MARKET INSIGHTS

SECOND QUARTER 2022

NAPLES GLOBAL ADVISORS

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Resiliency in the Face of a Storm

Just as we head into another hurricane season in Florida, the first quarter headwinds of the financial markets gained strength and perhaps approached tropical storm status during the second quarter. The Russia/Ukraine war continued to drag on with energy and food price ramifications intensifying. As a part of its zero-Covid policy, China shut down major metropolitan areas for extended periods of time, further exacerbating global supply shortages. The Federal Reserve raised its benchmark interest rate by 1.25% during the quarter and is projected to raise it by another 2.0% by year end in its quest to tame elevated inflation. Speaking of inflation, businesses are being challenged to pass on price increases to consumers as households gasp at the new daily cost of living. Sum it all up, and you have the nasty “Recession” word being thrown around in abundance.

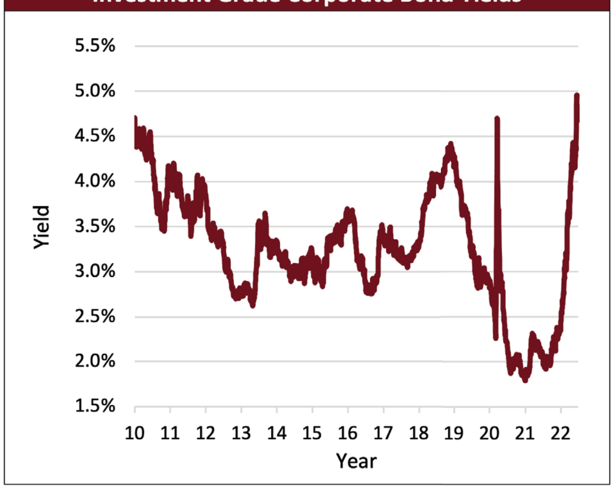
That’s a lot of negativity, yet we find ourselves feeling quite sanguine. Not because we know this macroeconomic hurricane will avoid landfall. No, it’s because we know that we built the house to withstand hurricane force winds. So, we wanted to take this opportunity to provide a general refresher of what you own and why you own it, which will hopefully result in some measure of comfort through these and future economic storms.

Bonds

In simplistic terms, if you own a bond, you have lent money to a government or corporate entity and in return, they are paying you interest. At the end of the term, they return the money you lent them. Therefore, bonds have a dual purpose of income and relative stability of principal.

However, as we have been acutely reminded this year, prices of bonds can decline. In fact, in 2022 the bond markets have posted their worst start to a year on record (data starts in 1978). So why do we feel so good about your bond holdings? For the first time in more than a decade the scale is starting to tilt in favor of the saver rather than the borrower. Remember in 2020 when Austria issued 100-year bonds at an astoundingly low 0.88% yield? That was definitely in favor of the borrower, not the saver. It was quite indicative of how bond investors were starved for yield in recent years. Well, the paradigm is shifting.

Investment Grade Corporate Bond Yields



Source: BofA/ML Indices, Bloomberg

The Fed is projected to raise its benchmark rate to 3.5% by year end which would be the highest level since pre-financial crisis in early 2008. Investors are trying to anticipate these future rate hikes and have already priced them into the bond market. As a result, from a yield perspective, this is one of the more attractive times to be investing in corporate and municipal bonds in the last decade, as highlighted by the corporate bond yield chart above. In contrast to having to accept the miniscule yields offered over the past few years, we are now genuinely excited to be adding bonds to our client portfolios.

Equities

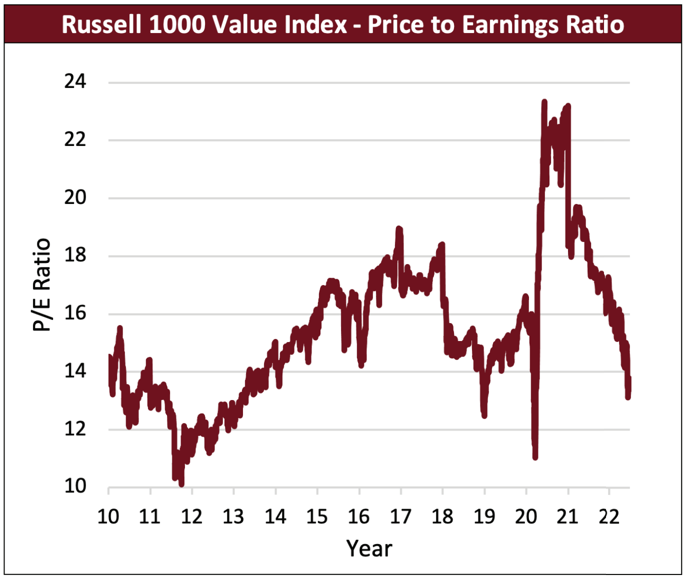
In simplistic terms, if you own a stock, you have invested money into a company in return for an ownership stake of its future cash flows (earnings). The stocks that we own have a dual objective of capital appreciation and income.

