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January 1, 2022

Dear Fellow Investors,

We've outlined the major topics & takeaways of our annual letter below – details follow!

MAIN MESSAGE HIGHLIGHTS:

- Sometimes there's just not much new to say
- 2022 – settling into uncertainty
- Importance of exponential thinking
- Preparing for the future – what ESG is all about

FORECASTS

- **Economy:** solid growth with GDP eclipsing $24 trillion
- **S&P 500:** earnings growth drives appreciation, S&P 500 5,060 by year-end
- **Short-term rates**: one or two hikes in 2022
- **Long-term rates**: 10 year near 2.5% by year-end
- **Oil prices**: sustainable energy impacts demand but OPEC countries try to maintain $80/barrel
- **Inflation**: pace slows with change approaching 4% by year-end
- **Commercial real estate**: slightly positive year for the REIT index, we prefer the same sectors, rising rates a potential headwind on valuations
- **Residential real estate**: people follow employment opportunities especially when it means areas with nice weather and favorable tax policy. Rest of the country catches up relative to top

Two more forecasts not entirely investment related:

- NFTs bring blockchain to the masses
- Widespread innovation in ag gains momentum

CONCLUSION

Not as much to say this year, but that's a good thing. We could all use a breather!

Not much new

Our main messages of prior years have discussed behavioral finance, historical market moves, info on how bad the last decade and a half has been, and last year's novel, *Welcome to the Roaring 2.0's*. As long-term investors these messages are centered on our long-term thoughts. Ideally, our beliefs and outlooks hold true for years, not months. With that said, we struggled with what to say without sounding like a broken record. We've talked about market volatility and the need to invest in where the future is headed. We've covered those topics in some way, shape or form every year for more than a decade. At this point our stance is pretty clear. Volatility is part of investing. Investing in stocks is risky in the short-term, but *not* investing in stocks is risky in the long-term. Further, financial media is exceptionally thorough. They have the news of the day covered. We don't feel we add much value in providing another opinion on a recent Fed decision or economic release, not because we don't feel it is important, but because we're focused on what is beyond it.

As long-term investors we are looking for companies that are exceptional at creating value. Companies that do something so well, that the world is a better place because of them. We strive for our commentary to provide value. We want to introduce you to new information or a perspective you might not have considered or believed to be material at first glance. We know you're making a time commitment when you read our commentary, and we don't take that lightly. We want it to be worth it. Last year's novel was a massive time commitment and we thank you for your commitment. This year's will be shorter, but the fact that we have far less to say is probably significant. The past two years have uprooted virtually every aspect of life, so perhaps this coming year will feel less disrupted.

2022 – Settling into Uncertainty

In saying this, please note we do not want to come off as making light of COVID. We're merely trying to acknowledge some of the feelings we've all experienced as everyone has made sacrifices. It's hard to believe we're nearly two full years removed from the initial shock of COVID. Not sure about you, but for us, feeling settled and enjoying some familiar routines has been a challenge. Take school as an example. Last week was the first time my daughter played in her annual winter band performance since December 2019! An event that all the kids eagerly anticipate, one that has come to define a significant part of their young lives, has been missing. Band instructors were literally in tears this year, overjoyed by performing in front of a packed house once again. I'm sure every one of those instructors is filled with glee at the thought of never having to orchestrate another band performance via Zoom.

Even familiar past-times haven't seemed so familiar. For many, sports represents a miniature escape from the daily grind. The leagues certainly tried, yet, it was rather eerie to watch your favorite team play in an empty arena or stadium. Likewise, going out to eat has been different. While it's incredible to see bustling restaurants there's just something odd about wearing a mask while you walk to your table, taking it off while you eat, talk, and laugh, but then converse with your server who's fully masked up.

