MASONRY
CAPITAL

**Q3 2023 Masonry All Cap Select Commentary** **October 2023**

*"So as the Federal Reserve raises rates, federal interest expense increases, and the federal deficit widens ironically at a time when deficits were the primary cause of inflation in the first place. It risks being akin to trying to put out a kitchen grease fire with water, which makes intuitive sense but doesn't work as expected."*

Lyn Alden Schwartzer | July 3, 2023, Seeking Alpha article titled 'Fiscal Dominance'

To Our Client Partners:

The MACS composite return year-to-date return was 9.58% through September 30, 2023, and for clients who have the MACS as their primary investment objective their returns should approximate this performance. By comparison the S&P 500 return during the same period was 13.06%.

## Overview of Performance and Positioning

As of September 30, 2023, the MACS strategy had approximately 93% in equity or equity-like securities and approximately 7% in cash and fixed income-like securities. The portfolio's largest positions at the end of the quarter were ConocoPhillips (ticker: COP), Kayne Anderson MLP / Midstream closed-end fund (ticker: KYN) and Everest Re Group (ticker: EG).

For the quarter, the portfolio's largest gainers were Tidewater (ticker: TDW), COP and Liberty Energy (ticker: LBRT). The largest detractors were the investments in Walgreens Boots Alliance (ticker: WBA), Warner Brothers Discovery (ticker: WBD), and Bristol-Myers Squibb Company (ticker: BMY).

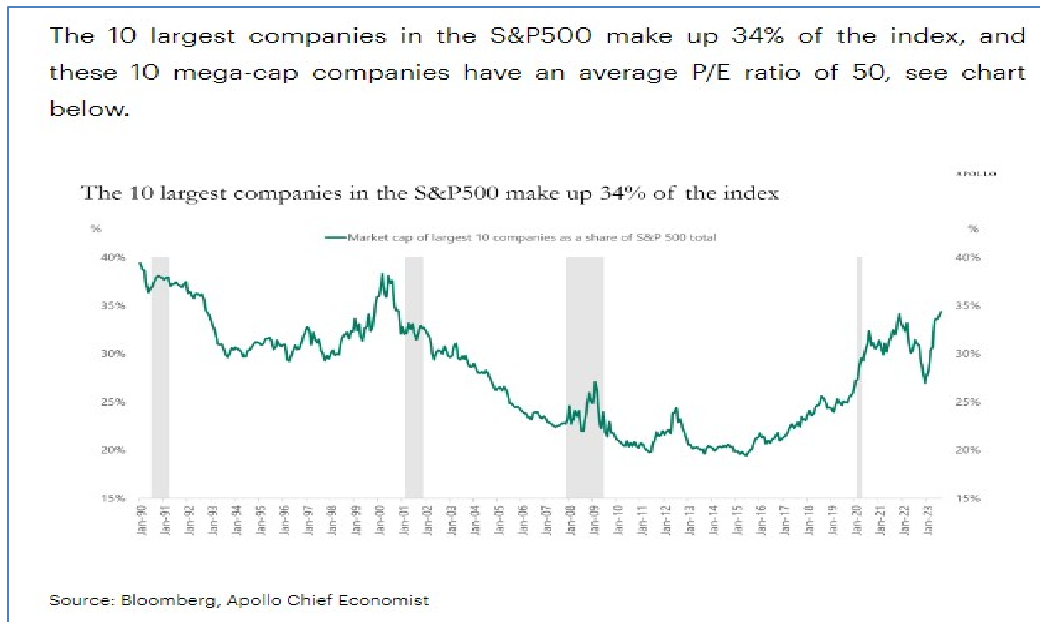
## Market Thoughts and Observations

Many investors are turning toward the complex or complicated during these seemingly uncertain times. The simple truth is there is no escalated reward for investing in the complex versus the easy to understand. At various times in market history there are great investment ideas that are *fairly simple to value* and are supported by underlying economics. However, they may not be *easy to invest in* largely because investors are blinded by what has happened in recent market

history or maybe by a confluence of factors at present (geopolitical, economic, etc.). What follows in the rest of this letter are "simple" concepts and ideas that taken together represent what we think offers compelling sources of value for those willing to look.

