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A Shot in the Arm

Early last year, one of our portfolio managers turned 50 years old.

"*Happy Birthday, Ralph* [not his real name]; *welcome to your middle ages*!"

Dr. R, Ralph's internist, was performing a routine health/fitness check.

"*While you are in excellent health, I am going to recommend a series of procedures, tests and vaccines, appropriate now that you've turned 50.*"

One of the recommended vaccines was a relatively new one for the prevention of shingles, a viral infection that causes a painful – for some even debilitating – rash. Shingles comes from the same virus that causes chickenpox in children, and it is estimated that up to 70% of those older than 50 have the virus. Yet only about half of those infected will develop symptoms. Why it remains dormant in some, yet savage to others, is not fully understood.

Ralph recalled investigating the *Shingrix* vaccine and so now, having always intermingled his personal and professional lives, he decided to move forward and take the shots (two doses required). He wanted to gain real life experience of a product he researched while, at the same time, protecting himself from the chance of illness. He recalled that this vaccine is produced by one of the world's largest vaccine makers, GlaxoSmithKline (GSK). The company was of interest to Ralph, as it recently acquired a consumer health joint venture that GSK had with Novartis.

Simple enough, Ralph booked an appointment online at a local **Walgreens** pharmacy, paid an insurance co-pay and had the vaccine administered.

"*As with any vaccine, there may be temporary side effects*," explained the pharmacist. "*These could include injection site pain or redness as well as fatigue and fever. They will be temporary and anything more severe is unlikely*."

"*OK,*" said Ralph, and off he went.

About four hours later, Ralph felt mild "flu-like" symptoms. A little run down, less appetite than usual and perhaps a tad foggy. But after a good night's rest, all was well.

"*That was easy*," he thought.

"Freedom is found when we let go of who we're supposed to be and embrace who we really are."
~ Anonymous

In this issue ...

Three months later and it was time for the second (booster) shot to complete the vaccine treatment. It was mid-December and Ralph figured he should get the shot sooner, rather than later, as when the COVID-19 vaccines arrive, the pharmacies could be deluged. But this time went very differently.

Ralph went back to **Walgreens**, visited the same pharmacist who administered the first shot (both doses are chemically identical) and went home. As before, a few hours later, he started feeling a bit "off." But the discomfort this time did not subside, it got worse. A fever developed and, while not too severe, stayed for a full 54 hours. Stomach pains came and went, and the previous "fogginess" turned to "dizziness," persisting for over two days.

But not to worry, as Ralph is still with us and is feeling back to his normal (always cheerful) self.

"*That was a rough couple of days*," he thought. "*But I am over the discomfort and happy to be protected. But why were the reactions so distinct? The same person was given an identical chemical compound three months apart. Yet the side-effect reactions were like day and night. Why would that be*?" he wondered.

It turns out that Ralph's experience was not all that unusual. After a conversation (or two) with GSK, the vaccine maker, he learned a lot about how vaccines work. This could be useful for those about to take the COVID-19 vaccine (also two shots in most instances). But remember that each person's reaction to the vaccine, and each of the two doses, could be different. [That is, here is our disclaimer: **Do NOT rely on this Report as medical advice**.]

Generally, for a two-shot vaccination, the first dose **informs** the immune system about an apparent infection, spurring it to build defenses to prepare for future re-infection by the specific infectious agent encountered in the vaccine. When the second vaccine dose is administered – usually 3 to 26 weeks after the first dose because of the time required for knowledge of the seemingly infectious vaccine to be broadly distributed in the immune system – immune cells are more capable of mounting a **fast and effective defense**.

When the second dose is administered, the patient's immune system is broadly and actively "looking" for signs of re-infection from the vaccine, which now tends to produce a more severe immune response, potentially including more injection site redness (local) and fever, chills, and fatigue (systemic). Further, the second-dose immune response may be heightened by the presence of **antibodies** in the blood made specifically to attack the previously identified apparent infection (the vaccine). This is what some refer to as **immunity**.

In addition to being a timely topic, what may this lesson in vaccines further teach us about the economy and investments?

