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The Essence

Source: Brad Penner-USA TODAY Sports

The "Bet"

Luck is often defined as when preparation meets opportunity. So it was on June 10th when thoroughbred racehorse Arcangelo won the 155th running of the Belmont Stakes, the third leg of horse racing's Triple Crown, amongst the most famous annual races in the sport.

Not (yet) a household name, Arcangelo, a gray colt, was surely prepared for the greatest race day of his three-year-old life. As reported by *The Daily Racing Form* publication, he was sired by Arrogate out of the Tapit mare Modeling. His great-grandparents included Unbridled (winner of the 1990 Kentucky Derby and Breeders' Cup Classic) and Storm Cat (a stallion whose breeding fee during the peak of his stud career was $500,000, the highest in North America at the time – now that's a nice night's work!). Arcangelo, a Kentucky bred, is trained by Jena M. Antonucci. He has improved his time, speed rating and placement in each of his races, culminating in this Belmont Stakes win. But he had few races under his belt and was, therefore, perhaps overlooked in the betting.

The horse that **was** favored to win perhaps all three of the Triple Crown races (including the Kentucky Derby and Preakness Stakes), Forte, developed a bruised hoof and did not run the first two races. While he did run in the third race, he may not yet have been in peak condition. Thus, Arcangelo's first opportunity. Mage, the winner of the Kentucky Derby, finished third in the Preakness and, as he could not win the Triple Crown, chose not to compete in the 1½ mile grueling third leg of the competition. So his exceptional jockey, Javier Castellano, became available and, thus, the second opportunity. National Treasure, who won the Preakness wire-to-wire, got out fast again in the Belmont Stakes. But the Bob Baffert trained horse tired at the head of the stretch and began to run just a little wide. Third opportunity!

So here comes Arcangelo, well-ridden and up with the leaders for the whole race, but also between horses, biding his time. Jockey Castellano seized the moment when National Treasure went just wide enough to allow for Arcangelo to squeeze inside, saving just enough ground. By the time Forte settled into his stride and began to close the gap with Arcangelo, it was too late. The race was over, and a new winner was crowned.

Yes, it was lucky for this horse to have won. Part preparation in breeding, training and positioning of the gray colt. Part opportunity of the jockey, development of the race and perhaps not quite the best performances of other horses that day.

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All during the race, and certainly in the moments afterwards, one could actually "feel" the energy of the crowd and the "roar" of those rooting for their favorite horses to win and "bets" to come in. Indeed, this author, and many others, lament at this last bastion of the "Sport of Kings." Thoroughbred horse racing is long past its prime in interest and attendance. These few big races keep it alive. Many racetrack owners have added slot machines, or other gambling venues, to the grandstands; those may now be the majority of revenues of these aging facilities.

Perhaps its past popularity was not so much in the interest of the sport per se, but in that for much of its history, until recently, it was one of the only legal ways for patrons to bet on anything outside of Las Vegas. It was the "bet" that kept it intriguing. The now proliferation of gambling everywhere has relegated horse racing to the niche, the little known and, we hope not, the forgotten.

A "bet" is not an "investment" …

The "moral" of our story above is that it is human nature to want to make "bets." The interesting history of the magnificent animal Arcangelo, together with the thrilling race in which he ran, is almost meaningless if not for the ability to make "bets" on the race's outcome.

We, at Aristotle Capital, have spoken often of our process that includes the minimization of "bias." One such bias is the desire on the part of many to forecast, put one's money down and root for a big payoff. That is a "bet"; that is **not** investing.

By way of a few differentiating examples:

➢ A "bet" is which (if any) company will "win" the streaming media race. This nascent field is too new to predict, with any degree of confidence, how it will shake out over time. Aristotle Capital's investment in **Sony** does not rely on such predictions. As a generator of content, not in competition with its streaming customers, the company "wins" when the experiences it produces – in film, TV, music or even anime (アニメ) – are "must haves" by consumers.

➢ A "bet" is which (if any) company will "win" the EV race. Existing OEMs such as Volkswagen or General Motors? New EV-only companies such as Tesla or China's BYD? Next generation batteries such as the work Toyota is doing on solid-state lithium ion? While we continue to learn about and monitor these trends, Aristotle Capital's investment in **Michelin** is not reliant on the winner. Instead, as a differentiated producer of tires (tyres), Michelin has developed models specifically for EVs (low friction, low noise, long life) that "outrun" the competition and are chosen nearly twice as much for the newest EVs than were their predecessor models.

➢ A "bet" is which cryptocurrency to buy. Aristotle Capital believes that crypto's underlying *blockchain technology* is what is truly revolutionary. We are hard at work learning all we may about the myriad uses it may be put to. Meanwhile, for now, we are generally avoiding the crypto hype.

