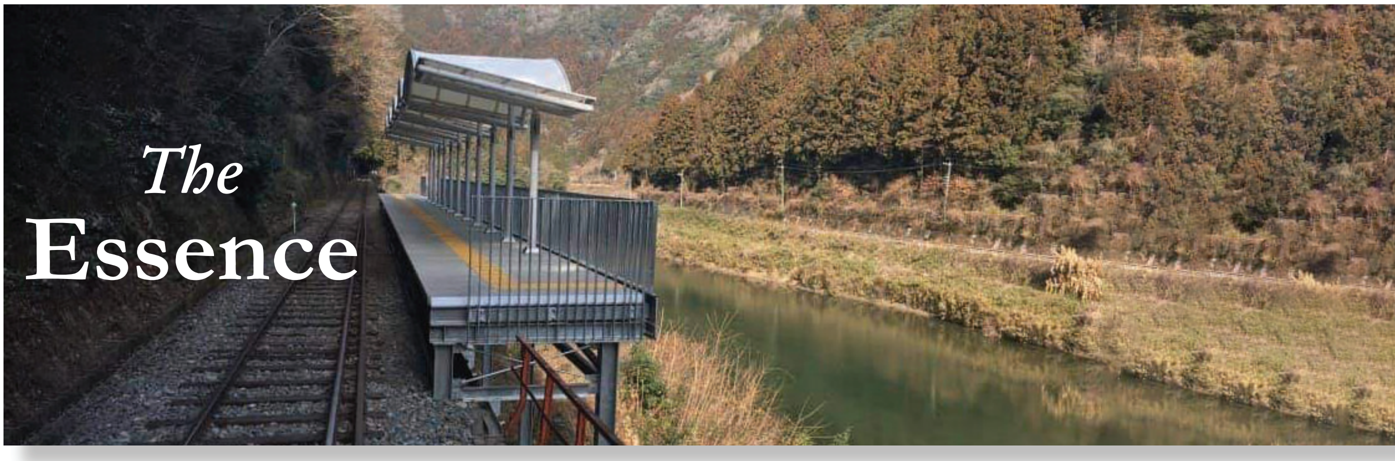

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Knowing When to Invest
(and when not)

Congratulations Argentina for your recent win over France in the *Fédération Internationale de Football Association* (FIFA) World Cup 2022 soccer championship. The World Cup is the most prestigious association football tournament in the world, as well as the most widely viewed and followed. Thirty-two national teams compete over the course of a month in two stages: the group stage followed by the knockout stage (including the final match). As the World Cup is held only once every ***four years***, it is one of the most highly anticipated and prepared for sporting events; on par with the Olympics, but that contains up to forty events.

"Those who are quite happy paying nothing for something are going to get what they pay for."

"Real" (as over 90% of the world's population would have it) football is not nearly as popular as "American" (though it is played elsewhere too) football in the United States. So, while four years may seem like a long time, one of our Portfolio Managers waited ***twenty*** years to be a live spectator of a football game in his home of Los Angeles. That's how long the city was without a home team until current owner Stan Kroenke moved the Rams back from St. Louis, where they played between 1995 and 2015. Simultaneously, the San Diego Chargers moved as well, now giving Los Angeles back its two-team status.

It could cost ~$6½ billion to host a World Cup – that's the price tag for recent host Qatar, including infrastructure and the eight stadiums it built. Similarly, it cost ~$5 billion to build SoFi Stadium in Inglewood, California – the new home of the Rams and critical to allowing for the team's move. Paris has budgeted close to €4 billion for the 2024 Summer Olympic Games (yet the actual figure is likely much higher) and that's not even close to an Olympics spending record.

Many believe that these huge price tags to host spectacular sporting events have low (or in some cases *negative*) returns on investment (ROI). With the number of entities involved and the imprecise way of calculating returns – how many people will visit Qatar, invest in its businesses or buy products from its companies over the coming decade uniquely due to the 2022 World Cup? – the ROI is nearly impossible to figure. So why do it?

