Laurus INVESTMENT COUNSEL

2023 Annual Investment Letter

Striving for excellence.

"Once a King in Narnia, always a King in Narnia. But don't go trying to use the same route twice. Indeed, don't try to get there at all. It'll happen when you're not looking for it. And don't talk too much about it even among yourselves. And don't mention it to anyone else unless you find that they've had adventures of the same sort themselves."

C.S. Lewis, The Lion, the Witch and the Wardrobe

Last year's letter began with a perspective driven by correcting markets, filled with messages of entrepreneurial concern as rising interest rates slashed investment multiples pushing equity prices into the proverbial sewer. But, like a phoenix from the ashes, the market rises again. Proving our ongoing contention that one can never predict a market direction.

Our various letters and commentaries over the past decade have made reference to the C.S. Lewis series, The Chronicles of Narnia. In Narnia, the characters often encounter magical creatures and artifacts that hold great power. Likewise, in the investment industry, investors must navigate a myriad of financial instruments, each with its own unique characteristics and potential for impact. From stocks and bonds to derivatives and alternative investments, the choices investors make can influence the outcome of their financial journeys, much like the magical artifacts shape the fate of Narnian characters.

Why this continued focus on the Lewis fable?

The concept of time is a recurring theme in the Chronicles of Narnia, with time passing differently within the magical land compared to the outside world. Similarly, in the investment industry, the element of time plays a crucial role. Investors must consider the long-term implications of their decisions, understanding that the effects of market dynamics and economic trends may unfold over extended periods. Patience and a strategic perspective are virtues that parallel the timeless wisdom imparted in Lewis's tales.

Just as Narnia undergoes transformations and upheavals, the investment industry is marked by cycles of boom and bust. Economic downturns and market fluctuations are akin to the challenges faced by the inhabitants of Narnia, requiring resilience and adaptability from investors. Learning from the characters' ability to overcome adversity in the face of change can serve as inspiration for navigating the uncertainties of financial markets.

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Ultimately, both Narnia and the investment industry invite individuals to embark on a journey of discovery and growth. C.S. Lewis's timeless tales provide allegorical insights into the human experience, offering parallels that resonate with the challenges and triumphs faced by investors in the dynamic world of finance. As investors navigate their own quests, they can draw inspiration from the courage, wisdom, and resilience portrayed in the Chronicles of Narnia, recognizing that the choices they make today contribute to the unfolding narrative of their financial futures.

As the reversal of market fortunes that began in November 2021 continued throughout most of 2022, many investors chose to head to the exits. By mid-2022, CNBC estimated nearly 40% of investors had sold down their portfolio including 70% of GenZ and 57% of millennials. The younger investor advantage, of course, is time relative to their older counterparts – to make up for the psychological errors in investing practices.

Investor fears are deeply rooted in psychological factors that influence decision-making; a concept extensively explored by Nobel laureate Daniel Kahneman. In his groundbreaking work, particularly in the book "Thinking, Fast and Slow", Kahneman delves into the cognitive biases and heuristics that shape human judgments, often leading to irrational fears in the context of investments.

One prevalent fear among investors, as highlighted by Kahneman, is loss aversion. The prospect of financial loss tends to evoke stronger emotions than the potential for gain. Investors, influenced by this bias, may make decisions aimed at avoiding losses rather than maximizing returns. This fear can manifest in actions such as selling winning investments prematurely or holding onto losing positions for too long, ultimately impacting the overall portfolio performance.

Kahneman's concept of overconfidence is another factor contributing to investor fears. Many investors exhibit overconfidence in their ability to predict market movements or pick winning stocks. This unwarranted self-assurance can lead to excessive risk-taking and a failure to adequately diversify portfolios. When the market doesn't align with their expectations, overconfident investors may experience heightened anxiety and fear, realizing the limitations of their predictive abilities.

The fear of regret is a psychological aspect explored by Kahneman that can significantly impact investment decisions. Investors may fear making choices that could result in remorse if the market moves unfavorably. This fear can lead to a reluctance to sell losing investments or a hesitancy to take calculated risks, as individuals seek to avoid the emotional burden of regret. Acknowledging and understanding this fear is crucial for investors in making more rational and objective decisions.

Fear has also led investors to the increased usage of alternative investments by investors, reflecting a growing desire for diversification beyond traditional public market investments like stocks and bonds. Alternative investments encompass a broad range of assets, including hedge funds, private equity, real estate, distressed debt, and more. Investors are drawn to these alternatives as they often have low correlations with traditional markets, providing the potential for enhanced portfolio diversification. Additionally, alternative investments may offer opportunities for higher returns or risk mitigation in certain market conditions.

However, the growing reliance on alternative investments is not without its dangers. One of the primary concerns is the complexity and lack of transparency associated with many alternative strategies. Unlike publicly traded stocks and bonds, alternative investments often lack standardized reporting practices, making it challenging for investors to assess their true risk and performance. This opacity can lead to misunderstandings and misinterpretations of the actual exposure and potential drawbacks associated with these investments.

Furthermore, while alternative assets are well suited for matching with long term liability obligations of entities such as pension funds or insurance contracts, they may pose inappropriate risk for individual investors due to their illiquid nature. Unlike stocks that can be easily bought or sold on public exchanges, alternative investments such as private equity or certain hedge funds may have limited redemption options. In times of need, investors might face difficulties in liquidating their positions, potentially exacerbating losses and increasing overall portfolio risk.