In particular, NGA’s equity investment philosophy calls for the companies in which we invest to have growing cash flows, for the price of the stock to trade at a discount to our perceived value of the company, and for the company to share its cash flows with its shareholders in the form of a dividend. The first two criteria drive capital appreciation, and the final criteria is the income part of the equation.

Growth: The companies in which we invest have generally experienced rising demand for their products and/or services over the last decade, highlighted by a history of sales and earnings growth. On average, NGA portfolio companies have reported 12% annual earnings expansion over the last five years (which includes a recessionary period). More importantly, we expect them to continue to experience improving demand. Analysts are currently projecting 8% average annual earnings growth the next three years. Admittedly, analysts are rarely 100% correct in their estimates, but a lot of bad stuff (our technical term) has to happen before the revenues of these closely vetted companies flatline, let alone decline. There is a resiliency in NGA portfolio companies' expansion stories due to their in-demand products/services, healthy margins, and strong balance sheets. As a result, we have great confidence the companies in which we invest will be able to weather the inevitable economic storms, just as they did in 2020 and 2008/09. While values go up and down over the short-term, we are optimistic about NGA portfolio companies continuing to expand their cash flows, which is the ultimate driver of longer-term stock price appreciation.

Valuation: Valuations ebb and flow with investor sentiment, and frequently the pendulum swings too far. As recently as three months ago, the market could have been characterized as over-exuberant, filled with speculative investments (e.g., crypto, meme stocks, SPACs), but that has all come crashing down as earnings reality and Fed action work to take the proverbial punch away from the party. As a result, valuations are now swinging to the opposite side of the pendulum. The median Price to Earnings (P/E) multiple on companies in which we invest is around 14.5x. Historically speaking, that represents a very attractive valuation which we have only witnessed in a few periods of distress in the last decade. (The chart below depicts the P/E multiple on the value stocks in the Russell 1000 Index, a good proxy for NGA portfolio companies.) We are quite optimistic about the odds of future success (i.e., capital appreciation) for our clients when we purchase high quality companies at these valuations. Paraphrasing Warren Buffet, "we want to be fearful when others are greedy, and greedy when others are fearful." There is ample fear being displayed this year!

Income: "Growth" and "Value" are widely discussed equity investment styles, but "Dividend Income" is often an afterthought. Not for Naples Global Advisors. There are plethora reasons why we want NGA portfolio companies to pay dividends but primarily because income is a major part of the total return equation. Although capital appreciation occurs more often than not, there are years of capital depreciation—à la 2022 thus far. Dividend income is the proverbial bird in the hand, something that can be counted on year in, year out. As a result, it can help dampen some of the pain in years of capital depreciation. What's also striking about the companies in which we invest is that they tend to increase their dividends year after year as their revenues and cash flows grow. On average, NGA portfolio companies have increased their dividend by 10% annually over the last five years. We believe this dividend growth is more than enough to compensate for today's inflation, especially for those clients who are using their investment portfolios to support their lifestyles. What better way to beat inflation than to receive a 10% pay increase each year?!



Source: Russell Indices, Bloomberg

So, while the year-to-date returns may not be pretty and markets may not be enjoyable for the next several months, it is important to keep a few things in mind. First, we have had successive years of higher than the average returns (it's easy to forget the +10% returns of 2019, 2020 and 2021). Second, but equally as important, your NGA portfolio is comprised of high-quality bonds and stocks backed by very sound investment rationale. What a great roadmap to consistently achieving your investment goals—regardless of brewing macroeconomic storms. After all, if a hurricane were barreling down on Florida, you wouldn't uproot your house and move it out of the potential "cone." Similarly, if a recession were barreling down on the global economy, you shouldn't uproot your investment portfolios in panic. Rather, take comfort in knowing what you own and why you own it. Ultimately, you would remain resilient in both scenarios, knowing there are sunny days ahead!