JAG CAPITAL MANAGEMENT LLC

# Quarterly Comments

## Ch-ch-ch-changes

**"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction.**

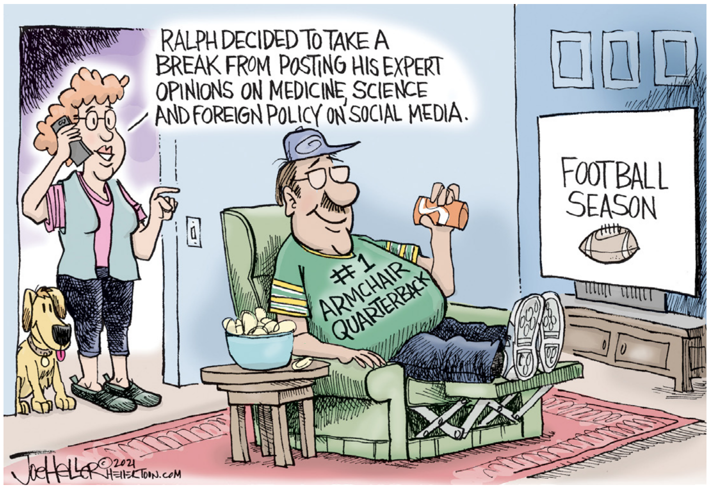
– Bill Gates, "The Road Ahead," 1996

This observation by Bill Gates — the founder of Microsoft turned full-time philanthropist — has long been one of our favorites. It accurately captures our human tendency to overestimate the pace of progress in the short run, while failing to anticipate altogether the exponential compounding of advances that will occur long-term. Consider that all the below now-ubiquitous products, services, and brands were either unknown or in their infancy a decade ago:

| Company/Product | Date Founded |
|---|---|
| Pinterest | 2009 |
| Uber | 2009 |
| Venmo (owned by PayPal) | 2009 |
| Instagram (owned by Facebook) | 2010 |
| Apple iPad | 2011 |
| Snapchat | 2011 |
| Zoom | 2011 |
| Lyft | 2012 |
| Robinhood | 2013 |
| TikTok | 2016 |

Source: Company documents

Ironically, our unprecedented collective experience with COVID-19 challenges the first part of Gates' hypothesis. Contrary to our normal history, we would argue that the global battle against COVID-19 accelerated the pace of change in society and the economy over the past 18-24 months. This implies that most of us underestimated the pace of change that would occur between early 2020 and today. To cite just one example, who among us could have anticipated in 2019 that in-person business meetings would almost entirely give way to Zoom by early 2020? Or that digital payment services like Venmo would become essential everyday tools for many of us? Or that social media platforms — for better or worse — supplanted more traditional methods of keeping up with our friends and families? Some observers, including JAG, believe that the COVID-19 crisis compressed as much as a decade of future technological progress into the space of a little over a year. Meanwhile, as long-term investors we are tasked with discerning the difference between transitory and durable progress in the markets. The former grouping can represent some risk, while the latter can present some opportunities. The distinction between the two is not always so clean cut.




Source: Hellertoon.com

### Firm Highlights

- **Welcome Kate!** Kate Hurt has joined JAG as Senior Vice President of Operations. Kate will work closely with JAG's CEO and senior leadership to drive continued operational excellence throughout our firm.
- **JAG's new website will launch in early November.** Please explore all the new information, enjoy the beautiful images, and share with your friends.

Over the past year, we have witnessed several examples of risks masquerading as opportunities. As we have discussed in previous Commentaries, the sudden onset of COVID-19 lockdowns and restrictions last year was quickly met with an enormous array of fiscal and monetary responses. An epic rally in risk assets ensued, as investors large and small took advantage of bargain prices created by the short but violent early 2020 bear market. In a story as old as financial markets, an abundance of shorter-term gains caused some market participants to conflate their investment acumen with the salutary effects of a bull market. The emergence last year of so-called "meme stocks" — in which loosely-organized groups of individual investors piled into stocks of challenged companies — was one example of this phenomenon. Another example was highlighted in our 4th Quarter 2020 Commentary, in which we expressed a cautious view of the then-booming SPAC (Special Purpose Acquisition Company) craze. Ultimately, per Bloomberg and CNBC reporting[1], more than $150 billion (about $460 per person in the US) was raised to fund hundreds of these "blank check companies" during the past 18 months, many of which were launched to pursue exciting but unproven projects like space exploration, electric vehicles, sports gambling, and new battery technologies. The SPAC frenzy continued into the first quarter of 2021 but has petered out in the second and third quarters because of poor investment returns and some high-profile Securities and Exchange Commission investigations into companies that appear to have misrepresented their technologies and capabilities.