Same Input = Different Output

Is history bound to repeat itself? Some investment philosophies are built around this paradigm. "Reversion to the mean" implies a sort of "steady state" that must be returned to. "Momentum" investing is one whereby patterns are thought to be continued … until they are not. Even "value" investing implies that what appears "cheap" or "expensive" today may revert to "normal" tomorrow.

But just as with two identical doses of a vaccine, identical inputs often result in ***different*** outputs. So too in life, so too in economics and so too in business.

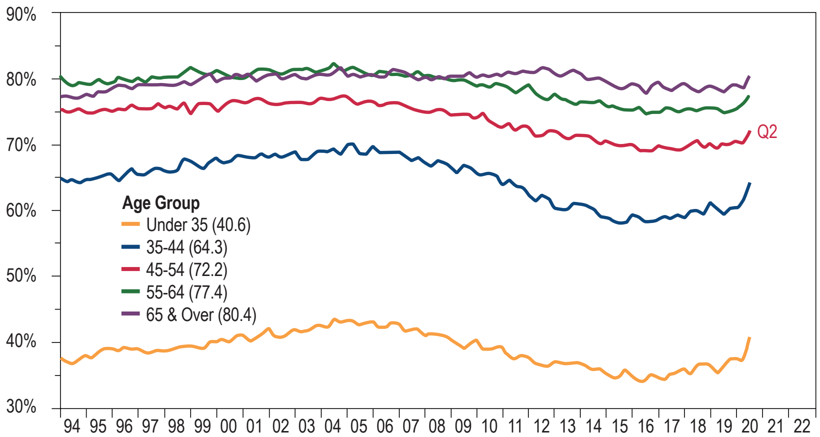
Let's take the following example to illustrate our point:

As for most topics we study, the "shot in the arm" is not an unbroken rule. Consider the heretofore "permanently" changed housing habits of the millennial generation versus their predecessors. Those born from the very early 1980s to the very late 1990s were supposed to be driven by "experiences" more so than "stuff." They were supposed to stay single forever, living in the basement of their parents' homes. Or those who did move out would rent apartments exclusively in densely populated urban areas. But even prior to 2020, this group was already "morphing" into their parents. When the Global Financial Crisis (GFC) of 2008-09 was a memory and jobs plentiful again, they got married. Still in cities though. More recently their children came about – welcome Generation Alpha!

Now somewhat "cramped" and no longer "hanging out" as much with friends, they need more space. So out to the suburbs they go. As we described in our last edition of *The Essence*, the events of 2020 sped everything up. Now millennials are moving out of cities by the droves, shopping more at Home Depot or Lowe's than Nordstrom or Bloomingdale's, and "date night" at the local club – well, that's gone!

During the GFC, the economy declined quickly, and home demand plummeted. This past year, as a result of pandemic "lockdowns," the economy also plummeted suddenly, throwing more than five million people out of work in a little more than a month. But, as with the second vaccine "shot in the arm," the reaction to this past year's downturn was quite different; demand for housing has ***soared***. The following graph shows, perhaps, why.

Homeownership Rate



Sources: U.S. Census Bureau; Yardeni Research

The five colored lines on the graph depict homeownership rates by age group, from 1994 to the present. Note that going into the 2008-09 recession, homeownership rates had been on a decline for five years, particularly for those under the age of 45. The opposite reaction today comes about as the homeownership rate has been on an **up**trend since 2015. All age groups are participating, led by millennials. The very recent uptick is perhaps just some demand pulled forward from future years.

So just as the second dose of the Shingrix vaccine resulted in a vastly different reaction than the first dose for Ralph, so too has the recent economic downturn had a starkly changed impact on housing than the prior recession. Each situation is unique, and one should not assume that prior patterns will necessarily be repeated. All inputs must be considered, though not all may be evident.