➢ Sometimes what appears obvious to some simply does not come to fruition. While to some a controversial statement to make, nuclear power is obvious to many. It is "clean" (no greenhouse gas emissions), its marginal cost to produce (after one builds the plants) is low and its inputs (uranium) are abundant on our planet. The "long tail" risk (of nuclear contamination during operation or from spent fuel) is minimal over the course of periods of time, but recognizably enormous in some unlikely (yet still possible) scenarios. For a time, the world was increasing its reliance on such energy solutions, but largely not today. Will that change? Our investment in Canadian uranium producer **Cameco Corp.** is not a "bet," but what we deem a "free option." That is, we calculate its cash flows and value today to be dependent on only those plants in existence today that require uranium to stay operative over their estimated remaining useful lives. Should nuclear power come back into favor, that could provide significant upside to our estimates. Indeed, perhaps it's a "one way" bet of, in our way of thinking, "break-even" or "win."

➢ A "bet" on China – economic, political or otherwise – is just that, a "bet." For until we can rely upon public data records, only the very largest Chinese companies (and perhaps some global firms with material exposure to China) will produce economic and financial statements that we believe may be relied upon.

➢ A corollary to the last bullet is a "bet" that globalization is "dead." Certainly, by listening to the "nightly news," one may conclude that this is a "sure thing." But the numbers simply do not back up this view. Indeed, according to the World Trade Organization, global trade (merchandise plus service) is projected for 2023 to be more than 10% ***higher*** than it was in 2019. While direct trade with China (and certainly Russia) may slow, that with India, Thailand, Indonesia, Brazil and others is more than making up for the slack.

➢ Lastly (for now), we believe that, generally, a "bet" is an investment time horizon of less than three to five years. Few companies can prove sustainable execution of their business models, including operating through inevitable cycles, in shorter time periods. Aristotle Capital, therefore, focuses its efforts on making "investments" three to five years *plus*, for the benefit of our clients.

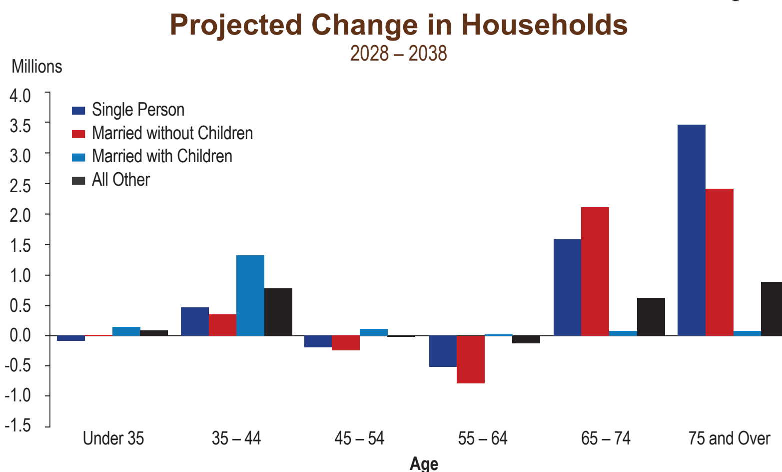
EQUITIES STRATEGY

Generally, one can think of the world of fundamental equity investing as two large buckets: One is a group of businesses, typically early in their lifecycles, that **require** capital. The other, typically more mature, that mostly **generate** excess capital. [Of course, expanding companies that also generate capital is the sweet spot.] Some refer to these two buckets as "growth" and "value," but we prefer to measure companies by their cash-generating abilities, rather than what labels others put on them as "price tags."

While we admit far from a precise analogy (and with many notable exceptions), investing in companies that *require* capital to execute their business models, is closer to a "bet." Seeking out and understanding businesses that generate *excess* capital while executing their models is, in our view, a more assured "investment." Over very long periods of time, both of these investment styles may produce respectable returns. However, the companies that require "bets" to succeed, as a group, may have far higher volatility and, individually, less certainty of results. We will have more to say on this topic in future editions of *The Essence* but, for now, we'll say that Aristotle Capital prefers what we assess to be the more assured, less volatile style. These are less reliant on "bets."

Other investment styles include "macro" investing. We believe that such is akin to a "bet" on one's ability to predict economic cycles. Aristotle Capital's investment style is to "look through" cycles of all types (economic, commodity, inventory, etc.) as our time horizon of three to five years (at least) will typically encompass one or more of these cycles. We do not attempt to make such "bets" as to the longevity, timing or depth of cycles as these factors are not always obvious to forecast.

There are, however, long-term factors that are known with great certainty. Demographics is one example. The following graph depicts projected changes in the composition of U.S. households. It is predictable with near certainty.