We see more durable opportunities for investors in the Health Care sector. The truly sad news is that the COVID-19 pandemic exposed major flaws in the public health infrastructure in the US and worldwide. Across the board, government leaders were faced with the realization they lacked adequate supplies, personnel, and processes essential to respond to a large-scale public health emergency. In hindsight, the speed and scale of the socioeconomic devastation wrought by the virus contributed to its severity. The potentially good news is that chastened global leaders are working to address the gaps that were exposed by the pandemic. The US recently unveiled a five-pillar plan focused on modernizing public health infrastructure to effectively prevent, respond to, and contain future biological threats. Preliminary budgets call for $65B of investments to be made over a seven- to 10-year period. Within weeks of the US announcement, the European Commission laid out its own roadmap for building a stronger more connected ecosystem for responding to public health crises. This is human history exemplified, where crises tend to accelerate social, ecological, economic, and political change positively (and at times negatively).


Source: Cagle Cartoons.com

JAG believes that public policy health initiatives will attract widespread support and significant funding, thereby creating attractive investment opportunities for long-term investors. Of particular interest are situations in which pro-business policies overlap with independent but related trends that are already providing tailwinds to a particular segment of the market, or where the priorities of regulators and health care companies are in concert.

We are watching several favorable themes that are likely to gain momentum in the coming years:

- Strengthening of supply chains for vaccines, diagnostics, and personal protective equipment (PPE)
- Establishing surveillance capabilities to identify and respond to emerging public health threats
- Promoting cutting-edge research focused on monoclonal antibodies, mRNA, and other next generation medicines
- Streamlining and simplifying the regulatory framework that guides the health care system
- Creating incentives that promote health equity and reduce disproportionate burdens on under-served populations
- Adopting modern technologies and standards that simplify data collection, accessibility, and sharing of critical data among stakeholders

1. Source: Source for 2020 and 21Q1 SPAC data: https://www.cnbc.com/2021/06/02/a-spac-frenzy-this-year-could-lead-to-riskier-deals-heres-why.html
Source for 21Q2 SPAC data: https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-spac-frenzy-cools-in-q2-relinquishing-ipo-lead
Source for 21Q3 SPAC data: https://files.pitchbook.com/website/files/pdf/PitchBook_Analyst_Note_Uncertainty_Clouds_Future_for_SPACs.pdf

## Market Outlook

**"People have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts. It happens over and over and over."**

– Charlie Munger, Vice Chairman, Berkshire Hathaway Inc.

**"The trick is not to predict an unknowable future, but to try to understand the present, and the probabilities of the various paths that may evolve from it."**

– Bill Miller, Chairman & Chief Investment Officer, Miller Value Partners

Clients often ask us for our opinions on the future. Unlike many of our industry peers, we recognize the folly of professing false confidence and unjustified certainty about what will happen in the markets next week, next month, or next year. As professionals who seek to help our clients achieve their long-term goals, we share our informed observations about risk and return probabilities rather than postulating on future index levels, yields, or commodity prices. Uncertainty — which drives asset price volatility of all types — is a "feature, not a bug" of modern financial markets. Without uncertainty and its resulting price volatility, investment opportunities that earn higher returns than cash equivalents would literally not exist. Indeed, much of JAG's investment discipline and process has been developed over the years to allow us to journey comfortably and confidently into the unknowable future.

In that context, we remain cautiously optimistic as we begin to look forward into 2022. As always, investors have many risks to consider. We have addressed some of the key risks we and others have identified below. Alongside each, we have detailed some counterpoints and potential opportunities.

### Point 1 - Asset Valualtions - Key Risks/Cautionary Datapoints

Asset valuations are historically high, which potentially reduces the attractiveness of both stocks and bonds. As of 9/30/2021 and per Standard & Poor's estimates, the S&P 500 traded at roughly 22x estimated 2022 earnings per share. Bonds are also expensive, with the benchmark US 10-year US Treasury (as published by the Treasury Department) offering a meager yield of approximately 1.5% (equivalent to 67x earnings). While valuation is far from a perfect predictor of future returns, there is no question that the best historical investment returns have typically occurred after periods of very low valuations (for stocks) or high yields (for bonds). The huge bull markets that arrived in the wake of "generational lows" plumbed by the stock market in 2009 and 1982 stand as historic examples of this. Similarly, the still-ongoing 40+ year bull market in bonds was birthed during the high-teens percentage interest rates of the late 1970s and early 1980s.