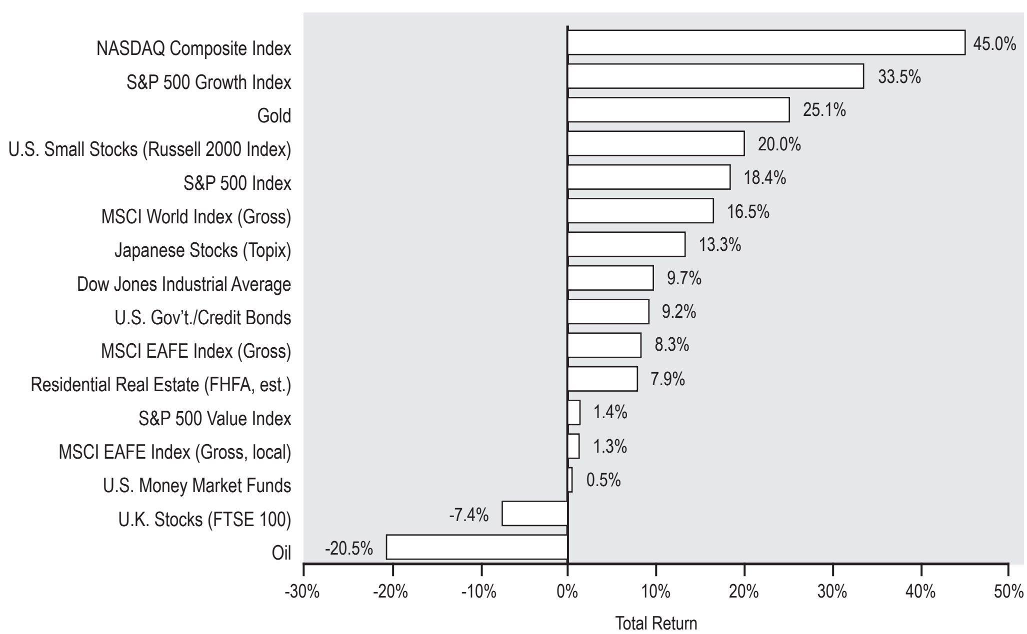
The investment team at Aristotle Capital treats each economic cycle on its own merits, each industry period as unique and each business according to its own set of circumstances. Yes, we may draw from historical parallels and consider them. But, as with the two separate "shots in the arm," each may cause its own individual reaction.

EQUITIES STRATEGY

We repeat from our last edition of *The Essence* that all will not be perfect, even after "The Great Pause" ends. Some companies and industries have benefited from this past year while others have gone or will go bankrupt. We continue to believe that, with perhaps many exceptions, trends that were already in place became accelerated the world over.

We present here a chart of select asset classes and their performance during 2020. The results are *oppositely* parallel to the topic of this report. Thus far we have said that identical inputs can result in vastly different outcomes. Here we point out that, in 2020, with vastly *different* input circumstances than prior years, performance results appear remarkably similar. Thus, just as in recent years, technology company stock prices soared, with the NASDAQ Index gaining more than +40%. Also strong were international markets (helped by a weak U.S. dollar), smaller company stocks, gold and, as discussed earlier, residential real estate.

2020 Asset Performance



Total return in U.S. dollars unless otherwise noted

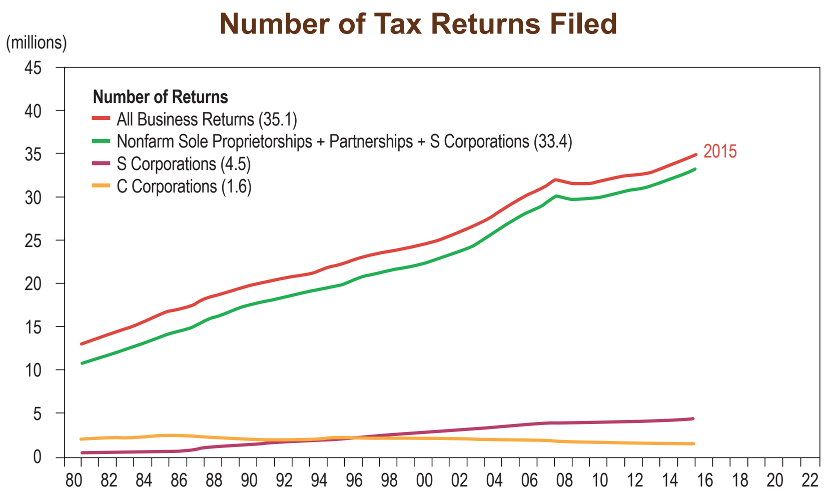
Sources: Bloomberg; Various

Laggards were also mostly similar to prior years, including U.K. stocks (weighed down by "Brexit" uncertainties – perhaps now resolved), value company stocks and the now nearly zero return on short-term credit instruments including Money Market Funds.