Sources: Joint Center for Housing Studies of Harvard University; DB Global Research

The previous chart depicts a projection of demographics in the U.S. from 2028 – 2038. It is based upon very well-known demographic and societal trends such as birth rates, marriage rates (and ages), family size and mortality. We know that the chart is accurate because it is based on human beings already born. The only variable is how long they will live. That, too, we know with a high level of confidence as mortality rates change only very slowly and typically over long periods of time. There could be sudden changes caused by extraordinary disease or cure, but, as we've just been through, even Covid-19 did little to change long-term mortality rates on earth.

This data is very helpful to investments as it can aid in determining the demand for various goods and services. Young families use diapers and consume a high quantity of food. Middle-aged people and families are generally in their maximum earning years and also are generally healthy and energetic. Therefore, they will be utilizers of consumer goods for their homes, transportation for their outings and services for their busy lifestyles. As we age further, we're less likely to have children residing in the homes and so, again, consumption changes.

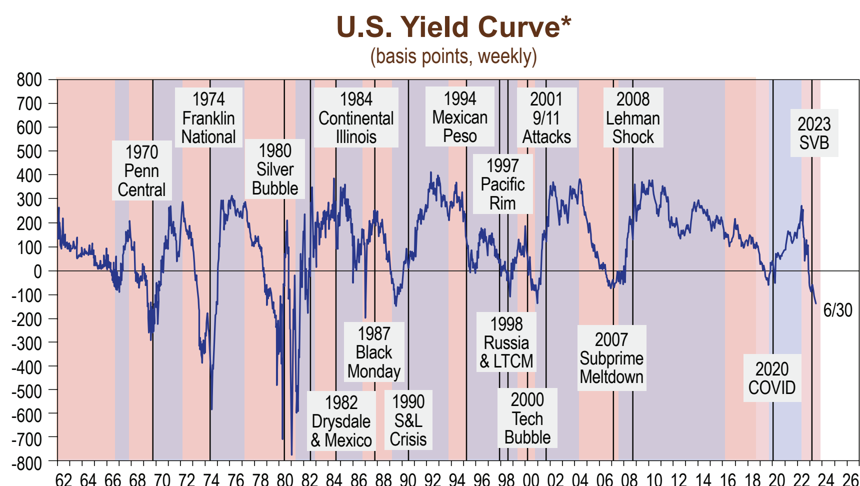
Note from the chart that middle-aged households (with and without children) will decline up to 2038 while the elderly population will increase dramatically. These are not "bets" of what will come, but are known demographic patterns that are nearly certain to come true. While Aristotle Capital's investment style is not one to "pick" investments from this type of top-down analysis, we can consider it in our work and know that, at least this factor, is nearly assured.

INVESTMENT ACTIVITY

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

• **Sysco** is the world's largest food distribution company, primarily focused on North America, with some operations in France, the U.K., Mexico and other countries. Not to be confused with the telecommunications equipment supplier Cisco, Sysco has been a critical link between food manufacturers and institutional food buyers, including restaurants (large and small) and other away-from-home prepared food providers (schools, hospitals, entertainment venues, hotels, etc.) Founded *only* 54 years ago, the company is by far the largest in its field yet still comprises less than 20% market share in an extremely fragmented industry. One by one, Sysco seeks to acquire adjacent customers (either organically or through acquisition) and implement its business model. The company serves >600,000 clients from >330 distribution facilities as a vital logistics conduit between its business partners.

Kevin Hourican joined as CEO in February 2020 (great timing!) and is charged with, on the one hand, perpetuating what has been a great business model, but also propelling the company forward – implementing new technologies able to assist the company's customers with their own changing menus and needs. In addition to the new CEO, *catalysts* for this business are many, including: Further penetrating its existing customers with new offerings, further expanding its assortment of the '*Sysco*' brand of products and expanding its geographic coverage. Mr. Hourican can also make use of the company's considerable cash flow to both sustain its 50+ year uninterrupted streak of increasing dividends and continue its M&A strategies.



**10-year U.S. Treasury yield less federal funds rate*
Note: Blue shaded areas are periods of monetary easing between cyclical peaks and troughs in the federal funds rate. Red shaded areas are monetary tightening periods.
Sources: Federal Reserve Board and Yardeni Research

STANDARDS OF LIVING COMMENT

We believe it appropriate, beginning with this issue of *The Essence*, to replace the "Fixed Income Strategy" section with a "Standards of Living" section. Our past discussions of inflation, interest rates and related topics, leading to suggestions as to the direction of interest rates, were always meant to foster a discussion of productivity, the "true" cost of living (around the world) and how this combination may transfer into "how people live." The section is no longer meant to discuss positioning of fixed income portfolios and so we will make this clear by a change in title.