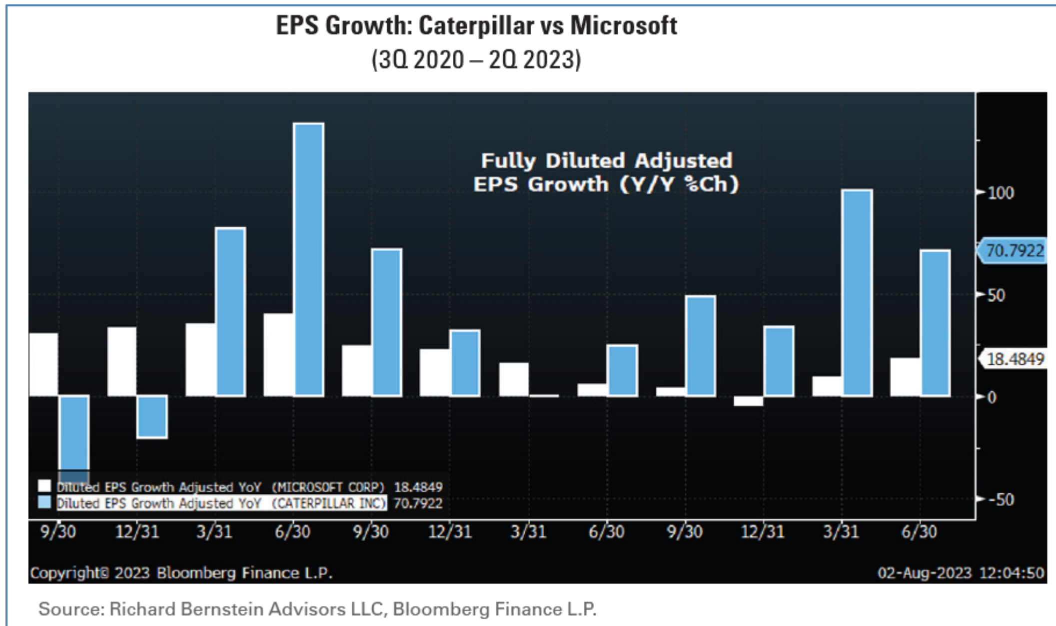
The fact that the S&P 500 is approaching past peaks where the 10 largest companies make up a large percentage of the index **(Chart 1)** doesn't necessarily give us pause. This condition can exist for quite some time. It's the *average* price-to-earnings (P/E) ratio of 50 for these 10 that strikes us. A top-heavy market with way-above-average P/E's should be of concern to any investor heavily invested in the market-weighted S&P 500 or the top 10 components individually. They would be well-served to study what has happened historically once we reach these levels. Hint: it doesn't end well. It's just a matter of time.

**Chart 1**




Richard Bernstein Advisors put out a piece in August titled "Charts for the beach." In it they reference the earnings growth of the Magnificent 7 and ask rhetorically, "Are there really only 7 growth stories in the world?" Caterpillar's earnings per share growth has dwarfed that of Microsoft's since the fall of 2020 **(Chart 2)** yet Microsoft still commands the type of premium valuation that has historically been tied to earnings growth that is far superior to those of other companies.

**Chart 2**



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

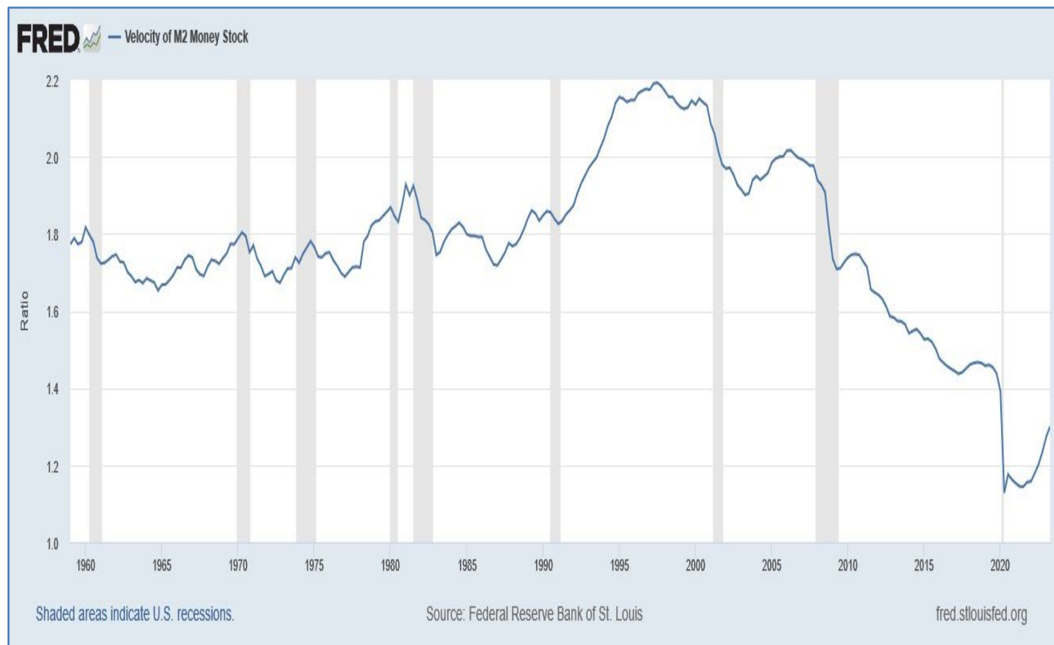
This has manifested itself in investors being crowed on one side of the boat which is characterized by U.S. stocks being valued at an outlier standard deviation (led by growth stocks) versus stocks in the rest of the world. To our delight the other side of the boat has some of the least expensive stocks, both domestically and internationally, and cheapest real asset plays that we have witnessed during our almost thirty years of investing (**Chart 3**).