Back to the Rams and Mr. Kroenke's $5 billion. Only six years after the team's return to the Los Angeles area, in February 2022 they became Super Bowl champions. Clearly, this enhanced the value of the franchise. [**Author's note: We won't delve into the results of the subsequent year with a rather less spectacular outcome.**] Its gleaming new SoFi Stadium is state-of-the-art, hosting many entertainment events in addition to football. The area surrounding the new stadium is set for new office buildings, hotels,

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apartments and retail. Basketball's Los Angeles Clippers are building their own arena across the street from SoFi. How to precisely measure this ROI? Does it even matter?

It comes down to long-term planning. When to invest in these types of mega projects and when to pass? [The departing cities of the Rams/Chargers declined to build new facilities and thus the teams moved from St. Louis and San Diego.] There's science that goes into these calculations, but some "*art*" as well. Some say that Tokyo, Japan's decision to host the 1964 Summer Olympic Games set it up for the next ***twenty*** years of prosperity. It was perceived by nearly everyone as a QUALITY event, and to this day, Japan is seen as producing QUALITY products. Similarly, Salt Lake City, Utah's hosting of the 2002 Winter Olympics was one of the first in modern times to turn a profit (positive ROI!) from Day-1. Coincidence that the forthcoming twenty years was a period of increasing prosperity for American businesses?

So, we may see that some such investments are, taken as a whole, worthwhile, and some perhaps less so. What may we learn from this as appropriate to business?

Long-term Planning

Companies, too, must learn when they should ***invest*** and when to ***harvest***. This part of long-term corporate planning is perhaps **the** most critical management competency we analyze when Aristotle Capital researches businesses. To attain a size – typically at least $10 billion in market value – worthy of our consideration, an enterprise must have done something right. Along the way, it faced choices of when to invest in additional people, products, factories, distribution channels or even companies through mergers and acquisitions. Where would the capital for these investments come from? Internally generated (always the best), borrowed (and at what cost) or via the dilution from additional equity partners (usually the most expensive to shareholders)?

If the company is in a position of generating excess capital, what uses are there for these funds? If used to invest, as from above, what would have been its ROI on past investments? We, at Aristotle Capital, are less forgiving of bad choices than many municipalities have been on the building of new stadiums or the like. If the choice is not abundantly clear, then prescient management teams have shown their abilities to either keep the funds available or return capital to shareholders (dividends and/or share repurchases). Many firms, we have found, feel compelled to buy "something" so as to "grow" at any cost. This, we believe, is fraught with danger and those companies are typically to be avoided. A couple of examples:

➢ Lumen Technologies (formerly CenturyLink and CenturyTel) grew via acquisitions. In its earlier years, these were mostly successful, giving the company sufficient scale to compete in its largely rural territories for telecommunications services. These were times to ***invest***, and it was done well. Then the telecom business changed, competitive threats became severe and many aspects of the industry began a long-term decline that some say continues today. Instead of pivoting to a ***harvest*** mode, Lumen continued to use its capital (and then some) to buy adjacent companies. While we are loathe to "kick a horse when it's down," we point out that Lumen merged with Qwest (owner of former Rocky Mountain "baby bell" company US West) for $12 billion of its stock, then, more recently, Level 3 Communications for <u>double</u> that amount. This "insistence" on "growth" resulted in a stock dividend that went from 72½ cents per share to 54¢, then a few years later to 25¢. On November 2, 2022 management had to "throw in the towel" and completely eliminate the company's dividend (formerly telegraphed as sacrosanct).

➢ Alternatively, Altria Group (formerly Philip Morris) has consistently and steadily raised its dividend in spite of (or perhaps ***because*** of) it being in a declining tobacco industry. It knows it must ***harvest*** its cash flows, as ultimately smokers around the world will become fewer and fewer. It may be inevitable that this business goes to zero (or very close) and the current management team is running the company with that in mind. The current indicated dividend yield on the common equity is ~8.0%, and we believe this to be sustainable under current management's guidance.

