The Quarterly Report

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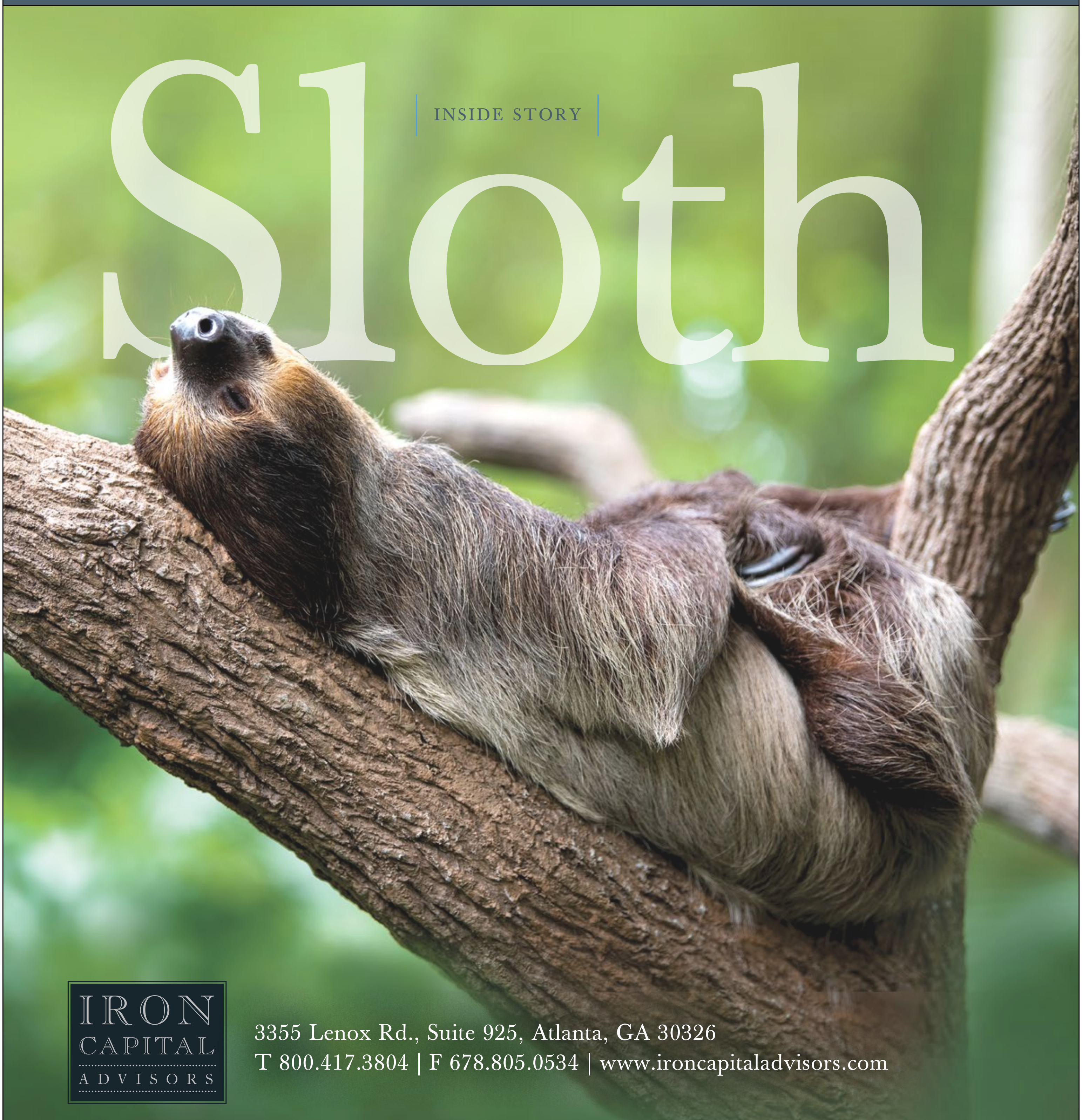

INSIDE STORY

Sloth

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326
T 800.417.3804 | F 678.805.0534 | www.ironcapitaladvisors.com

Several weeks ago I was talking to our research director, Michael Smith. We talk all the time of course, and most of those conversations relate to the market, our clients, and the investments held in our client's portfolios, as well as new ideas for future investment opportunities. To be more accurate, that is how most of our conversations begin; they usually end by philosophically solving one or more of our world's problems before one of us finally says, "We have to get back to work." These world problems could range anywhere from how Alabama will get back to playing the stiff defense for which their football team was known (Michael is a big Alabama fan), to solving the riddle that is our healthcare system, and myriad topics in between.

