

As of June 30, 2022, the Ravenstone Equity Portfolio declined by 24% year-to-date, net of expenses. The three-year, five-year and since inception returns are 12.4%, 11.9% and 12.1%.¹

The first half of 2022 was a difficult one for your portfolio. We typically expect, that owning high-quality businesses would weather a market downturn better than their inferior counterparts; however, this has not been the case so far this year. The investment environment in 2022 has brought no shortage of challenges, each of which is rapidly changing the investment landscape. Inflation has risen to levels not seen in 40 years, China's lockdowns continued to disrupt global supply chains, and the ongoing military conflict between Russia and Ukraine has sparked an uncomfortable increase in global oil and food prices. The confluence of recent events has prompted the U.S. Federal Reserve to turn undeniably hawkish, resulting in sharply higher interest rates.

Financial markets reacted quickly to the incoming economic data. The S&P 500 fell by 20.6%, the most in the first half of a year since 1962² and interest rates (as measured by the U.S. 10-year Treasury Bond) increased from 1.51% on January 1st to 3.02% on June 30th³, delivering the largest six-month decline in bond values (including coupons) since 1980. With inflation fears driving bond yields higher, technology companies fared worse than the overall market. A long list of speculative companies in the sector with no earnings or positive cash flows sold off dramatically given these businesses are expected to deliver a higher proportion of cash flows in the distant future. In theory, these longer dated cash flows become comparatively less attractive as interest rates rise. Simultaneously, many highly profitable technology companies with high operating margins and growing cash flows today, got caught up in the downdraft, albeit less so. It is noteworthy to point out that your technology holdings, some of which have been held for many years and through various market cycles are attractively priced today, even with today's higher interest rates – we will address this more below.

There is no doubt that the economic outlook is uncertain; however, it is always uncertain. History teaches us that fundamentally strong companies, underpinned by resilient business models, can adapt and perform well over time, regardless of the inevitable volatility of the business cycle. Equities have generated excellent long-term, real returns for those who didn't get scared out of owning them. The key is to allow for the magic of compounding to remain uninterrupted. It is easy to become fearful with so much negativity and uncertainty abound. It is the urge to sell that threatens to disrupt the compounding process and often leads to disappointing results.

Most of the time, longer term returns from these valuation levels are quite strong. After experiencing a 20% drawdown on the S&P 500 index, based on historical performance, high odds exist for earning strong returns over the next 1, 3 and 5 years! On average, the market gains 16% over the following twelve months and 13% annually over the next 3-5 years (including any additional losses)⁴.

Should equity investors fear higher rates? Based on historical evidence, the answer is no. While valuations of all financial assets are adversely impacted by increasing interest rates, it does not mean that companies with robust business models generating growing cash flows, will generate poor future returns. Since 1969, the S&P 500 Index has fared relatively well regardless of the direction of interest rates. Over the past three decades, the United States central bank has embarked on four rate hike cycles. None have been detrimental to the long term returns of equities. And technology, which has experienced the brunt of selling this year, was typically among the best performing sectors during those cycles⁵.

Will high inflation hurt equity returns in the long run? Not necessarily. When inflation has exceeded 7%, the median return of U.S. stocks over the next year was 7.3%, compared to 10.3% when inflation has been below 7%. The median inflation-adjusted return of U.S. stocks over the two years following periods of high inflation is nearly identical to the two-year return following periods of lower inflation (18.5% vs 18.7%, respectively)⁶. This suggests that the impact of inflation will be less detrimental to investors who own financially strong, growing businesses.

Despite the recent run-up in energy and other commodity-related stocks, we continue to believe that avoiding these companies is the correct strategy. At Ravenstone, we do not rotate from high-quality businesses to lower quality ones based on where we are in the business cycle. We only want to own companies that meet our investing criteria with the expectation of maintaining ownership throughout periodic downturns. Our investment philosophy is rooted in one of the oldest schools of thought: to **think and act like a business owner**. This means, aligning our clients with a portfolio of the most financially superior and competitively advantaged businesses that are expected to compound earnings and free cash flows at highly attractive rates over time. This approach tends to exclude businesses such as mining and energy companies whose success is inextricably tied to the volatile price of an underlying commodity. When commodity prices are rising, such companies can make high returns on capital, however, they remain vulnerable to inevitable downturns that follow as supply and demand move back into

¹ Performance of the Ravenstone Equity Trust I Series Units is used to reference the Ravenstone Equity Portfolio results. Performance calculation is to June 30, 2022. Inception date is April 1, 2016.