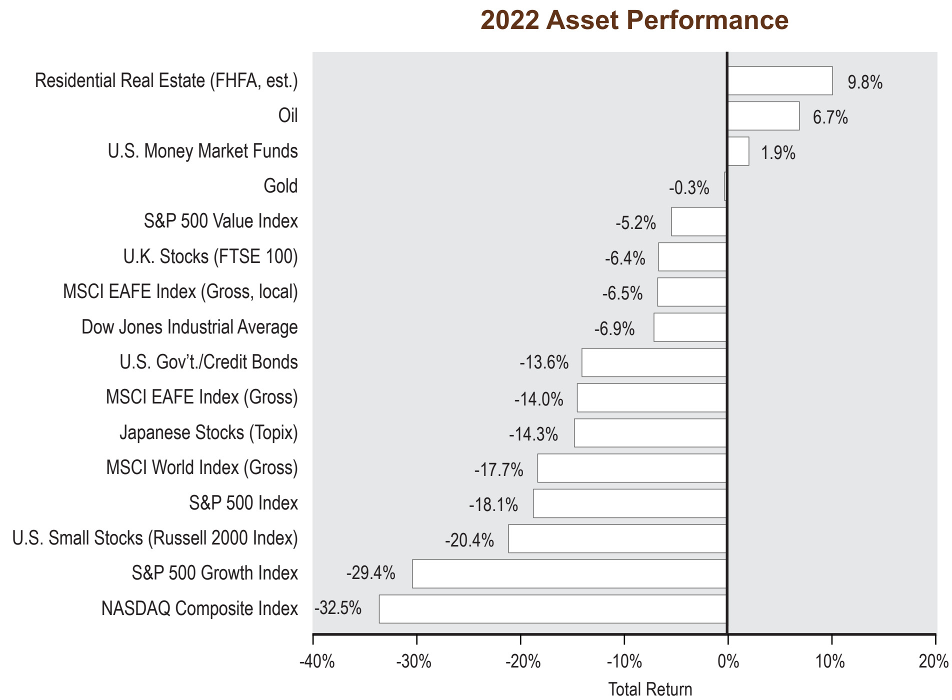
➢ The above two companies are not currently owned in Aristotle Capital portfolios. One that is, Parker-Hannifin (PH), recently closed on an acquisition of Meggitt plc. The cash transaction value of £7 billion (approx. $8.5 billion) is modest compared to PH's enterprise value of ~$50 billion, yet a meaningful indication of management's prowess. We believe this to be a very well-timed combination, as Meggitt will add complementary aerospace and defense businesses to PH's existing strong portfolio. It will further the company's goal of greater aftermarket exposure, that which is typically more predictable and higher margin than original-equipment sales. PH is no stranger to successful acquisitions, having executed literally dozens (though mostly smaller than Meggitt) throughout its history.

As for the year just passed …

EQUITIES STRATEGY

As depicted in this chart, 2022 experienced the opposite results as the positive ones we've become accustomed to in recent years. As often occurs during trend reversals, asset volatility picked up markedly. Short-term equity price movements were even more severe than during the depths of the Global Financial Crisis of 2008-09 (GFC). In 2022, fully one-third of days witnessed S&P 500 Index movements of greater than 1%, the most since 1945. As volatility leads to uncertainty and uncertainty implies greater risk, it is no wonder that most asset prices, and nearly all equities, moved lower last year.

"Value" (as defined by index providers) outperformed "growth" by a substantial margin, reversing the trend of most of the past decade. While some of the gap that had opened closed quickly these past 12 months, for the past ten years, the S&P 500 Growth Index has still outperformed the S&P 500 Value Index by 274 basis points annually (2.74% ***per annum***), even including the much higher dividends paid by the latter.