It's kind of like we've been in that episode of Full House where the Tanner girls have put a hole in the wall of Dad's bedroom. They quickly patch it up and then move every bit of furniture a few inches to the

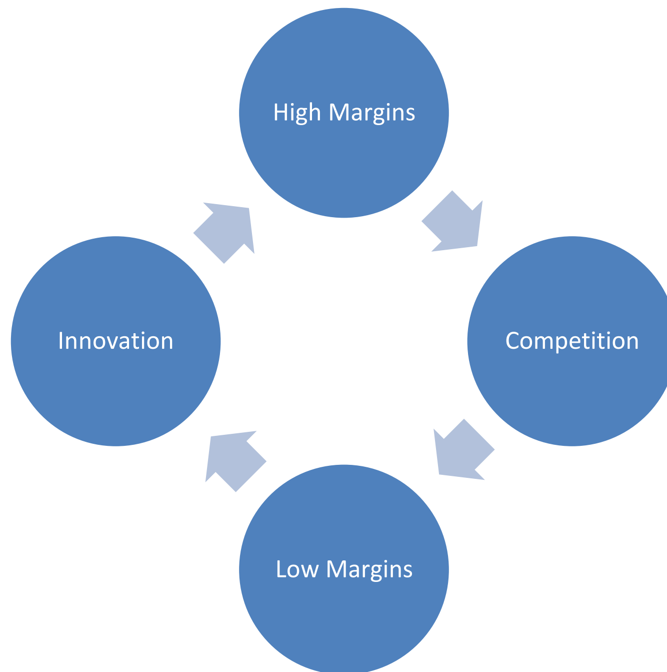
right to cover their work. Being the Danny Tanner that brings his "Agenda of Fun" on vacation, his after-work routine is consistent and precise. After the famous "He's our Dad" song, Danny proceeds to take off his coat, completely missing his rack, then dropping his wallet on top of his dresser, once again hitting nothing but air. He proclaims, "guess I'm a little off today". If you've been feeling a little off, rest assured, we know that feeling too. Things have been off for a while now. Fortunately, we see several signs that could have us all feeling much more settled in 2022.

- **COVID being recognized as an endemic** – many in the medical community are now clear in saying COVID will be an endemic. Researchers note, while Omicron is the latest variant seen to date, it will almost certainly not be the last. COVID will routinely evolve and be part of our daily life. At this point, we're all familiar with the vaccines available, alternatives available, and the risks if you don't want to use them. This risk of COVID is here to stay. However, we must keep in mind that we all deal with risks everyday. There is actually an incredible amount of risk when we hop in our cars and make our daily commutes. We do our best to mitigate the chance of injury and death with innovations like seatbelts, anti-lock brakes, and airbags, but there are approximately 6 million accidents and 35,000 deaths in the US every year. In spite of these risks, most of us don't think twice before getting behind the wheel. The risk has become part of our daily life and we all assume it. Eventually, we believe COVID will be viewed in this light, here to stay, and something we will continually have to deal with.

- **Odds of widespread lockdowns seem remote -** Modern society breaks when we're not open. As we've largely transitioned into a service economy, many of us are unfamiliar with the complexity of what it takes to make stuff. Recent shortages of everything from toilet paper to cream cheese has shined light on just how valuable and important these complex systems are to our modern world. Further, to now be two years into COVID and still be seeing large inefficiencies should serve as incredible proof to elected officials that the economy is not a light switch. Once you flick things off, they don't come back that quickly.

- **Getting back to work** – We currently have over 10 million unfilled jobs in this country. We see a couple of factors in play here. Number one is that temporary support programs have expired and people will eventually need to get back to work. However, with many of these unfilled jobs being at the lower end of the pay scale, we envision wages rising to compensate for the work. This is not a bad thing as the real federal minimum wage in the US is the same in 2015 as it was in 1950! However, we also envision many of these jobs will permanently be lost to automation. Companies are in great financial shape and investing CapEx to future proof their business operations will be top of mind.

- **Forced to compete** – competition creates efficiency. High margins draw increased competition. Increased competition leads to lower margins. Lower margins causes companies to innovate. New innovation leads back to high margins. And the cycle repeats, repeats, and repeats.