In the last edition of *The Essence* we highlighted that "the big were getting bigger." This is true of government and this is true of corporations – think Amazon.com. At the same time, we notice that what is getting squeezed is mid-sized firms. Very small companies (typically sole proprietorships), however, are in vogue.

Per Dr. Ed Yardeni of Yardeni Research: "*Of course, the pandemic isn't over, and too many people and small businesses are still suffering. Nevertheless, we'd like to …* [highlight a] *widely overlooked trend in America: The number of sole proprietorships has been growing very rapidly. We have become a nation of* [small business owners]. *The pandemic may weigh on that trajectory, but not for long once the pandemic is over.*"

Thus, as shown by the green line in the following graph, selling T-shirts on eBay, offering up fresh matcha on Main Street or setting up an app. featuring one's cat playing with a string, working for oneself (as represented by sole proprietor tax filings) is "on trend" in the recent world.



Sources: The U.S. IRS; Yardeni Research

This trend has us optimistic about the future for the U.S. economy. Particularly coming off of a (seemingly endless) political "season," we hopefully disagree with the notion that the country (joined by others around the world) is in "class warfare." Sure, we wish there were more of a balance in the rhetoric of taxes. Sure, someone will have to "pay" for a lot of the "waste" that inevitably is required to get the economy through local "lockdowns." Sure, we wish that many more in government would focus on the long-term issues this country must solve, with the recognition that the vast majority in the country understands the imperative to doing so. Yet, as further pointed out by Dr. Yardeni:

"*This proliferation of sole proprietorships is an important development that challenges the core beliefs of proponents of class warfare. They see the economy as composed of numerous battlefields where workers clash with capitalists. The Communist Manifesto, written by Karl Marx and Friedrich Engels in 1848, was intended by its authors to be the proletariat's declaration of war against the owners of capital. It was an overly simplistic analysis back then, resulting in some of the worst economic forecasts in history and widespread economic misery rather than a workers' paradise. The class warfare concept is even less relevant today considering the growth of entrepreneurship.*

*… Proprietors … are both **workers** and **owners** of capital. Proprietors are entrepreneurial capitalists ... To stay in and succeed in business, they must satisfy their customers and keep their employees happy.* [If left alone, they tend to be in control of their own destiny.] *Crony capitalists* [on the other hand] *tend to be corporations that have grown* [too?] *big along with* [too big?] *government* [and hope to benefit from a close working relationship] ... [sometimes] *aiming to create barriers to entry for would-be* [entrepreneurial] *competitors.*"

These barriers, we believe, can be held at bay – affording small, medium and large firms alike equal access to customers – so that the booming entrepreneurial spirit of society can expand, with benefits for all.

INVESTMENT ACTIVITY

We thought up a new version of the acronym "PPE." As personal protective equipment (eventually) fades to less relevance, we will be in a **P**ost-**P**andemic **E**conomy. To that end, We at Aristotle Capital continue to focus on, and learn about, individual unique businesses, as opposed to broader "macro" themes. Though we prognosticate about such "larger" issues in some editions of *The Essence* and try never to have our "heads in the sand," we understand that businesses do not operate in a vacuum. So, we will not rush to judgment or jump to conclusions. We will continue to learn about companies. Along the way it very well may be that things have changed permanently for some. Over time we will learn this. We may (most likely will) be late to arriving at these observations. This is intentional. We rarely act before we have conviction, and such takes time.

We would now like to highlight two recent additions to Aristotle Capital equity portfolios.