**Chart 3**

**Source:** BofA Global Investment Strategy, Global Financial Data, Bloomberg
BofA GLOBAL RESEARCH

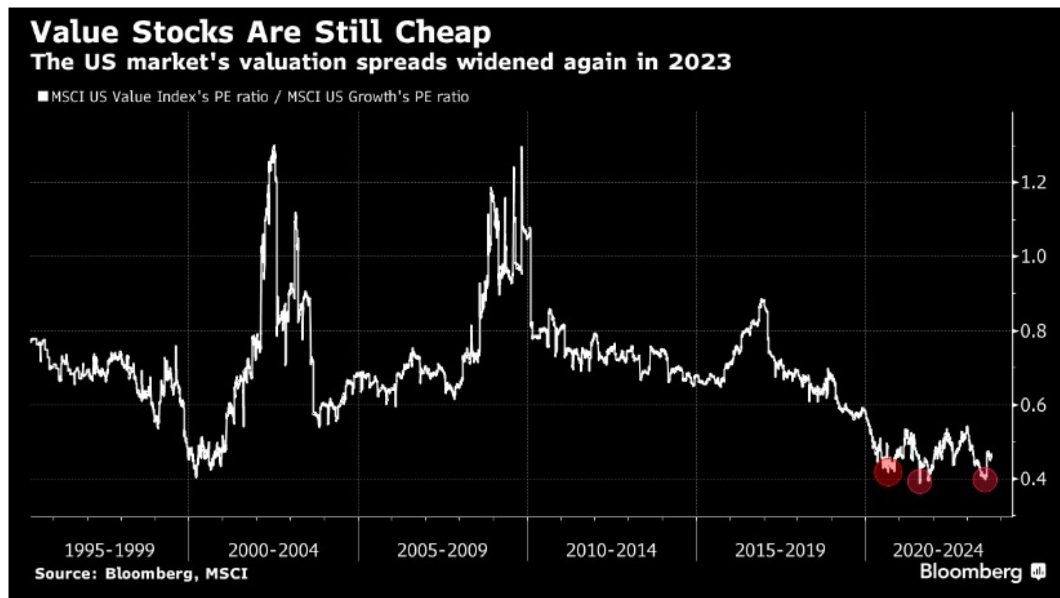
It seems investors are expecting a repeat of the disinflation and declining interest rates of the last 20 years and are positioned as such. **Chart 4** tracks the Velocity of M2 Money Stock. Inflation will not recede for long if the current trend line of velocity remains in place.

**Chart 4**




We have been expressing our view in client and prospect meetings that we, unbelievably to us, have an opportunity at another bite of the apple of extraordinary bargains in the 'Value' bin (**Chart 5).** Times of severe dislocations such as today are rare. In fact, outside of the fall of 2020 (and today!) the next closest period of such extremes in valuation between Value and Growth happened in the early 2000's and culminated with the bursting of the dot com bubble. Lo and behold, we are here again and so soon after the last valuation dislocation. Our performance since November of 2020 has been well-documented by us in our communications to you. ***The MACS Composite has annualized at a net return of just under 24.7% from 10/31/20 – 9/30/23. This is substantially better than the S&P's annualized return of 11.5% and the Nasdaq Composite's annualized return of 7.7% during that same time period***. Yet, through it all, investors at large seem unconvinced that the winds of change are blowing fiercely.

