# The Long Run

**INVESTMENT LETTER**
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REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

*"Don't judge each day by the harvest you reap but by the seeds that you plant."*
*—Robert Louis Stevenson*

The first quarter of 2021 has been a period of extraordinary transition. At the start of the year, the seven-day pace of vaccines administered in the United States was averaging just over 325,000 doses a day. As of this writing, the U.S. is administering more than 3 million vaccine doses a day, on average. Non-farm payrolls rose by 916,000 this March, exceeding economists' estimates of 675,000, while the unemployment rate fell to 6%. Jeffries reported that business activity in March was at 93.5% of its pre-pandemic levels. In January, we witnessed rioters attack the seat of our democracy and overtake our capitol building. Yet somehow today, we are watching a new $1.9 trillion government stimulus plan being injected into our economy—with the debate over an additional large infrastructure package already underway.

Each of these elements—particularly when combined with deep personal U.S. household savings reserves and a highly accommodating Federal Reserve that has committed to keeping interest rates low into 2023—provide the ingredients for a potentially historic economic recovery. The mood on Wall Street has been ebullient. Pundits on CNBC tell us that we are on the cusp of a major boom, and *Forbes* magazine compares 2021 to the beginning of a new Roaring Twenties. The economic numbers are already beginning to offer a preview of good news ahead, but the question becomes, "How much of this excitement might already have found its way into the equity markets?"

It has been awhile, but speculative fervor and greed are back. The pandemic showed us that innovations, when applied to the right circumstances, can accelerate and create large new markets in short periods of time. Many trapped at home during the pandemic started tuning in to business television, which showcased daily the surprising and powerful 2020 stock market rally that grew on the back of technology and the digital economy. Sports gamblers, who had no place to go with sporting events cancelled, began to speculate in the markets with great initial success and bluster. Meanwhile, retail investors who were new to the market, but flush with stimulus checks, were not far behind.

With added capital hitting the economy now, investment banks have ramped up their profit engines. They are doing so, in part, by organizing a dizzying array of special purpose acquisition companies (SPACs) that allow management teams to raise money without actually announcing (or, perhaps, knowing) what company they might be taking public. This enables them to bring an enormous number of initial public offerings to hungry investors who fear that if they don't participate, they could be missing out on the next Tesla or PayPal.

The fear of missing out—or FOMO as it has been dubbed in the media—has long been a driver of speculative excess. To many, it seems as though the rest of the world has made a fortune on Bitcoin, or a newly minted software-as-a-service (SAAS) company. These observers are, therefore, looking for the chance to bite at an apple that could deliver similar outsized returns. In periods like this, investors often overlook fundamentals and risk management, and popular "strategies" emerge claiming to win the largest or fastest gains.

Today, investors are tempted by a raft of highly volatile, futuristic investment options that offer a chance at large, "fat-tail" growth outcomes that, in many cases, could be ten or twenty years away. This occurs even though most of these companies have no actual earnings—or sufficient operating capability—today to support their

investment theses. Financial media have also fed a short-term trading mentality by having investors focus on companies as either "reopening trades" or "closing trades." Investors have seen investments in some cruise line companies and selected small retailers, for example, more than double since the lows of last fall. Consequently, they are seeking ways to ride the back of the recovery and double their money with new reopening trades.

Of course, we have seen this movie before. Greed is no stranger to equity markets. But, when it dominates market psychology, it tends to distract investors from fundamentally sound core investment opportunities and nudge them toward investments with more binary "win big or lose big" outcomes. We have already seen some corrective action in many of the high-flying, futuristic technology stocks in the first quarter, with some down by as much as 50%. When we see that reopening trades drove the languishing energy sector up by an extraordinary 31%—and the beleaguered financial sector up by 16%—in the first quarter alone, we suspect that there could be more pain ahead for speculative investors.

While it is true that oil prices have risen dramatically in the last year, and that some investors have been rewarded handsomely for this trade, the reality is that much of the price increase in oil in the last year is due to supply controls and management, not the kind of rising demand that leads to sustainable price increases. (Some readers might remember that it was only last April when an oversupply of oil in global markets led to such a collapse in prices that West Texas Intermediate oil futures contracts actually went negative to -$37 a barrel for a brief period.) Indeed, the headwinds created by alternative energy, electric cars, and improved energy efficiency, combined with the potential liabilities that carbon release presents in a world in the grips of climate change, make carbon-based energy investments—which dominate energy exposures in the S&P 500—particularly unattractive long-term investments.

The recent Archegos hedge fund explosion illustrates that greed is not merely an affliction of the inexperienced. Bill Hwang founded Archegos as a family office to have a vehicle for investing after he had been accused of insider trading and barred from the investment advisory business in 2012. Having built net capital at Archegos to an estimated $10 billion last year, Hwang apparently decided to make a bid to become one of the wealthiest individuals in the world by quietly approaching multiple banks to negotiate enormous margin loans for large derivative investments that bet on a small basket of media and tech stocks. These stocks initially moved up dramatically due to the sheer size of Hwang's levered investments but, when the initial momentum stopped and the stocks began to fall back, Hwang was faced with enormous margin calls. When the first round of margin settlement trades began, banks realized that the size of Archegos bets, mostly funded by borrowed money, might total more than $30 billion—even though Archegos only had $10 billion in capital. As banks raced to get their money out, share prices in the companies held by Archegos cratered, leading to one of the largest reported losses of personal wealth in history. And the banks did not come out unscathed. In the opaque world of finance and leverage, Mr. Hwang was able to cut quiet, independent deals with individual banks who had little idea of the leverage that he was taking on with other institutions. Credit Suisse Group, for example, reported a $4.7 billion loss and slashed its dividend. Nomura Holdings estimates a loss of $2 billion as of this writing. When conspicuous greed begins to seep into the equation, it often reveals the deepest vulnerabilities in our economic systems. Systemic leverage is not as fully understood as it should be as a risk factor, and we continue to avoid investments in money center banks for this reason.

Over the last few years, carefully selected investments in critical technologies and core innovations, including digital transaction technology, cloud systems, and genomic sequencing technology, among many others, have provided outsized returns for our clients. We were disciplined about regularly harvesting and pruning positions to control risks and keep portfolios appropriately balanced, as these innovations became more popular and well understood by other investors. Importantly, we also turned our attention to new areas of opportunity that support what we recognize will be a long, global build-out of new infrastructure and digital scale—and we planted new seeds along the way, with investments in companies that will help us to meet the new demands of tomorrow.

As debate begins over the infrastructure bill here in the United States, many investors will be directing capital toward classic infrastructure investments like materials, earth-moving equipment, and engineering companies. Larger opportunities, though, will likely come with investments in technologies to prepare global economies for a more sustainable, climate-friendly, and energy-efficient future. We believe that investments in profitable companies supported by accelerating innovations are significantly more likely to create long-term, compounding return drivers than one-time repair and update investments. Looking ahead, some of the most promising investment areas include new electric grid technologies, alternative energy solutions, electric transportation, 5G technologies, automation and robotics, machine learning and AI applications, and analog chip technologies. The reality is that there are reasonably priced, technologically progressive, profitable companies in a range of industries that are currently riding innovation waves that will only grow larger with time. While the investing herd chases the siren song of quick, outsized profits and discounts risks, we are focused on backbone investments in innovations that will be foundational to the global economy over the next decade and beyond. RM

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