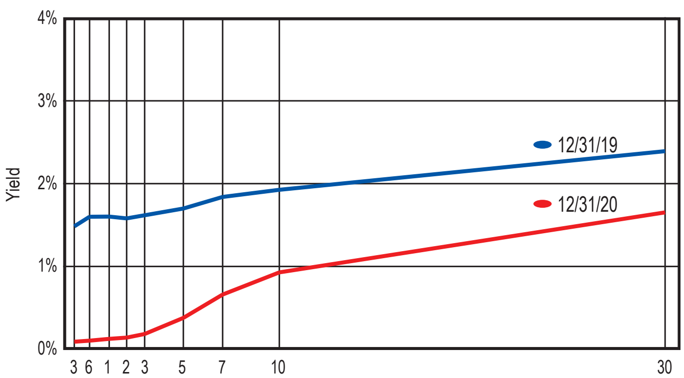
- **PNC Financial** is not "just another bank" in which to invest. Based in Pittsburgh, PNC has, in our estimation, a long history of success, a unique corporate culture and a vastly superior management team. With meaningful operations throughout the Midwest, Mid-Atlantic and Southern U.S., it recently announced the acquisition of Texas-based Compass Bank. We believe PNC maintains businesses with high predictability, low churn of customers, diversification of assets and liabilities, proven loan underwriting prowess, growing market share within territories served and a value-added business model whereby normal return-on-equity (ROE) can exceed the company's cost of capital. A material catalyst for fundamental improvement is the Compass acquisition. We believe in its potential, as PNC has a history of similarly favorable acquisitions, including BlackRock, National City Corp., RBC Americas and others. Valuation, as with many financial companies, is favorable and, in our estimation, is not reflective of the long-term future of this business.

- The **Fuji Automatic Numerical Control (FANUC) Company** maintains its headquarters and a large R&D center at the foot of Mt. Fuji in central Japan, about 60 miles west of Yokohama. We perceive the company to be as unique as the scenery surrounding its signature yellow buildings. Founded in 1955 by Fujitsu, Fanuc is credited by some to have been meaningfully responsible for Japan's industrial ascension. Factory automation is not possible without computerized numerical control (CNC) devices, of which Fanuc is the world leader. Widely used in auto factories, CNC, robots and other Fanuc devices are now used to automate the production of everything from cell phones to juice boxes. Future opportunities are just now coming into view, including new "cobots" (collaborative robots) that are expected to automate the world's warehouses. Having briefly fallen out of favor due to significant capital investments, we view Fanuc as having significant untapped potential.

FIXED INCOME STRATEGY

As the following graph shows, interest rates, that previously seemed like they were as low as they could go in this country, took another tumble across the yield curve in the year just past.

U.S. Treasury Yield Curve
12/31/19 versus 12/31/20

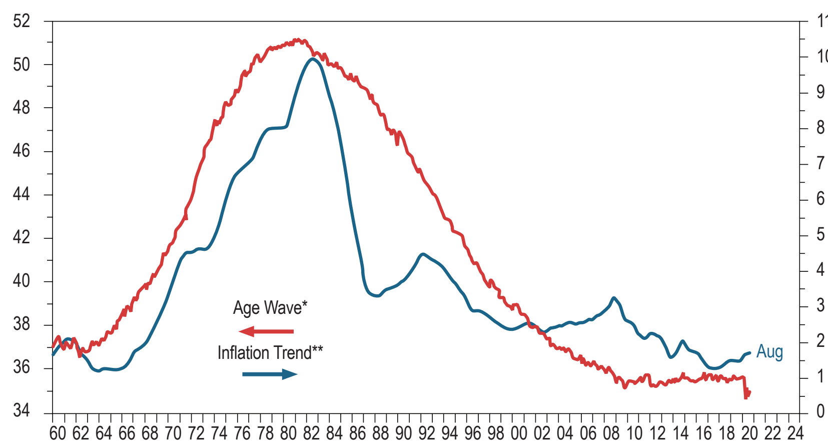


Source: Bloomberg

Rates through ten years declined almost 150 basis points (1.50%) to end below 1.0%. Rates were largely pushed lower as economic activity (along with the demand for credit) stalled. As government debt expanded dramatically – to ensure the economy did not collapse even as the movement of people the world over essentially ceased – we have not (yet) witnessed the "typical" reaction of higher inflation. Again to our theme, similar input with a vastly different outcome.