**Chart 5**




Simon White, a Bloomberg macro strategist, encapsulated today's economic and investment environment very succinctly in a piece from July 20, 2023:

> *"Large and persistent fiscal deficits will entrench inflation and decimate the long-term return of stocks and bonds, while reversing the secular underperformance of real assets.*
>
> *Leviathan is back. After the post-GFC (Great Financial Crisis) years of fiscal restraint, governments around the world are running persistently higher deficits. This is a sea change, and it means a markedly different investment environment.*
>
> *The Fed put was a backstop for financial assets. But the Treasury put is a different beast.*
>
> *Assets may be able to post a positive nominal return, but in real terms they are likely to do poorly. Real assets, after 60 years of dreadful underperformance, are poised to finally begin outpacing stocks and bonds."*

Russell Napier of Orlock Advisors, and someone whose opinion we greatly respect, describes the Treasury put (meaning the fiscal authorities are running the show now and not the monetary authorities i.e. the Fed) from a market perspective leading to structurally higher inflation and bond yields, and a secularly weaker dollar. Somewhat counterintuitively, it also means a constructive environment for stocks (at least in nominal terms) due to the reduced risk of severe

recessions. This may speak to the fact that maybe the most widely anticipated recession in history has yet to materialize after so many months of waiting. Last, it means real assets should finally begin to outperform financial assets as seen in **Charts 6 and 7**.

**Chart 6**

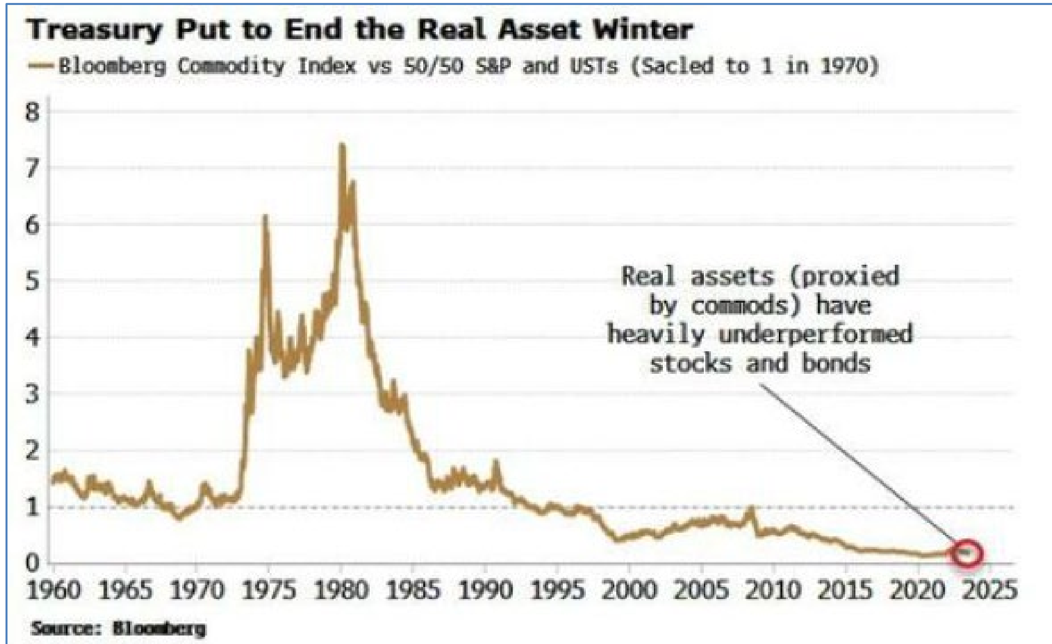



**Chart 7**

The prevalent themes moving forward will be the inability of the Fed to control inflation, other than for short periods of time, because the fiscal authorities are spending at levels never seen before outside of when we are at war. Again, we have a U.S. debt-to-GDP ratio at a level last seen post-WWII and the U.S. is running budget deficits that are getting larger (not shrinking as usual) during a time of economic expansion. History has shown that governments in our current position either inflate away their debt, default, or restructure, and part and parcel with this comes a structural decline in the currency (weaker USD over the longer term). In our view, it is just a matter of time before inflation reasserts itself. When it does, short-duration sectors (energy, utilities, healthcare) and the stocks that make them up will regain investor preference relative to long-duration securities (growth companies).