This in no way diminishes the importance we place on interest rates. Indeed, the value we ascribe to any business has, as its base, the interest rate a prudent investor may earn on a "risk free" investment – the *risk-free rate*. That rate has always been (and we surely hope it may always be) T-bills backed by the full faith and credit of the United States Treasury. Everything else, we believe, globally, in all asset classes, of all risk levels, varies off of the *risk-free rate*.

During most "normal" times, the *risk-free rate* is the lowest yielding of securities as it is deemed the safest. But it is also the shortest to mature and thus subject to the greatest variability in total return over time. That is, the interest rate may be reset every month (at the shortest) and thus, while the return of principal is guaranteed, the long-term rate of return is not.

During periods of monetary tightening, these shortest-term fixed income instruments could yield the ***most***. That is because longer-term investors do not believe the high rates will be maintained. It is this "inverted shape" of the yield curve that has caused recent angst within the banking world.

The graph above depicts the U.S. yield curve, as measured in basis points (1/100th of a percent) from 1962 to June of this year. Note that the curve is currently inverted. That is, 10-year U.S. Treasuries yielded 3.81% while the federal funds rate – a proxy for the *risk-free rate* – was 5.125% at its midpoint; thus, a *negative* 130 basis points yield curve. The U.S. is not alone with most major developed countries in the same situation. Only Japan has a positively shaped yield curve as inflation has remained relatively low with interest rates still near zero.

Note, too, from the graph above, that an inverted yield curve has either preceded, or been nearly coincident with, a financial "crisis" of some sort. Whether an inverted yield curve is *causal*, or a *symptom* of those dislocations, is not entirely clear. But from Penn Central through to the Global Financial Crisis to today, each of these inverted yield curves was around the time of dislocations that led to economic recessions. Will this time be different?

In its recent commentaries on why it continues to increase the interest rates under its control, the U.S. Federal Reserve Board (Fed) has explained that, amongst other factors, "*wage growth is too high*." Perhaps we're from Mars, but real high wage growth seems to be a ***positive*** wish in most cases. This is another reason for our transition to this "Standards of Living" section, so as to better communicate what we view as relevant. A goal of all policymakers should be one of improving real living standards, perhaps irrespective of many other metrics. Prices (and even wages) are just individual components, often requiring a combined analysis. Currency, by its lonesome, has zero value. It is what money may be exchanged for (food, clothing, a daily Starbucks coffee, etc.) that flows through to living standards. Even housing or rent

are only relevant when understanding the types of shelter and/or warmth they provide.

We have commented before that we believe there is a risk that monetary policymakers are either "outdated" in their tools, "out of touch" with what they should be doing or perhaps both. Consistent with our theme of this edition of *The Essence*, we shall not "bet" on how the economy will cycle through. Instead, we remain of the long-term view that the many factors that have been in place (over the past several **decades**) that have worked to keep inflation in check will remain so. Many of these factors are based on demographics (including an aging population), such as those we previously described. We are, therefore, actually more worried that policymakers will kick us back to the fears of **de**flation that, at least today, appear a distant memory.

CONCLUSION

The last time we used a horse race analogy as a topic of our reports was in 2006 at our predecessor firm. "*The Morning Line*" told a story of "figuring" the races the night before so as not to be *biased* by the morning line odds – the experts' predictions of each horse's betting odds at post time. Precisely 17 years later we are still attempting to minimize *bias* – our work is never done! We use horse racing as there are parallels between the sport (including "betting" on it) and investing. This time, we used the "bet" itself as a *bias* we look to minimize. Most people, by nature, enjoy the thrill of making bets and rooting for a winner. It is the "vested interest" that gets the crowd to roar. But at Aristotle Capital, we differentiate between a "bet" and an "investment," preferring the latter. A "bet" usually involves the attempt to forecast something with unreliable data, such as who will 'win' the streaming media or EV business races. An "investment" holds greater certainty of results, often relying upon that which is known. Demographics is but one example.

A "bet" on Arcangelo to win this year's Belmont Stakes paid $17.80 for a $2.00 wager. Perhaps one could have figured the winner, yet "luck" is often that serendipitous combination of when preparation meets opportunity. The opportunity came with an available jockey and a race run to favor the winner's style. Preparation included trainer Jena Antonucci who became the first female trainer ever to win a Triple Crown race. That's what we call a great PAYOFF!

We thank you for reading our periodic reports.

We would like to welcome Aristotle Pacific Capital, LLC and Aristotle Investment Services, LLC to the growing Aristotle family. We also thank everyone at Aristotle Funds Series Trust (AFST) for their hard work and support.

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> ***"I like the idea of artificial intelligence, because we're so short of the real thing"***
>
> *~ Charlie Munger,*
> *Vice Chairman, Berkshire Hathaway Inc.*

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