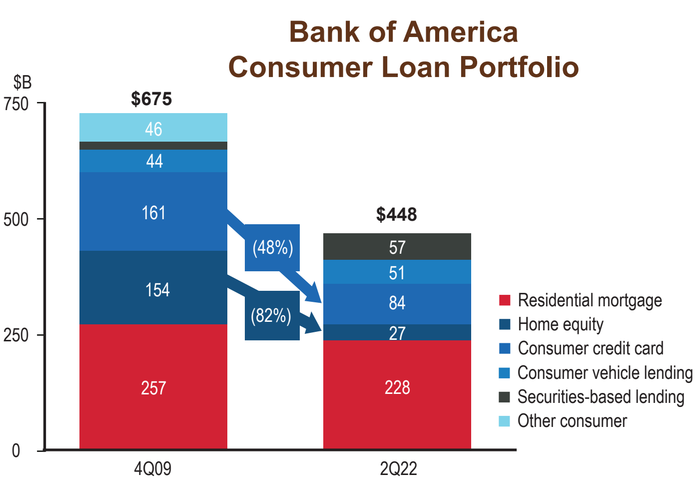


Total return in U.S. dollars unless otherwise noted
Source: Bloomberg

Residential real estate price **growth** actually **<u>d</u>**ecelerated from 2021 to 2022, yet the 9.8% increase was still higher than at any time since the 1970s (ex-2021's +18.5%). Rental rate growth was similarly extremely elevated. We point out that few homeowners move yearly, while renters, though having more flexibility, often stay put for at least two years, on average. Justin Fox, a Bloomberg reporter, has pointed out that "*… rent inflation for new tenants leads the official Bureau of Labor Statistics rent report by four quarters.*" By this measure, "*The Fed* – Federal Reserve Board – *was behind the curve when it started raising rates last year – a year after rents on new leases skyrocketed – and could end up late again as rental rates have already begun to normalize …*"

We have read many commentaries that the "*likely coming U.S. economic recession is apt to be short and mild.*" The thinking is that it is very well telegraphed, allowing both companies and individuals to prepare. There have also been "*few obvious private sector imbalances or aggravating factors*" that may require "*curing.*"

The following chart, taken from a recent Bank of America earnings report, shows its own consumer loan portfolio, currently, and as compared to the GFC days.



Sources: Bank of America; Federal Reserve Board

While the U.S. economy has expanded by greater than 50% since 2009 (as published by Statista), note that the bank's consumer loan portfolio has ***contracted*** by 33%. Consumer loans are often considered the riskiest and most prone to default in times of economic contraction. BofA is somewhat indicative of the largest U.S. banks; thus, one example of a much stronger financial system than that leading up to the last downturn.

Still, we remind our readers that each economic cycle is unique. Rarely do we know how they will play out and what "*unintended consequences*" may be in store. We will therefore, really as always, be cautious, careful, and, importantly, **long term** in any actions we may enact.

Could it be that the Covid period actually ***saved*** the commercial real estate market? Prior to 2020, interest rates were low, capital was nearly "free," the labor market was very strong and inner cities were THE place to be. Thus, commercial construction, particularly office, was brisk. Even though technology was making it ever more possible to work from anywhere, companies were expanding office space. The WeWork (shared office) model was taking hold around the world, as offering workers flexibility was required to obtain the best talent. Still, new offices were being built at a rapid clip.

In our view, a day of reckoning could have taken hold should this trend have continued. Then the world "shut down" and workers shunned offices. New office development, too, by and large was halted. Existing projects mostly got done, but in the last three years, very few new ones have started.

It's difficult to call anything about Covid "lucky," but in this case, the pull-forward of the flexible office may have saved countless new buildings from being constructed … only to then sit empty.