We are positioned to benefit over the long-term from this new market regime. We do so by approaching each prospective investment as we always have; from a fundamental, bottoms up perspective and we only buy when our estimate of a security's intrinsic value is substantially higher than the share price we are asked to pay. What gives us staying power and conviction in our holdings is our 50,000-foot view. In this regard, we maintain that everything has changed but very few yet realize it.

## Portfolio Highlights

One of the advantages attributed to value investors over the years is the idea of time arbitrage. In essence, a foundational aspect of value investing is to be able to look over the bridge and stay focused on getting to the other side. For investors subjected to the whims of the daily news flow, the imagery is akin to walking across a rope bridge, doubting your safe passage at every step and entertaining the idea of turning back as you become assured you will never make it to the other side. Our belief is that the law of economics and markets will continue to persist just as they have throughout history. For reference, the long-standing Keshwa Chaca bridge of the Incas has existed for over 500 years and is made out of grass! Astute investors don't get easily influenced by the gyrations and swaying of the bridge along the journey. They understand history and are focused on longer-term outcomes. If you have this view, you can tolerate (and profit from) the temporary dislocations that disconnect the intrinsic value of a security from its current price.

We have seen this dynamic play out in our investments in oil and natural gas related stocks. The playbook of the last 20 years has been that if a recession hits, it will dampen demand, the suppliers will be slow to restrain production, and taken together, this will drive the price of oil lower and also the profits of the oil and gas industry. What this view fails to incorporate is that some new plays have been added to the playbook. The 'inevitable' recession that took the MACS Composite down over 15% in June of 2022 never came to pass. We maintained our focus on the longer-term. The economy continued to grow albeit in a lumpy manner, and these stocks soon recovered. The counterpoint to the view that one should focus solely on the demand side is that we believe the most important aspect driving the economics today is actually ***the scarcity of supply.***

A large portion of our investment portfolio is allocated to the supply scarcity theme that spans multiple industries. This is in large part due to shareholder demands for capex constraint as well as the limited ability of companies to add supply even if desired. Higher interest rates only exacerbate this dynamic as it raises the break-even to bring on new capacity.

In an interview with Bloomberg TV, CEO Doug Lawler of shale driller Continental Resources made comments regarding oil prices and the crude output in the Permian Basin that support the supply scarcity dynamic. In sum, Lawler thinks it's highly likely oil will head towards $120 to $150 without the U.S. government encouraging more exploration and production. He also added that one day (we think sooner than later) the Permian Basin will peak as other shale regions in the U.S. have. From what we know, the Permian Basin is virtually solely responsible for any production growth we are seeing in the U.S. This basin alone has become the de factor "swing producer" in the U.S. and once it peaks it will have massive ramifications for oil prices. Last, he reiterated the stance we have heard and read so many times from so many industries but particularly in the oil and gas industry; which is that there is a great desire to be disciplined in bringing on new supply. Lawler said, "To go and invest and being producing as much as we can is not how we generate the greatest value."

The basket of stocks we own subjected to this dynamic are plentiful and include oil and gas producers, oil services, tankers, certain industrial companies, and commodity producers.

## Select Portfolio Details

Star Bulk (ticker: SBLK) is a holding in the special situations portion of the portfolio. It fits squarely in the "supply scarcity" theme we have been espousing. In their corporate presentation from September 30, 2023 (**Chart 8**) they described both the demand and supply for dry bulk commodities and the ships that transport them.

**Chart 8**

**Demand Outlook**

**Demand growth projected to rebound during 2023**

- Healthy demand across all dry bulk commodity groups, resulting in forecast of +2.2% growth in 2023 vs +0.7% in 2022.
- Upgraded coal trade outlook due to increased focus on energy security.
- China economic stimulus focusing on infrastructure and real estate revival post COVID.
- Strong ton mile generation from A) Grain trade recovery B) Brazil iron ore exports and C) Guinea Bauxite to China and D) Atlantic disruptions related to the war

**Supply Outlook**

**Most favorable supply dynamic in decades**

- Fleet growth during 2024-25 is expected to be at its lowest level since 2000 and unlikely to cross 2% per annum.
- Global dry bulk newbuilding orderbook below 8% is at 25+ year lows as a percentage of the global fleet.
- Shipyard capacity covered up to 2025 with more profitable and sophisticated vessel types.
- Increased bunker costs (IMO2020) and new emissions regulations (EEXI/CII) to continuously incentivize slow steaming and limit effective capacity.