There is a great chart comparing the price of goods in competitive markets (TVs, cellphone service, software) vs. more regulated markets like college education and healthcare. A lack of competition leads to complacency. Fortunately, COVID highlighted just how productive some things can be done from anywhere with an internet connection. This is why we've seen companies forced to offer remote employment to compete for top talent and new geographic hubs like Austin, TX and Miami, FL see such an influx of people. Whether you're a company, city, or country, if you're stuck in prior ways and not willing to change, the risk of being left behind is greater than ever.

- **Extreme policy change looks more and more unlikely** – we wrote last year America had heard many of the concerns from a more socialist agenda but had largely voted against it. We believe the lack of universal party support for the Build Back Better plan proves this is still the case. At a time when inefficiencies are still abound, costs growing faster than any point in the past three decades, and 10 million unfilled jobs, many are questioning if now is the best time to drastically raise taxes and take on more debt. We do believe general consensus wants an upgrade to physical infrastructure like roads, bridges, and airports but also is not in favor of significantly raising taxes to cover items like community college for all or free child care for 3 and 4 year olds. Negotiations continue, but we believe if anything is passed, it will be far less costly than initially proposed.

We are honestly a bit surprised that disruptions have taken this long to correct. It is crazy to us to still see 50 plus containerships floating offshore waiting for their chance to unload. Some issues we're still facing seem rather easy to solve. We're not alone in this thinking and you now have a great deal of brainpower dedicated to fixing these problems which is why we have confidence in thinking 2022 could feel much more settled. This inherent desire to solve problems is what makes us so unique and why

investing is such a wonderful thing. Today's problem solvers are hard at work, thinking big, and coming up with solutions. We too need to embrace this thought process.

THINKING EXPONENTIALLY

In Thomas Phelps' book 100 to 1 in the Stock Market there is a great quote about thinking big: "To make money in stocks you must have the vision to see them, the courage to buy them and the patience to hold them. Patience is the rarest of the three."

What if I told you there is an investment that has returned 1,745% over 30 years. Would you jump at the opportunity? What if I told you there is an investment that has returned 11,740% over a lifetime (50 years). You might expect evening news stories highlighting stampedes as people battle it out to sign up for such life-changing returns. Unfortunately, this isn't the case. Instead, a surprisingly high amount of people view this investment as too dangerous and liken it to gambling. Knowing how much we value long-term research, you're probably not surprised to hear that these incredible 30 and 50 year returns are nothing more than compounding at the stock market's average annual return of 10%. Not quite as impressive when stated this way.

Source: internal calculations and historical data from Factset

Humans struggle to comprehend exponential growth which is why we typically bring returns to an annualized format. We're really good about comprehending years. We celebrate annual milestones like birthdays and anniversaries and enjoy planning annual vacations. Our kids progress through a numbered grade each year. When it comes to long-term investing, this annualizing of returns is rather meaningless and often a disservice for understanding the magnitude of what is possible. We propose a different paradigm through which to think about your investments. Instead of focusing on whether a company or portfolio had a good or bad year, perhaps investors should focus their resources on trying to invest in businesses that can produce positive, exceptional results for the greatest amount of time. When it comes to investing, being average for a long time can lead to quite impressive results. Likewise, being above average for a long time can produce results that seem magical.

In our opinion, the opportunity for these results is as strong as ever. This ties into our Muck and Up message as well as our Roaring 2.0's message. Let's not get distracted by short-term noise. There are ample opportunities to find these compounding machines. The sooner you start your compounding journey, the better off you'll be.

ESG AND ITS ROLE IN THE FUTURE OF INVESTING

I recently completed CFA Institute's Certificate in ESG Investing program. Some may not be familiar with what ESG means. You can think of it as an approach to managing money where investors explicitly acknowledge the relevance of Environmental, Social, & Governance factors in their investment decisions.

- Environmental factors - items pertaining to the natural world. Includes climate change, pressures on natural resource use including water, land, forests, oceans, biological diversity, pollution and waste.

- Social factors – affect the lives of humans. Includes the management of human resources, health and safety, human rights, labor rights, living wages, communities, and clients.

