizing being a value investor in 1999. A 17-year-old kid went from playing Diablo in his parents' basement to trading stocks, and his portfolio was doubling every six weeks. The only things he knew about the businesses in his portfolio were how to spell their four-letter tickers and that they were internet companies and going up. (I was 26 in 1999, but I was an old soul.)

Value investors that kept to value investing and didn't chant the "this time is different" mantra were going out of business (frustrated clients were leaving them) or were simply quitting out of frustration. Julian Robertson, an incredibly accomplished value investor, could not take the frustration anymore. Here is an excerpt from *The New York Times* of March 31, 2000:

After 20 years of generating superlative investment returns by buying stocks that were undervalued and selling short those that carried excessive valuations, Mr. Robertson, 67, confirmed yesterday that he was shutting Tiger's operations. He has essentially decided to **stop driving the wrong way down the one-way technology thoroughfare** that Wall Street has become.

"I'm not capitulating," he said. "I'm not going to quit investing. But it will be nice to get out of the public eye. I don't mind people calling me an old-economy investor, but it doesn't go over well with the clients." (Emphasis is ours.)

The irony of March 31, 2000, the day that the *Times* article was published, is that it was *the day* the Nasdaq peaked. Then it crashed, wiping out years of gains in weeks. And lo and behold, value stocks started going up. Value investing embarked on a phenomenal decade.

We'd be lying if we told you that over the last few years investing was not frustrating. Just like Julian Robertson in 2000, over the last few years we've felt like we were driving the wrong way on a one-way growth highway. Albert Einstein defined insanity as "doing the same thing over and over again but expecting a different outcome." We can relate to this on some level. But let me tell you why we are not writing this from a mental asylum. We found our solace in stoicism.

Being A Father

Painting by my father Naum Katsenelson

As I get older I find that I value material things a lot less. I am still partial to gadgets, but soft things like conversations, walks – experiences – have…

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As I get older I find that I value material things a lot less. I am still partial to gadgets, but soft things like conversations, walks – experiences – have started to matter to me a lot more than things. My writing was supposed to be about investing, how to make $2 out of $1, but existential topics have lately had a greater appeal for me than discussions about stocks or the economy.

Writing this scribble that I'm about to share with you was very difficult, because while I was writing it I kept asking myself "Am I a good father?" and I was not sure of the answer.

BEING A FATHER?

Dana Carvey on when you most feel loved in your life:

"When humans started to call me Dad. That is the word that gets me. You are famous to a billion people but only three people call you Dad!"

I have a client. Her husband was a second-generation American, a Yale-educated lawyer who worked in the family business that was started by his father, a Russian immigrant. Four years ago he was diagnosed with cancer. He put up a great fight, but cancer won, and a year later he was gone, at 66.

He left $100 million, which went to his wife, son and daughter (the kids are in their late 20s). I had a meeting with the family recently. The son's wife was a few days away from giving birth to a baby girl. As the son and I were talking about his upcoming fatherhood, I asked him what kind of father he wants to be. He said, "I don't want to be like my father." I was a bit surprised and asked why.

He said,

After my father passed away, his friends would tell me how he was this larger-than-life, gregarious man. I never saw that man. My father worked 16 hour days, seven days a week. He worked in the basement – he'd come up for dinner and go back down. He never spent time with me or my sister. My mom did everything, from driving us to school to taking me to football practice. I always felt like I was raised by my mother. I don't want to be like that. I want to be there for my kids.

He went on,

My father thought till the last moment that he'd beat the cancer, and so he never expressed his true feelings to me or my sister. A year later my father's friend told me that my father confided in him that he wished he'd spent more time with us kids.

Listening to him, I felt a sudden urge to run home and hug my children. I also felt enormous sadness. I was thinking, what if he had worked eight or maybe even ten hours a day instead of 16 and had left his kids a $10-million pile rather than $100 million? Would it really have made a difference for his kids' lives? They are wonderful, thoughtful young adults who don't have pretentious lifestyles (they live in $200,000 houses and drive modest cars). His son would probably trade all his money for a father who was there for him.

I was deeply impacted by this story because, as a father who runs a business, I was asking myself, am I doing the same thing to my kids? I shared my worry with a good friend. He has a struggling website design business that has not moved out of the startup phase, ten years on. He is anything but wealthy. But his bills are paid and his family doesn't go hungry. He works eight hours a day and spends all of his free time with his three young kids.

As I was mentally comparing these two dads, my definition of what success means got completely redefined. It's not how much money you are going to leave your children; it's the memories you'll leave them with.

Our appreciation of material things has a very short shelf life. We value the experiences and memories they create exponentially more. His kids may not have the fancy toys and big houses that some of their friends do. But to them those things won't matter much; they'll have the warm glow of love their father gave them.

As an entrepreneur you always want to grow your business larger. Your current revenue and profit are never enough; they just set the bar higher for next year. We always want more. But this "more" has a cost, a cost we don't see at the time: time with our family. It's my core responsibility to provide for my family, but at some point I (and maybe some of my readers) may say that *more* is not worth it.

P.S. An additional thought. Sometimes work for us is a game, a real-life version of *Candy Crush,* where money is not a currency that buys us material stuff but chips that we never intend to spend but are just there to keep count of our successes – they are the currency that moves us to the next level, and the next level. Just as we can mindlessly spend tens of hours playing *Candy Crush*, our work can turn from being something we do to live into an addiction.

As I am writing this I keep thinking that on one hand I was incredibly fortunate to discover my love for investing when I was in my early twenties, but also that there's a danger in this love, which at times can conflict with my love for my family.

My own father often quoted from *The Little Prince*, by Antoine de Saint-Exupéry: "*You* become *responsible*, forever, for what *you* have tamed."

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About Vitaliy Katsenelson

Vitaliy Katsenelson was born in Murmansk, Russia, and immigrated to the United States with his family in 1991. After joining Denver-based value investment firm IMA in 1997, Vitaliy became Chief Investment Officer in 2007, and CEO in 2012. Vitaliy has written two books on investing and is an award-winning writer. Known for his uncommon common sense, Forbes Magazine called him "The New Benjamin Graham."

He's written for publications including Financial Times, Barron's, Institutional Investor and Foreign Policy. Vitaliy lives in Denver with his wife and three kids, where he loves to read, listen to classical music, play chess, and write about life, investing, and music.

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