Source: Clarkson Research Services Ltd. (Shipping Intelligence Network, database)

Despite this favorable outlook the stock trades at what we believe is an undemanding valuation of less than 6x next year's earnings per share, generates substantial free cash flow at today's shipping rates and has an 8% dividend yield.

### Firm Update

Total assets actively managed were approximately $60 million at the end of Q3 2023. Total assets (discretionary and non-discretionary) were approximately $478 million.

Thank you for your continued confidence and trust and please feel free to contact us with any comments or questions.

Best Regards,

Masonry Capital Management, LLC

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**INVESTMENT PERFORMANCE:**

THE PERFORMANCE REPRESENTATIONS CONTAINED HEREIN ARE NOT REPRESENTATIONS THAT SUCH PERFORMANCE WILL CONTINUE IN THE FUTURE OR THAT ANY INVESTMENT SCENARIO OR PERFORMANCE WILL EVEN BE SIMILAR TO SUCH DESCRIPTION. ANY INVESTMENT DESCRIBED HEREIN IS AN EXAMPLE ONLY AND IS NOT A REPRESENTATION THAT THE SAME OR EVEN SIMILAR INVESTMENT SCENARIOS WILL ARISE IN THE FUTURE OR THAT INVESTMENTS MADE WILL BE PROFITABLE. NO REPRESENTATION IS BEING MADE THAT ANY INVESTMENT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN PRIOR PERFORMANCE RESULTS AND ACTUAL RESULTS ACHIEVED BY A PARTICULAR TRADING PROGRAM.

ANY PERFORMANCE DEPICTED HEREIN IS AUDITED ANNUALLY. PARTIAL YEAR PERFORMANCE IS UNAUDITED. PERFORMANCE SHOWN IS ALSO NET OF ALL FEES AND EXPENSES AND REFLECTS THE REINVESTMENT OF DIVIDENDS AND OTHER EARNINGS. THE FEE STRUCTURE APPLIED TO THE PERFORMANCE WAS THAT OF A TYPICAL INVESTOR: PERFORMANCE SHOWN IS FOR ELIGIBLE INVESTORS PAYING THE STANDARD FEES (AS APPLICABLE). YTD PERFORMANCE ASSUMES AN INVESTMENT HAS BEEN HELD SINCE JANUARY 1, OF THE RELEVANT YEAR. BECAUSE SOME INVESTORS MAY HAVE DIFFERENT FEE ARRANGEMENTS AND DEPENDING UPON THE TIMING OF A SPECIFIC INVESTMENT, NET PERFORMANCE FOR AN INDIVIDUAL INVESTOR MAY VARY FROM THE NET PERFORMANCE STATED HEREIN. ACTUAL RETURNS WILL VARY AMONG INVESTORS. INVESTMENT RETURNS AND THE PRINCIPAL VALUE OF AN INVESTMENT WILL FLUCTUATE AND MAY BE QUITE VOLATILE. IN ADDITION TO EXPOSURE TO ADVERSE MARKET CONDITIONS, INVESTMENTS MAY ALSO BE EXPOSED TO CHANGES IN REGULATIONS, CHANGE IN PROVIDERS OF CAPITAL AND OTHER SERVICE PROVIDERS. INVESTORS RISK THE LOSS OF THEIR ENTIRE INVESTMENT.

MASONRY ALL CAP SELECT (MACS) PERFORMANCE: NO REPRESENTATION IS MADE THAT THE PERFORMANCE SHOWN IS INDICATIVE OF FUTURE PERFORMANCE. AN ACCOUNT COULD INCUR LOSSES AS WELL AS GENERATE GAINS. PERFORMANCE FIGURES FOR EACH ACCOUNT INCLUDE INCOME ACCRUALS, REALIZED AND UNREALIZED GAINS AND LOSSES AND REFLECT THE DAILY WEIGHTING OF CASH FLOWS. ACCOUNTS THAT HAVE THEIR PRIMARY INVESTMENT OBJECTIVE AS THE MACS STRATEGY ARE INCLUDED IN THE PERFORMANCE PRESENTED AND ARE NET OF ACTUAL INVESTMENT FEES, NET OF TRANSACTION COSTS AND INCLUDES THE REINVESTMENT OF ALL INCOME. NET OF FEE PERFORMANCE WAS CALCULATED USING THE ACTUAL ANNUAL FIXED MANAGEMENT FEES OF THE CLIENTS IN THE STRATEGY APPLIED MONTHLY USING THE TIME WEIGHTED RATE OF RETURN METHODOLOGY. TRADE

DATE ACCOUNTING IS USED FOR CALCULATION AND VALUATION PURPOSES. SECURITIES ARE VALUED DAILY USING CLOSING MARKET VALUES. PERFORMANCE IS PRESENTED IN US DOLLARS.