- Governance factors - affect broader stakeholder groups. The process and structure for overseeing the business and management of a company. This really applies to a board of directors tasked with representing owners of a business and holding management of that business accountable. Includes shareholder rights, executive pay, audit practices, board independence & expertise, and transparency.

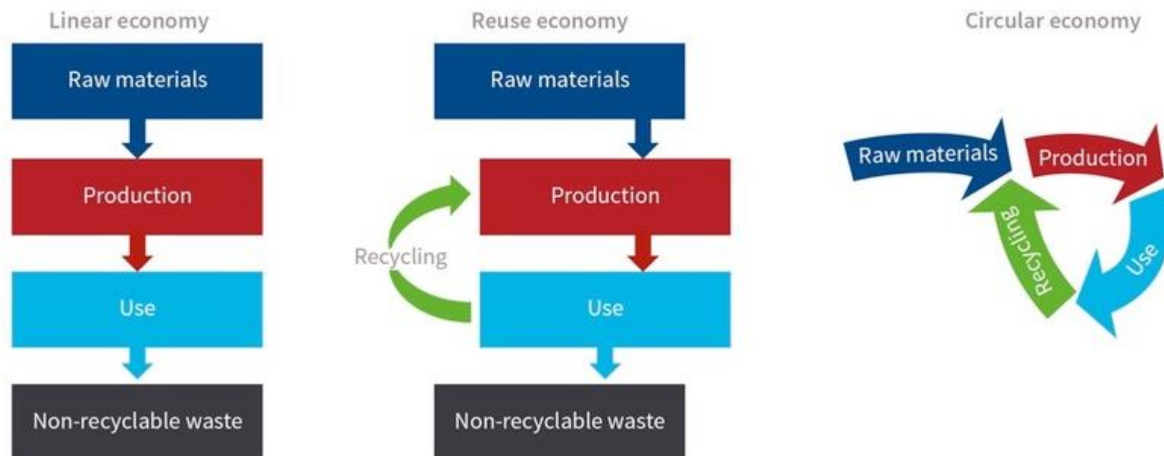
Some of you might be thinking that a lot of this isn't really new. After all, investing in a "responsible" manner dates back as far as investing itself. In the 17th and 18th centuries the Quakers and Methodists laid out guidelines for their followers on how to invest. Negative screening, such as excluding tobacco, alcohol, or pornography companies has been used for decades. While true, what is relatively new is that modern "responsible" investing has the expectation that shareholders will be involved in a far more active manner and that investment decisions won't merely exclude "bad" industries, but instead seek out those companies doing the absolute best for people, the planet, and maximizing long-term profit. This modern focus on investing is similar to what we discussed last year in that capitalism is going through a reboot, with a newly refreshed vision for what the purpose of a corporation is: *"Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."*

The direction is exceptionally clear at this point. Large asset owners like foundations, pension plans, endowments, sovereign wealth funds, family offices, and insurance companies are setting the tone for the entire investment value chain. Their perspective that ESG factors do indeed influence risk and return sets the stage for how their capital impacts the real economy. As asset owners with long-term liabilities (like pension funds) these institutions are establishing long-term investment mandates that place value on projects that may require years of research and development and patient capital to develop. We'll give a few examples of what these long-term risks and opportunities look like.

Long-term opportunity – companies that can contribute to the Circular Economy. This economic model aims to avoid waste and preserve the value of resources like raw materials, energy, and water for as long as possible. It is based on three main principles:

- Design out waste and pollution
- Keep products and materials in use
- Regenerate natural systems

This is an evolution of how we've operated in the past. Traditionally, we've had a linear economy. For many of our processes, we've now reached a reuse economy. However, a circular economy is ideal:



Source: CFA Institute

It takes a great deal of knowledge to get a system to this point, but in many industries, we are approaching this. If you want to see how one of the largest companies in the world is thinking about this, take a look at Apple's most recent environmental progress report.