Herd mentality – or, influence by the majority – is frequently delved into by Howard Marks. Over the past cycle, the advancement of alternative investments, the broad use of index and derivative index products (what is an "active ETF" anyway?), and sundry other marketing tools used by the investment industry to garner assets have been snapped up by unsuspecting investors. Markets rising for long periods of time leads to investor complacency and low perceived risk along with a general lack of fundamental analysis. Which can only lead, ultimately, to an increased vulnerability to unexpected downturns.

Marketing hype – emphasizing storytelling and promotion over fundamental principles – continues to abound. Marks has frequently emphasized the importance of conducting thorough due diligence and maintaining a disciplined, contrarian mindset. By recognizing the impact of marketing on investor behavior and decision-making, individuals can better navigate the investment landscape, focusing on fundamentals rather than being swayed solely by persuasive marketing campaigns.

So, to paraphrase, too much of a good thing is just that – too much.

There has been plenty of talk these days of returning to a "normal market", though how one defines normal is in the eye of the beholder. Howard Marks emphasizes the importance of understanding that markets are inherently cyclical and that periods of calm and stability, which is his definition of "normal markets", are merely temporary phases in the broader economic cycle.

Marks contends that during a normal market, investors often underestimate risk and become complacent due to the prevailing sense of stability. This complacency can lead to the neglect of fundamental risk assessment and a tendency to overlook warning signs. According to Marks, the perception of a market as normal can lull investors into a false sense of security, causing them to underestimate the potential for adverse events – like the public markets meltdown that began November 2021.

Marks underscores that the concept of a normal market is relative and should be viewed within the context of the market cycle. He suggests that investors should be cautious during these seemingly stable periods and remain vigilant in assessing risks. Furthermore, Marks argues that recognizing the limitations of predicting market movements is crucial, as markets can deviate from expectations, leading to unexpected challenges.

The COVID-19 pandemic had a profound impact on global economies and individual behaviors, prompted by changes in spending patterns and a general reassessment of priorities. Digitalization and e-commerce has forced businesses and consumers to adapt quickly to a more digital-centric world which, in turn, influenced a variety of investment opportunities. Apparently, what it did not do was underscore the overall nature of having a long-term perspective across investment strategies. This goes back to Kahneman's fear of losing out.

When individuals or entities invest capital, they are essentially exchanging present resources for an expectation of future benefits. This promise to pay can take various forms, such as interest payments on bonds, dividends from stocks, or capital appreciation from the resale of an asset. The underlying assumption is that an investment will generate positive returns over time, compensating the investor for the risk and opportunity cost associated with committing funds.

Unfortunately, returning to Daniel Kahneman's research again, humans often exhibit a bias toward immediacy, seeking immediate gratification and overlooking the potential consequences of short-term decision-making. Kahneman's work on prospect theory underscores how individuals tend to place a higher value on certain gains in the short term, even if the long-term benefits are greater. This behavioral tendency can contribute to a myopic approach to decision-making, with investors overly fixated on immediate outcomes rather than considering the broader and more enduring consequences of their choices.

Which returns me full circle to the concept of time.

What if we could meet ourselves in the future? It's a strange question, to be sure, but what if – admittedly a big if – you could meet your future self. Obviously, that would give you perspective on all the good and bad decisions made over time. For example, if you could view yourself at retirement age at a time when you were just beginning your career, it might challenge your perspective on wealth in retirement and perhaps encourage you to make better choices on both contributions to, and investing of, savings.

Should you meet your younger self, perhaps one might emphasize the importance of embracing failure and viewing it as a steppingstone to success. In the pursuit of goals and dreams, setbacks are inevitable, but they provide invaluable lessons that contribute to personal growth. I would encourage my younger self to approach challenges with resilience, understanding that each stumble is an opportunity to learn, adapt, and ultimately thrive.

Or perhaps one might encourage a mindset of continual learning and adaption. The world is ever-changing, and staying curious and adaptable is crucial for personal and professional development. Our advising your younger self to prioritize self-care, nurture relationships, and appreciate the present moment. Achieving success is fulfilling, but it is equally important to savor life's journey and find joy in the little moments.

It's no secret that I turned seventy this year. Reflecting on this question of meeting myself now, or perhaps simply reflecting on my past, it's interesting to note the things I'm most proud of and the ways I've changed – both negative and positive – over the years. I've more than a few regrets, to paraphrase Sinatra, and my fair share of embarrassments. I’ve been far too stressed at times over things that meant so little in the longer term and missed paying more attention to those that meant more. But that’s life.

Yet if I could speak with my younger self now, some of those early issues might be overcome. Or perhaps my idealistic self would ignore the advice. To quote Marty McFly in the movie *Back To The Future*, “…the crowd might not be ready for that yet, but [their] kids are gonna love it."

As I bemoaned in last year’s letter – and, for that, I apologize – the difficult part of being an entrepreneur is the continued worry about the abyss. In his book War and Peace, Leo Tolstoy wrote “The two most powerful warriors are patience and time”. The dark days of the pandemic seem to be waning, and that little sliver of light gives us hope for a new beginning of growth.

I thank our incredible team for their kindness, support, patience, and counsel over what has been another difficult year. I truly hope the coming year rewards our hard work.

And, of course, a heartfelt thanks to those who have entrusted us with their investment assets. We truly appreciate your continued support, your confidence in our abilities and, dare I say it, friendship. Personally, I remain forever grateful and, speaking on behalf of everyone at Laurus, we humbly thank you.

I will once again conclude this year’s letter with my fondest wish, echoed by the Laurus family, that you have the courage, faith, and strength of spirit to walk the difficult road ahead, along with the tenacity and patience to achieve everything you desire.

Christopher Page