² *S&P 500: Worst Performance through 124 Trading Days (1928-2022)*, Compound, June 30, 2022

³ Thompson Eikon, July 13, 2022

⁴ *Plea(sing) For the Long Term*, Miller Value Partners, July 1, 2022

⁵ Strategas Securities

⁶ *Will high inflation hurt stock returns in the long run? Not really*, April 5, 2022, [cnbc.com](https://www.cnbc.com)



balance. History has shown that high profitability in these industries has typically been followed by poor capital discipline, leading to the eventual destruction of capital. When returns are high, companies are inclined to boost capital spending with little regard for return on invested capital. Competitors will often follow suit to avoid losing market share. There is a reason these companies are typically labeled “cyclical”. In our opinion, these are stocks that are meant to be rented, not owned.

Portfolio Update

Microsoft (MSFT) is down 24% year to date and 25% from its all-time high. In fact, all technology companies that we own have seen their stock price fall more than 20% year to date. When asked why we are not selling these stocks, we like to remind clients that some technology businesses provide essential services that are so integral to daily life and global data infrastructure that their respective earnings and performance patterns are quite reliable. In our opinion, Microsoft exhibits utility-like qualities with an attractive growth profile. In April, MSFT reported third quarter revenues for fiscal 2022 increased 18%, earnings per share was up 9% and the business generated \$20 billion in free cash flow, up 17% from last year. MSFT ended the quarter with \$56.6 billion in net cash and investments on its balance sheet. Given MSFT is at the forefront of many secular growth trends (e.g., the cloud shift, AI, gaming, security, health care), we are confident it will continue to deliver strong financial results. Consider the cloud market; companies around the world continue migrating data to the cloud. Earlier this year, JPMorgan Chase & Co. CEO Jamie Dimon said “If we can spend \$2 billion more and get to the cloud tomorrow, I would do that in a second”⁷. He made it clear that spending on technology infrastructure modernization is critical to reducing costs and improving productivity. Microsoft is the second largest cloud vendor and, in our view, is likely to continue benefitting from the widespread shift to cloud computing.

Charlie Munger was quoted as saying “over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for those 40 years, you’re not going to make much different than a six percent return – even if you originally buy it at a huge discount.” Over the past five years MSFT has generated an average return on invested capital of 24%. Even with the current macro headwinds, the business is likely to continue growing at an attractive clip given its growth drivers are secular in nature, not cyclical, and the ‘stickiness’ of its products and services affords it the ability to pass on price increases to customers. Given their financial strength and durable growth profiles, we expect MSFT and your other technology holdings to perform well, despite what appears to be a challenging macro environment.

Market declines tend to also provide for opportunities. The heightened uncertainty and outright fear emanating throughout asset markets of late, has allowed us to increase our position in one of our favorite companies, Sherwin Williams (SHW). SHW’s share price has been impacted by concerns about the housing market, rising input costs and supply chain issues; however, the company has an excellent track record of passing through prices to cover rising costs. While the market is focused on recent threats that are likely temporary in nature, we chose to increase ownership in a business that we know well and have gladly owned for many years.

We also initiated a new position in Home Depot (HD). Shares in the home improvement retailer fell 24% from its high due to concerns of rising interest rates and the impact it will have on housing. Home Depot recently reported results that were much better than expected, which is at odds with the recent decline in the share price. We purchased shares of HD at 18 times earnings (below its ten-year average multiple) with a 5% free cash flow yield.

We believe both companies will have significant demand growth for their products as the U.S. faces a housing shortage, estimated to be several million units. At the same time, HD and SHW should benefit from continued strength of home remodelling and repairs due to an increasingly aging housing stock. HD has also invested heavily in digitization that is strengthening the company’s competitive advantage and value proposition with contractors. In our view, the fundamentals of both businesses remain strong, and we are confident that today’s share prices provide for attractive entry points.

⁷ 2021 Annual Report, JPMorgan Chase & Co.



We sold our entire position in Masimo (MASI) following the unexpected acquisition of Sound United, an audio and home entertainment company. MASI is a health care company that is the dominant provider of pulse oximeters, the clip that is placed on your finger to measure blood oxygen levels. This is a razor and razor blade type business model - MASI makes money selling the sensors used in the device, which need constant replacement. Our investment thesis for owning this company was based on its successful medical sensor business. Masimo believes that the acquisition of Sound United will help the company extend their medical technology into home-based patient monitoring - we think management is overreaching. The stock sold off sharply on the news of the acquisition. Our decision to sell was based on management's poor communication of its rationale for the acquisition. We lost confidence in management and believe the acquisition dramatically increases the risk profile of the company. As a result, we decided to cut losses and exit your position. We never like making mistakes, but when they happen, we will always be forthright, transparent, and act swiftly.

We are sincerely grateful for your business and ongoing trust.

Thank you,

Daymon Loeb

Adam Donsky

Paul Bleiwas

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