Sloth

Sloth had far more to do with the 2008 financial crisis than greed.

This particular day our conversation somehow turned to the topic of laziness. To be honest I'm not sure what turns the rabbit hole took to get us there, but it was a fruitful conversation. Sloth, after all, is one of the seven deadly sins according to Catholic teaching, and it is certainly worthy of inclusion in that list; yet it is often overshadowed by the more flashy sins like greed and wrath, which get all the glory. Nothing is more indicative of our modern society than seeing someone full of wrath over someone else's greed.

Milton Friedman once said, "Of course, none of us are greedy, it's only the other fellow who's greedy." We hear the greed thing all of the time because of our chosen profession, as investing and the accusation of greed seemingly go hand in hand. The 2008 financial crisis is a great example of this phenomenon. Books were written and movies made, and all of them had one big theme: greed was the root of the crisis. As I pointed out at the time, to believe that means that for years and years investors were not greedy and then all of a sudden became greedy, which is, of course, ridiculous. Greed could not have caused the financial crisis – not because it doesn't exist, but because it always exists. If greedy investing decisions led to crisis, then we would always be in crisis.

The truth is that sloth had far more to do with the financial crisis than greed. Analysts got lazy. They stopped doing their jobs and were asleep at the switch. Bankers were not doing proper due diligence on mortgages they were underwriting as they figured the investors who actually provide the funds would let them know if a mortgage was too risky. Instead of thinking about what they were doing, they simply checked the box. In other words, they were slothful.

The rating agencies were slothful as well. Instead of doing real due diligence, they just assumed the bankers were doing their jobs. These securities are made up of mortgages, which are safe. They believed that a banker wouldn't underwrite a mortgage that wasn't safe: Check the box and rate them AAA.

Investors were slothful. Analyze the securities? Dig down into the actual mortgages themselves? The rating agencies said they are AAA, and look at the yield! What more would one need to know? Check the box, AAA security with relatively high yield: sold.

The regulators were slothful. What was there to be concerned about? They were meeting their social goal of housing for everyone: check. Banks appeared to be strong: check. After all, they had forced the banks to invest their reserves in AAA securities, so what could go wrong?

Things had been good for almost 30 years once we had gotten off the disastrous economic path of the late 1960s and 1970s and started heading in the right direction. People had gotten lazy at every level of the system. Sloth, not greed, caused the financial crisis.

Then there was the reaction: Pundits and the media all took one look and said, "This is Wall Street, it must be because they are greedy." All they had to do for "proof" was to find a few juicy anecdotal stories of greedy idiots, and on Wall Street those stories are never hard to find. It is a low bar, but the media whose propaganda framed the narrative may very well have been the most slothful cog in the whole wheel. Why break a sweat trying to find out what actually happened when all you have to do is write the words "Wall Street Greed" to generate clicks and likes and shares?

Sloth was everywhere in 2008 and it is still with us today. Most obviously we see it with people being slow to come back to work, which has been the big story this quarter. We were undergoing a strong recovery from the reaction to the pandemic, and then we got hit by two bad jobs reports in a row. The unemployment rate actually rose at one point. People don't want to work, and if they don't have to because they are making more by staying on the dole, as they used to say, then they won't. I want to be very clear: there is absolutely no judgment in that statement, it is simply a fact. It would be slothful of me to point my finger and say, "Look how lazy those folks are." No; the reason sloth is among the Catholic deadly sins, and is a theme in every other religion and philosophy through the history of humankind, is because it is part of the human condition. It is in every single one of us. Some may be better at overcoming it than others, but we all suffer from it.

People are complicated, so an individual may show great discipline and drive in one area of her life and still be slothful about other things. I once knew a very disciplined person who competed at a high level in triathlons. She hated doing laundry and often lived out of her laundry basket to avoid having to fold her clothes when they came out of the dryer. When it came to training and competing she was extremely disciplined, but when the subject changed to laundry, one would have a hard time finding someone lazier.

Highly successful people who are frankly lazy about their own investments are Iron Capital's bread and butter. I am thankful they exist, otherwise I would have to find another way to make a living. Many of our clients will tell us that they rely on us because they don't have the desire or the time to do it themselves. One really can't be disciplined in every aspect of life because there are only 24 hours in a day. Somewhere, outsourcing is necessary.