### Counter Points/Opportunities

Investors have long been forced to steward their assets using relative rather than absolute valuations. Risk-free assets like cash and short-term bonds are much less volatile than stocks in the short run. But today these historically low volatility assets offer exceptionally small long-term returns. Any investment portfolio that fails to at least keep pace with inflation will erode purchasing power. A carefully selected, well managed, and reasonably diversified portfolio of stocks continues to offer high odds of maintaining purchasing power and growing wealth in the coming decades.

### Point 2 - Stocks - Key Risks/Cautionary Datapoints

Stocks have appreciated significantly over the past decade. In general, periods of higher-than-normal returns tend to be followed by periods of lower-than-normal returns. Using data from Bloomberg, FactSet, and Morningstar, the S&P 500's annualized return of 16.64% in the ten years ending 9/30/2021 ranks in the top 15% of rolling 10-year returns for the index since 1935. Based upon history, it is unlikely that the S&P will be able to match this in the coming decade.

### Counter Points/Opportunities

This type of historical analysis hinges upon the starting point one chooses. Using the same sources listed above, note that the S&P 500's annualized return of 9.51% over the last 20 years has been solid but not spectacular and ranks in the bottom 50% of all 20-year time periods. After similar such 20-year periods in the past, the S&P has averaged double-digit returns in the subsequent five years.

### Point 3 - Corporate Earnings - Key Risks/Cautionary Datapoints

Corporate earnings and profit margins have been very robust in recent years. It is possible that the corporate sector will not be able to live up to lofty expectations in 2022 and beyond.

### Counter Points/Opportunities

Certain sectors and many companies may not be able to maintain the halcyon growth they experienced during the post-COVID-19 recovery. But if history is any guide, others will continue to thrive. This emphasizes the need to apply a disciplined and selective investment process.

### Point 4 - Geopolitical - Key Risks/Cautionary Datapoints

Geopolitical risks appear to be growing rather than shrinking. China is the world's 2nd largest economy, and its central government has recently embraced a distinctly market-unfriendly tone. Meanwhile, a more-assertive President Xi appears to be rattling sabers in the direction of Taiwan, a US ally.

### Counter Points/Opportunities

Geopolitical risks have been investors' constant companions for more than 200 years. Sometimes these risks materialize in the form of terrible conflicts, but more often tragedy is averted. While we are far from experts in Sino-American relations, we know that global actors have a myriad of reasons to escalate and de-escalate relations for internal and external reasons. Given the ongoing interdependence of Chinese and American economic interests, we believe the probability of conflict remains low.

### Point 5 - Corporate & Individual Tax Rates - Key Risks/ Cautionary Datapoints

Corporate and individual tax rates in the US appear to be poised to move higher, which could dampen investor sentiment and potentially crimp demand for equities.

### Counter Points/Opportunities

Tax policy is a near-constant source of partisan bickering in the US. Although investors tend to fear higher tax rates, historically the capital markets have successfully digested tax changes, once implemented. Indeed, some of the best and most enduring bull markets occurred during the extremely high tax rate regimes of the 1950s and early 1960s.

### Point 6 - Inflation - Key Risks/Cautionary Datapoints

Inflation will accelerate and diminish portfolio returns and purchasing power, and will slow down the American economic engine.

### Counter Points/Opportunities

Without knowing the future level of inflation, we do know that companies who command pricing power for high-quality goods and services stand well-positioned to weather all types of inflation regimes. These types of "price maker" companies are exactly the kind of investments we look for every day.

### Point 7 - Environmental Change - Key Risks/Cautionary Datapoints

Environmental change threatens to radically alter the global socio-economic order.

### Counter Points/Opportunities

While environmental threats are real, so is the power of corporations and policy makers to innovate solutions to address them now and in the decades to come.

We at JAG remain hard at work to position clients' portfolios for long-term success. Our responsibility is to successfully navigate all sorts of markets and develop the strongest investment ideas that can survive and thrive in the future.

Warm regards,

**Norm Conley**
CEO, Chief Investment Officer &
Portfolio Manager

**Mike Kimbarovsky**
Managing Director &
Portfolio Manager

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JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm with offices in St. Louis and Chicago.

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