Long-term risks – Systemic impacts on our financial system. Investors, central banks and policymakers have become increasingly aware of implications for the financial sector through two main types of risks - physical and transition:

- **Physical risks** - arise from damage to property, infrastructure, and land. If we do see a continued climb in global temperatures resulting in rising sea levels we might not want to own companies with assets like office buildings right next to oceans. Further, we may want to reconsider investing in or altering our valuation for a property and casualty insurance company with heavy geographic exposure to coastal areas.

- **Transition risks** - results from changes in policy, technology, and consumer and market sentiment. If policy setters determine that we need a universal price for carbon, we might not want to own companies with high carbon output that will now have to show this in financial disclosures as a quantifiable expense in their operations. Further, we may be willing to pay a premium valuation for a company that we believe has a business model set up to deal with this future risk, while discounting a competitor unwilling to adapt to where the future is going.

Of course these aren't all the opportunities or risks we could cover. We merely want to provide a sense of what's coming with respect to the direction of our industry and what we believe we need to be prepared for when it comes to managing assets for the long-term. Companies will absolutely be expected to provide greater transparency in regards to environmental impact and their long-term plans.

We will have new data available to analyze items such as a company's intensity of water use. We will be able to quantify a company's carbon output and further, apply it across an entire portfolio. This new information will allow for an entirely new lens around which to view risk / reward trade-offs. The program gives a thorough framework for which to work these beliefs into a firm's analysis and investment philosophy. At the end of the day, this ESG focus is largely how we've always thought about investing. We prefer to own companies with well-defined strategies, great management, and desirable products or services that are better for the consumer and the world at large.

FORECASTS

This is the section of the annual letter where we discuss forecasts made in the past and discuss the bullets on the opening page of this annual letter. As we do every year, we remind ourselves it's a foolish section where we think we can actually make forecasts for the future! We had nine of eleven possible forecasts correct last year which is a great year as far as forecasting goes! We enjoy using "What If" in our thought process as it allows for outside-the-box thinking and challenges our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter in mid-December. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the then current investment environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we have been dealt.

We reiterate, our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2021's annual letter and make some new and bold (and perhaps foolish given our long-term perspective) forecasts for 2022.

The Economy:

Last year we switched to looking at the economy on dollars of output rather than percentage comparisons as the drastic measures initially used to try and combat COVID have led to some wild and misleading results. **We forecast that by the end of the 3rd quarter, the economy would be producing at least $19.4 trillion in output. This will be the first quarter in which we will surpass the economic output of 2019.** The reality was that US GDP came in at $23.2 trillion in 3rd quarter 2021, surpassing 3rd quarter 2019's $21.5 trillion, and well above 3rd quarter 2020's depressed $21.1 trillion. If you just looked at year over year percentage change you would see nearly 10% growth for 2021. Comparing percentage change to pre-COVID levels gives a more reasonable 3.6% two year growth rate illustrating why we've shifted our focus to dollars of output and also how time helps smooth wide gyrations in annual growth figures. **Full point for this forecast.**

Source: Factset

With entrepreneurship, innovation, and risk-taking all engrained in the American spirit, we believe there is ample long-term opportunity for economic growth. However, there are a few potential headwinds that could impact near-term economic growth:

- **Inflation** - Persistent inflation is a significant threat to economic growth. Once the inflation genie has been let out of the bottle it's very difficult to get it back in. The longer inflation is allowed to persist, the greater the likelihood of spinning up a negative feedback loop of higher wages trying to keep up with higher prices but with no real gains to be had. While the core of the US economy is indeed service related, supply chain disruptions have led to a short-term spike in inflation which should impact the prices of goods and services. However, just as we illustrated with the GDP numbers, we believe the same may hold true for these higher prices. Many are looking to build supplies to better weather a future disruption (have we seen the end of "just in time"?) and significantly increasing order size to try and satisfy current demand. Fortunately, we believe inflation numbers may have peaked and could retreat from the higher pace recently seen.

- **Interest rates** - The traditional tool of fighting inflation is to slow the economy through higher interest rates. With our sizable federal debt load (that seems to creep up constantly as a percentage of GDP) we may have left ourselves little wiggle room to combat inflation without significantly increasing our own borrowing costs and running the risk of slowing economic growth.