Often today that laziness manifests in how we get our news and decide what to believe. A prime example from recent history is the Wuhan virus origination story. The New York Times recently admitted that they rejected the Wuhan lab-leak theory largely out of groupthink and partisan polarization, because it was being pushed by people they did not like. To disagree with a statement or idea simply because one does not align with the person or organization offering it is the epidemy of sloth, yet we see it all the time and from people we would never describe as slothful.

This brings me back to Michael's and my conversations. We must get back to work. Our job is to invest our clients' money, and our own tendency toward sloth must be overcome. We believe that prudent investing has three attributes: it is done from the bottom-up, it is absolute return-oriented, and it is risk-averse. Each one of those attributes takes discipline.

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REVIEW *of* ECONOMY

The 1st quarter 2021 GDP growth came in up 6.4 percent as the economic recovery continues. As good as that is, it disappointed the market. Expectations for 2nd quarter are even higher. Reality is likely to be good, but is it good enough?

The official unemployment rate is 5.9 percent in June. Jobs have come back at a rapid pace but workers have come back much slower than expected. Higher than usual unemployment benefits is certainly a factor, and there may be some hesitancy due to the virus.

Inflation is 5 percent based on the latest consumer price index report. It has moved upward rapidly. The producer price index, which tracks wholesale prices, is up 6.6 percent over the last 12 months. Inflation is worrying everyone and even the Fed is beginning to notice. Don't expect any action soon, however. +

REVIEW *of* MARKET

The market continued to climb. For the quarter, the S&P 500 finished up 8.55 percent and small company stocks represented by the Russell 2000 index were up 4.29 percent. Growth came back into favor as concerns about the strength of the recovery surfaced.

Bonds during the quarter. The Barclays U.S. Aggregate Bond index ended up 1.83 percent. High yield bonds rose 2.74 percent.

International stocks underperformed but were still up. The EAFE index finished up 5.38 percent while the MSCI Emerging Markets index ended the quarter up 5.12 percent. +

MARKET *forecast*

The market is in need of a correction. It is always hard to know when it may occur but we have gone up too far too fast. Markets do not go up in straight lines.

Value stocks and small company stocks still have more room to run in the long term, but growth concerns have boosted growth stocks. International stocks should continue to do well.

Bonds are back to crazy low yields. They are still a shelter in a storm but are not going to fund any retirements. +

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However, we can also fall into the trap of just checking a box. Good investments are always found bottom-up in our opinion, yet that does not mean one can just ignore what is happening. A tobacco company may look fantastic in isolation and may very well be fantastic for an investor seeking income, but there is no growth to be had in that industry. When analyzing a company from the bottom-up one cannot be lazy and ignore the realities of what is happening in the big picture.

We believe strongly in an absolute return orientation. The grass being greener over there is the death knell for most lay investors who always chase after the highest returns. However, if one gets lazy she can use this as an excuse to ignore investing mistakes which may have caused underperformance.

Investors must be risk-averse as it is defense which wins championships, but many in our industry use this as a lazy excuse to accept lower returns in low yielding "safe" investments. They forget that market volatility is only one form of risk, and in reality the least important. The risk of outliving one's money is far more dangerous than a simple market correction.

The greatest example of sloth is the tendency to see what one wants to see, believe what one wants to believe, and accept only facts one wants to accept. In investing this means one who believes the market is always wrong will just go counter to the market, while one who believes it is always right will go with the market. Both are forms of sloth, and both are wrong. An investor always has to do her work and think through her investments. There is never just one simple cause for everything. There is always another point of view, and prudent investors must have the discipline to see that. This means fighting their own biases. A disciplined investor is not without sloth; he is simply aware of his unique tendency toward sloth and therefore able to fight it.

It would be easy to say that the lazy investor hides in index funds, follows trends, and invests in what is popular. To a large degree this is true; however, there may be times when the index makes sense. Fighting the popular trend just to be contrarian can be just as lazy. The key to overcoming one's own sloth is to understand it. What form does it take? A prudent investor must always be questioning himself. I used to work with a senior marketing person who loved to say that he was "often wrong but never in doubt." I would respond, "I'm always in doubt, which is why I'm seldom wrong."

We would laugh and then go down some rabbit hole conversation until one of us would say, "It is time to get back to work."

Warm Regards,

Chuck Osborne

CHUCK OSBORNE, CFA *Managing Director*