Another economic *savior* from the Covid period may be the sudden shock of inflation. "*What??! I thought inflation, and the Fed's response, is what is causing some of the market volatility,*" one may ask. Perhaps in the short term, but longer run we have a much more sanguine view. In *The Essence* of a year ago entitled "*Puffins*" we highlighted one of the reasons for the recent price increases. The quick change in demand from services (like restaurants and hotels) to goods (like sanitizer and toilet paper) and now back to the experiential (like airlines and concerts) has made it impossible for supply chains to keep up. But adjustments are now well underway, the Fed is aggressively slowing down the economy and "normal" may soon appear.

Bloomberg Global Aggregate Negative Yielding Debt

Sources: DB Research; Bloomberg

Note from the above graph that the pre-Covid peak of $17 trillion of negative yielding debt around the world has all but vanished. That is, as should be a normal condition, fixed income has a positive yield. Borrow a dollar (or ¥en or Swiss franc) and pay back that note, with at least a little interest. Most of the negative yields prior were symptomatic of very low (or even negative) rates of inflation and central banks' policies to combat such.

Our positive take on the disappearance of negative yields (even with a little "pain" along the way) is our prior concern that **dis**- (and even **de**-) **flation** was becoming entrenched in many parts of the world. We have previously said, and continue to believe, that history has given policymakers many tools for dealing with high or increasing prices. Yet **de**flation has mostly ended miserably – the 1930s-'40s being a major example. Could it be that the current "shot" of **in**flation is just what shocks the global system enough to forestall a return of the prospect of the opposite for at least some time to come? We hope, and, if so, the short-term dislocation we may now go through could be well worth it. We shall carefully monitor these trends.

INVESTMENT ACTIVITY

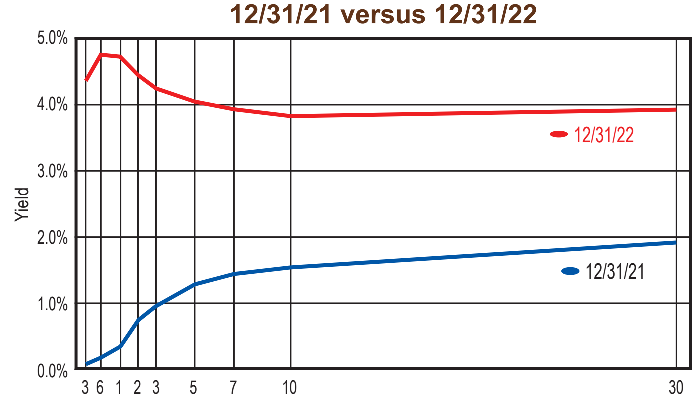
We would now like to highlight a recent addition to Aristotle Capital equity portfolios:

- **Ecolab** had been previously held in Value Equity and Global portfolios. It was decided to sell this company several years ago. While its "base" institutional and industrial chemicals business continued to favorably progress, the newer energy-related acquisitions appeared, in our view, to be "distractions" and not nearly as value-added as its base. Thus, we believed our initial investment thesis was being diluted. More recently, with the ChampionX (upstream) energy businesses divested to a separate company, Ecolab is again executing on its mission of gaining (largely organic) share of global institutional and industrial water, hygiene & sanitation management via the use of treatment chemicals. Customers' ROI on the use of its products is often measured in months and thus this "razor and blades" business is highly attractive. The company is by far the leader in this still highly fragmented business with its closest competitor only one-fifth its size. Ecolab's management team has proven it is capable of knowing when to **<u>in</u>**vest and when to **<u>di</u>**vest.

FIXED INCOME STRATEGY

In our January 2022 edition of *The Essence*, we said: "*Even after a slight uptick in 2021, by just about any measure, short-term interest rates may be considered to be held artificially below normal.*" The Fed has agreed and, during this past year, tightened considerably by raising the federal funds rate from essentially zero to a range of 4¼-4½%. Chairman Jay Powell has telegraphed they are not yet done.