PERFORMANCE RESULTS ARE NOT GIPS COMPLIANT.

PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.

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REFERENCE TO THE S&P 500 AND OTHER INDICES IS FOR COMPARATIVE PURPOSES ONLY. THE S&P 500 IS AN UNMANAGED CAPITALIZATION-WEIGHTED INDEX OF 500 STOCKS, DESIGNED TO MEASURE PERFORMANCE OF THE BROAD DOMESTIC ECONOMY THROUGH CHANGES IN THE AGGREGATE MARKET VALUE OF 500 STOCKS REPRESENTING ALL MAJOR INDUSTRIES. THE INDEX TRACKS THE CAPITAL GAINS OF THE STOCKS OVER TIME, ASSUMING THAT ANY CASH DISTRIBUTIONS, SUCH AS DIVIDENDS, ARE REINVESTED BACK INTO THE INDEX AND IS NOT AVAILABLE FOR DIRECT INVESTMENT. THE S&P 500 MAY BE MORE DIVERSIFIED THAN AN ACCOUNT MANAGED BY MASONRY CAPITAL MANAGEMENT AND MAY NOT REPRESENT AN APPROPRIATE BENCHMARK. HOLDINGS MAY VARY SIGNIFICANTLY FROM THE SECURITIES THAT COMPRISE THE S&P 500. PAST PERFORMANCE OF THE INDEX SHOULD NOT BE CONSTRUED AS AN INDICATOR OF FUTURE PERFORMANCE OF THE FUND OR YOUR ACCOUNT.

HFRI INDICES ARE BROADLY CONSTRUCTED AND DESIGNED TO CAPTURE THE BREADTH OF HEDGE FUND PERFORMANCE ACROSS ALL STRATEGIES AND REGIONS. PAST PERFORMANCE OF AN INDEX SHOULD NOT BE CONSTRUED AS AN INDICATOR OF FUTURE PERFORMANCE OF AN ACCOUNT.

HEDGE FUNDS TRADE IN DIVERSE COMPLEX STRATEGIES THAT ARE AFFECTED IN DIFFERENT WAYS AND AT DIFFERENT TIMES BY CHANGING MARKET CONDITIONS. STRATEGIES MAY, AT TIMES, BE OUT OF MARKET FAVOR FOR CONSIDERABLE PERIODS WITH ADVERSE CONSEQUENCES.

THE MSCI EMERGING MARKETS INDEX CAPTURES LARGE AND MIDCAP REPRESENTATION ACROSS 21 EMERGING MARKETS COUNTRIES. WITH 824 CONSTITUENTS, THE INDEX COVERS APPROXIMATELY 85% OF THE FREE FLOAT-ADJUSTED MARKET CAPITALIZATION IN EACH COUNTRY.

THE DOW JONES – UBS COMMODITY INDEX IS DESIGNED TO BE A HIGHLY LIQUID AND DIVERSIFIED BENCHMARK FOR COMMODITIES AS AN ASSET CLASS. THE INDEX IS COMPOSED OF FUTURES CONTRACTS ON 19 PHYSICAL COMMODITIES. NO RELATED GROUP OF COMMODITIES (E.G., ENERGY, PRECIOUS METALS, LIVESTOCK, AND GRAINS) MAY CONSTITUTE MORE THAN 33% OF THE INDEX AS OF THE ANNUAL RE-WEIGHTINGS OF THE COMPONENTS. NO SINGLE COMMODITY MAY CONSTITUTE LESS THAN 2% OF THE INDEX.

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CRUDE OIL IS THE WORLD'S MOST ACTIVELY TRADED COMMODITY, AND THE NYMEX DIVISION LIGHT, SWEET CRUDE OIL FUTURES CONTRACT IS THE WORLD'S MOST LIQUID FORUM FOR CRUDE OIL TRADING, AS WELL AS THE WORLD'S LARGEST-VOLUME FUTURES CONTRACT TRADING ON A PHYSICAL COMMODITY.

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