Hosking Partners®

Quarterly Commentary Q1 2022

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The bulk of the portfolio's decline during the quarter was caused by its holdings in the Russian stock market: Russian companies amounted to c. 4% of the portfolio at the start of the quarter and were written down to a virtual zero following Russia's invasion of Ukraine.

The portfolio's Russian exposure was diversified by sector across resources, financials and consumer discretionary, a mix of state and private sector ownership, and a combination of local listings, depositary receipts and overseas listings. However, what they all shared in common was that they are Russian companies. Turning to the rest of the portfolio, the picture is in marked contrast to the situation in Ukraine. Even prior to the invasion, the portfolio's exposure to capital-intensive stocks, in particular those companies invested in physical assets, were starting to benefit from long-term underinvestment in capacity even as the market's admiration continued to be bestowed instead upon so-called growth stocks. The essence of this portfolio remains grounded in a belief in mean reversion and the proven power of the supply-side disciplines of the capital cycle approach to investing. Regular readers of our quarterly reviews and Hosking Posts will be all too familiar with this stance. As a consequence of the imposition of sanctions (both official and voluntary) on Russian companies, which had the effect of squeezing supply even further, as well as the removal of Ukrainian output (temporarily, we hope), commodities were the asset class this quarter whose positive performance stood out against negative returns in the rest of the market, so to a limited degree there was a natural offset in the rest of the portfolio to the Russian impact, and the effect of Russia's actions has been to accelerate some trends already in train and which have been apparent since last year. The portfolio's exposure to resources, energy and shipping stocks all made a welcome contribution.

Wary of over-confidence – despite the compelling argument that the runway of future positive returns from this area of the market is long – we were disciplined in taking profits during the quarter from recent winners. At the same time, determined not to be rabbits in the headlights of geopolitical events, we have been busy: we topped up our energy investments to compensate for that lost with

the Russian exposure, acquiring shares in royalty companies. We also added to China, taking advantage of weakness exacerbated by regulatory noise.

Looking forward, a key question is the extent to which we should extrapolate from the vertigo-inducing inflation figures of 7.9% in the US and 5.9% in the eurozone (both numbers are for February 2022 which is the most recent month to report). Whatever the long-term answer, the immediate consequence will be monetary tightening, whether through higher rates or slowing asset purchases (and more so in the US than in Europe), and our overweight in US financials is well positioned to be a beneficiary here. Further out the picture is less clear. According to the consensus of a number of market historians, the much-anticipated inversion of the two/ten-year yield curve which finally occurred at the end of the quarter presages a US recession in exactly 18 months' time. We lack their certainty, but we do worry about demand destruction from the elevated commodity prices in which we have more confidence because of the supply deficit which has been years in the making, so we are keeping a weather eye on the outlook, and our profit taking during the quarter is a part of this prudent stance. Brent crude finishing the quarter at $107 per barrel, well down from its peak of just less than $140, is helpful in this respect, but were the European Union to bite the bullet and impose a ban on the import of Russian pipeline gas, then the further jump in energy prices that would result would be a flashback both to the energy shock of the 1970s and potentially the recession which followed.

Further out, if inflation reveals itself to be less an itinerant guest whose stay is transitory, but instead lingers for long enough to become a hard-to-remove lodger, then how is the Hosking Partners portfolio positioned? At the end of the quarter, over half the holdings were in the Materials, Financials, Industrials, Energy and Real Estate sectors, compared with a benchmark weight of c. 36%, with most constituents of these sectors united by their capital-intensive nature and therefore inflation winners in the most general sense. However, it is worth pointing out that these positions have been accumulated over years rather than months, not as the expression of a macroeconomic hunch that

inflation is coming, but rather as the consequence of bottom-up stock-specific work leaning heavily on capital-cycle analysis, and as such they have a deep and wide margin of safety which should allow them to outperform over the long term irrespective of the inflation outcome. Outside these sectors, our holdings in Information Technology and Healthcare largely avoid stocks whose valuations rely on cash flows far out into the future being discounted at low rates which are likely to be the first casualties in the war against entrenched inflation, which the Fed has already initiated.

To conclude: it is already clear that global energy production is not keeping pace with global energy demand, with the shortfall only set to widen if the world's economy is to grow in step with its historic pace. The causes are both readily observable and well known – energy companies have seen access to capital rationed as punishment for historic poor returns, ESG pressure has acted as a further brake on investment in conventional energy, and investment in renewable energy has not yet been sufficient to fill the gap. As the price of energy rises to reduce demand from those least willing or able to pay, the cost of those things for which energy is an input will rise also, which includes all commodities. Taking Charlie Munger's advice to "invert, always invert" – whereas money can be printed when conditions are tight, you cannot print oil to heat or wheat to eat (with a nod to Zoltan Pozsar). With its overweight to the commodity complex, including to shipping which provides the means of transport to areas where demand is strongest, the Hosking Partners portfolio benefits from some protection in the new world we find ourselves in. The world has experienced violent shocks since the start of this decade, not least from Covid and the return of war to Europe, and the portfolio has suffered in consequence. Worse may be yet to come: we are not particularly advantaged at predicting events, but our edge lies in a willingness to imagine what's downstream in the second and third order consequences of known events. This is what we are continuing to do, at the same time as applying the prism of capital cycle and stock-specific analysis to ensure your portfolio is built to be resilient and therefore better prepared than many.

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