Looking to the future, will the unprecedented growth in debt levels the world over finally result in higher inflation? While this author has vacillated over the years (decades) as to an answer to this question, thus far there is scant evidence that debt levels in developed countries are correlated with inflation. Japan is such an example whereby public debt has increased dramatically, yet inflation remains moribund. Perhaps the following graph is one explanation?

Age Wave & Inflation



*Percent of labor force 16-34 years old

**Five-year moving average of yearly percent change in CPI

Sources: Bureau of Labor Statistics; Yardeni Research

The red line above depicts essentially an inverse of the average age in the U.S. Specifically, the line represents the percent of the labor force that is aged 16-34. The blue line is the five-year moving average of the change in the Consumer Price Index (CPI). Note the strong correlation of the two lines. That is, a young workforce tends to demand new goods and services such as homes, schools, retail, travel infrastructure, etc. As demographics change and the workforce ages, people are generally more stable in their careers and locations. Thus, new shopping malls are not needed (even though they continued to be built – a problem being reconciled today).

One may conclude that regardless of the levels of debt (has to be within "reason," doesn't it?) or the size of the nation's money supply, the age demographic could overwhelm other factors to keep a lid on the demand for goods and services and the inflation it may bring. As inflation is highly correlated with interest rates, that too could remain low well into our future.

But doesn't all the recently created debt ***have*** to be paid back eventually? Ethically, one would say "yes." But *how* to pay it back is a question asked for almost a century. A recent edition of *The Bank Credit Analyst* reminded us that in 1923 economist John Maynard Keynes was discussing monetary reform:

"*The … deterioration in the value of money through history is not an accident and has had behind it two great driving forces – the impecuniosity of governments* [meaning habitually penniless] *and the superior political influence of debtors. No state or government is likely to decree its own bankruptcy or its own downfall so long as the instrument of 'taxation' still lies at hand.*" Keynes, in his essay, goes on to define "taxation" as including currency depreciation, inflationary depreciation or simply monetary taxation – better known as the confiscation of labor and wealth. The question he then asks is *"Who is the more electable, those who will depreciate or those who will tax*?"

Sounds like a great topic for a future edition of *The Essence* so we'll leave this topic to discuss further then.

The characters described and stories told herein are often, but not always, based on true incidents. Poetic license is taken to dramatize a point about an investment topic. Not all securities mentioned herein are necessarily owned in all Aristotle Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decisions to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable and it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed. A list of at least five contributors to and five detractors from performance is available upon request.

CONCLUSION

[AUTHOR'S NOTE: On both personal and professional levels, we are so grateful to the constituents of Aristotle, as we passed the ten-year milestone since the founding of the current form of our firm. Many of us have been working together now for more than 30 years. We believe we have assembled a combination of talented team members, long-term oriented clients, business partners who wish to help "grow the pie," a community eager to work with us and an ownership that rewards integrity, perseverance and a focus on becoming truly "meaningful" in the marketplace.]

William Shakespeare was reported to be amongst the first few people in the Western world to receive a recently approved COVID-19 vaccine. The 81-year-old received his shot on December 8 at the University Hospital in Coventry, England, no more than 20 miles from Stratford-upon-Avon, the birthplace of his namesake. Though he said he is unrelated to the author, his name was heard round the world in a hopeful sign we are within sight of the end of this terrible pandemic.

In our message to you this period, we discussed the Shingrix vaccine and how two identical shots may result in vastly different reactions – similar, we are told, for many vaccines including that administered to Mr. Shakespeare. From an investment and business perspective, we are reminded that many company or economic "reactions" are different, even from similar circumstances. Housing demand during the 2020 recession has soared, opposite to the implosion witnessed during the Global Financial Crisis.

This highlights the process used at Aristotle whereby we analyze each environment, each time period and each business on its own. We strive to keep generalizations to a minimum, working diligently to understand the "why" of just about everything, not simply the "ifs" or "whens."

We wish you a swift and painless "shot in the arm" very soon.