CAIM
CATHERINE AVERY INVESTMENT MANAGEMENT

3Q21 Review & Outlook

EXECUTIVE SUMMARY

Pandemic Hangover - We underestimated how stubborn the Delta variant would become in its economic effects. But Merck's new pill may get us over the hump. Meantime, the quarter and outlooks about to be reported could be mixed as a result.

Inflation NOT Transitory – We are sticking to our call, and the evidence so far is on our side. And like last quarter, we think Inflation will be a key theme discussed on the upcoming conference calls. We prefer to own the beneficiaries (e.g., Cyclicals), and not those that cannot pass it through (e.g., Consumers). The Fed now seems to be agreeing, as seen in the latest 'Dot Plot', which we think has as much of a chance of being behind the curve as the Fed itself.

Labor Markets the New Focus - The Fed may have its hands tied by its dual mandate of inflation and employment. And the labor market part of it is not cooperating. Simply put, there are a lot of job openings, but a lot of unemployed folks, and we won't pretend to know why, but 'c'est la pandemic'.

Inflation Now Moves to Wages as Well – It appears that companies have to pay more for workers. We believe we will hear a lot on the upcoming conference calls about management having a hard time finding workers. So they will have to pay more for them. Minimum wage legislation is inflationary as well. So wage inflation is likely here to stay, and wages are much stickier. And over time, it usually results in consumers having more spending power.

Fed Has to Let Inflation Run Hot – Despite heavy government spending, our bet is that the Fed lets inflation run hot until it figures out what is going on with labor markets. Another factor is the high debt burden in 'wealth effect' sectors like housing, which make a decision to tighten that much more difficult. In fact, we think such wealth effect from any negative reaction in stock prices still frightens the Fed from moving too fast.

Inflationary Psychology Strong - We have continued to shift our portfolio toward companies which see more benefit from an inflationary environment. In this part of the cycle, it is easier to get price increases when everyone thinks that rising prices are the norm. In that sense, Inflationary Psychology can help drive Corporate Profits**,** especially when prices catch up with input costs.

Demand is Strong, But Supply is Not - While demand for goods is clearly very strong, supply is overall not keeping up. Logistics delay and shortages of shipping containers, chips and other key goods are having ripple effects downstream. So Inventories in the system have consequently been plummeting, and shipments are lagging orders in most industries. But since this is the first time in recent memory, it is hard for us to view any pent-up demand as anything but bullish.

The Consumer Feels Rich As Well – It is not just companies with swollen cash coffers, but Consumers have emerged from the pandemic with lots of cash and little debt. The pandemic may have permanently changed the Housing sector, which is perhaps seeing the fastest inflation. While this rate of change is not sustainable, the marginal worker has been moving from the office to the home – and they are not all going back. This may be another example of inflationary psychology, but it also has a positive impact on the 'wealth effect'. We believe our overall higher Cyclical stock exposure will benefit here as a result.

Higher Dividend Income is an Inflation Hedge - We believe that absolute dividend yields are important in an era of rising rates, and a level of 'yield support' tends to hold stocks up on the downside. We see a greater need for income from stocks to offset rising inflation. A full half of our portfolio has current yields of 3% or better, which we view as a psychologically important level. And we believe all of these dividends are rather safe.

Earnings Season – Mixed, But For Good Reasons – The Delta variant effects were worse economically than we expected, and got a bit worse as the quarter progressed. It is not clear if outlooks will be better than results, so we expect a mixed earnings season. But the good news is that we appear to have gotten through 'warning season' without a lot of damage, so results may not be that bad. But the bar is high based on last quarter's considerable positive surprises. But the good news is that analysts may have also gotten spooked too. If management blames an 'inflation squeeze', we think our portfolio is well positioned.

Longer Term, Margin Expansion the Story – We see the unprecedented pandemic cost cutting may prove in large part permanent, and that profit margins could widen from both sides**.** Margins are now starting to hit new peaks, and each 100 bp gain in margins could drive 10% upside in the stock market.

Sector Weightings – Biased Toward Value & Inflation - Our 'risk on' changes in our portfolio weightings this year have resulted in increased weightings in Financials, Cyclicals & Energy. We also see Health Care as attractive on a GARP basis. On the flip side, we have lightened up a bit in Consumer, Communications and Growth Tech. We still see good ideas in the latter sectors, but we can't own them all in our concentrated portfolio approach, and prefer our strategy going into year end, in line with our posture that we don't think inflation is transitory. Finally, we have an overriding non-sector specific focus on transformation, merger synergy and management change stories.

3Q Performance Pause - After a very strong first half, the third quarter took a characteristic seasonal pause, further hit by worries about the surging Delta virus. Our portfolio and benchmarks were down slightly for the quarter, though all are still up double digits for the year. Going into the fourth quarter, we think 'hope will spring eternal' with a brighter outlook toward 2022. With persistent inflation, we are further emphasizing our 'barbell' approach, with both inflation-sensitive cyclicals and financials, as well as defensive higher yielding growth names.

Consistently Strong Long-Term Performance - Our longer term strategy continues to be rated 4-Star by Morningstar, Our 3- and 5-year returns are well ahead of our benchmark, and we have lower risk ratios and standard deviations and drawdowns than our peer group.

Dividends Still Capturing Superior Growth – Over the last 60 years, dividends have accounted for one-third of the total market return for the average stock. And compared with the overall market over this period, companies which increased the dividend consistently grew at a 3% faster rate. For 2021 so far, over 60% of our holdings have already increased the dividend, with the remainder expected during the seasonally more prevalent 4Q. Further, our companies have on average raised the dividend nearly 7%, notably higher than the broader market. Recall that last year, the average company in the S&P 500 kept the dividend flat, while our portfolio companies increased the dividend on average over 8%. Further, our CAIM average dividend yield, 3.1%, continues to be more than double that of the S&P yield, which in turn has now dipped below that on the 10-year Treasury bond.

ESG Ratings Well Ahead of Average - It remains our discipline that companies with higher scores in Environmental, Social, & Governance (ESG) standards are front and center in our stock selection process. While the MSCI scoring system addresses most of the risk components, our own qualitative research looks at the active steps companies are taking for good corporate stewardship, which should result in ESG score and/or ratings upgrades. Our portfolio overall has seen score increases over the last year, and overall the vast majority of our holdings have above average ratings.

Focusing on Quality & Long-Term Perspective - We know that getting to our long-term goals in a straight line is not a realistic expectation. But when we combine our long-term focus with our philosophy of owning high quality dividend paying stocks, we believe we are the most set up we can be to weather the bumps along the way.

Wishing you a Safe, Healthy, and Prosperous Fourth Quarter!

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