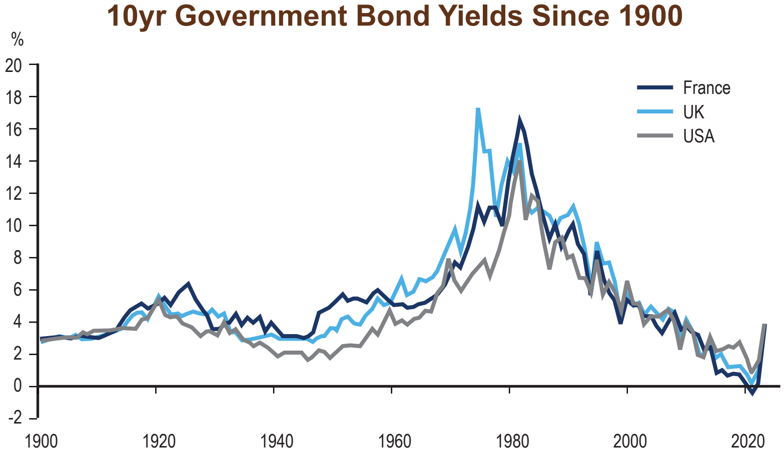
U.S. Treasury Yield Curve
12/31/21 versus 12/31/22



Source: Bloomberg

According to Henry Allen of DB Research, "*10yr Treasuries saw their worst annual performance since 1788!*" As short-term rates went up, longer-term rates mostly followed suit. As shown in the above yield curve graph, 10yr. U.S. Treasury yields climbed from 1.5% at the start of 2022 to 3.9% at year-end. Thus, the value of those securities witnessed an approximate 16% decline including income; almost as much of a drop as the S&P 500. Longer-dated Treasuries lost even more. Still, by historical standards, interest rates are relatively low.

10yr Government Bond Yields Since 1900



Source: GFD, DB Research

This graph depicts, for each of France, the U.K. and the U.S., 10yr. government interest rates since the year 1900. Note that while the past year's uptick was swift and meaningful, it came from a near-zero starting point. Thus, rates are still below their 100-year average, and we may not be overly alarmed should they rise somewhat further before the end of the Fed's tightening cycle. As discussed earlier, a resumption of "normal" interest rates due to more "normal" inflation levels may be a welcomed event.

CONCLUSION

Seventeen countries have hosted the World Cup, most recently Qatar, which hosted the 2022 edition. The 2026 tournament will be jointly hosted by Canada, the United States and Mexico, which will give Mexico the distinction of being the first country to host games in three World Cups. It is a very expensive event to host, thus the reason for multi-country hosts in recent years. Other large events, such as the Olympics and American football, also require huge investments be made, without knowing with certainty what the returns on those investments (ROI) will be.

While countries often cannot measure the monetary benefit of these large outlays, the "prestige" that comes with them is sometimes reason enough to spend the money. Companies are different and must account for their expenditures, answering to their owners (public or private) and proving positive ROI. Some companies have been historically capable of pulling off large investments (we gave the example of Parker-Hannifin), while some (example given of Lumen Technologies) are not. Often the biggest benefit to a company is ***not*** to invest at all, but, instead, to ***harvest*** its cash flows. Management prowess is required to make these large, long-term decisions. Aristotle Capital focuses extensively on uncovering those few management teams capable of demonstrable success.

On September 8, 2022, at 15:10 BST, Elizabeth II, Queen of the United Kingdom and the other Commonwealth realms, and the longest-reigning British monarch, died at Balmoral Castle in Scotland, at the age of 96. We celebrated the life of her husband, Prince Philip, Duke of Edinburgh, in a prior edition of The Essence. We mourn the Queen's passing today.

In southern Japan, there is a train station in the middle of nowhere, with no entrance or exit. You get off, but you can't go anywhere and, to leave, you have to wait for the next train. This station has only one function: to remind people of the importance of stopping, and admire the view.

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