Our belief is that 2022 sees the normalization of supply chains, COVID become less disruptive, and the long-term deflationary impact from disruptive technology continues to pulse through the economy. This could lead to inflation rates approaching a more normal level (somewhere near 3%) and allow for interest rates to rise at a normal pace. We urge caution in underestimating the potential of the US economy. COVID variants, potential policy changes, and the constant negative, short-term thinking by "news" agencies has not been able to derail an economy that at its core is stronger and more resilient than pundits think. **Therefore, we forecast GDP numbers for the 3rd quarter of 2022 will once again be strong and should eclipse $24 trillion.**

Stock Market:
Perhaps our most popular forecast. While we believe successful, long-term investing requires a multi-year time horizon, we nevertheless hazard a forecast here every year**. Last year we thought the Price to Earnings ratio for the index could expand as more high-growth, technology companies make their way into the index. Further, we thought a broad-based earnings recovery could take place. We forecast a rise in the S&P 500 index to 4,200 or greater.** As of the last week of December, the S&P 500 had enjoyed a rather substantial growth of earnings (more than forecast) and an expansion of the Price to Earnings multiple (a bit more than forecast) so that the index is now around 4,500! **Full Point!**

2022 is set to see the federal funds rate rise (see our forecast on interest rates for more on this). Many have pondered how high rates need to climb for bonds to once again be considered an attractive alternative to stocks. Let's face it, the term TINA (There Is No Alternative) has come about because rates

have been so low for so long and there are very few alternatives for yield other than the stock market. We regularly calculate a ratio called the Fed Model that compares the earnings yield of stocks to interest rates on bonds. The model currently shows interest rates would have to rise substantially before fixed income would be considered as attractive, let alone more attractive, than equities.

When it comes to equity prices and valuations, the reason for interest rates rising is usually more significant than the mere fact that they are starting to rise. If rates are rising simply to try and correct inflation, that is much different than rates rising due to economic strength, confidence that we no longer need the "training wheels" of zero percent interest, and the Fed trying to find neutral. We're in the camp of rising rates being a positive due to economic strength. A good economy translates into better earnings for corporations which eventually should be rewarded with higher valuations. What sentiment will be at the end of 2022 and looking into 2023 and beyond, we will never know with certainty**.** We believe there is some upside to Factset's current 2022 S&P 500 earnings estimate of $221.48. **Based on this, we believe current valuation multiples can remain intact as we progress through the year. We see an earnings increase driven advance on the S&P 500 index to a level of 5,060 before year end 2022.**

As a reminder, the markets and our thoughts are dynamic. Please stay tuned to our quarterly updates where we will discuss any changes to our outlook. For 2022, we do want to highlight a potential headwind that could cause some market volatility. The Federal Reserve will be removing their significant bond purchases and should start raising the discount rate. This could cause some short-term volatility in the market that will almost certainly be overhyped by the media. Our caution is to not let short-term volatility lead you astray from long-term investment disciplines and asset allocations. As we've highlighted before, it is next to impossible to get market timing correct. We typically experience a greater than 20% decline about every three years and March of 2020 was the last time we saw a decline of that magnitude. Could we see one again soon? No one knows for sure. However, the short-term benefits of trying to avoid these declines does not outweigh the long-term opportunity of owning great companies that continue to perform well fundamentally.

Short-term rates:
For 2021 we saw no reason to believe the Federal Reserve would raise rates at any time during the year and they most certainly did not. Full Point.

As previously noted, the economy did better than most expected in 2021. As such, the Federal Reserve finds themselves with growing confidence to begin removing the accommodations put in place when COVID first hit. As they begin tapering bond purchases, they are clear in signaling that tapering is one thing, and raising rates is another thing all together. The current dot plot (the Federal Reserve's internal forecasts by its members of where they see interest rates out in the future) shows as many as three rate increases in 2022 after the bond purchase program is completed. That would take the Federal Funds rate from a current range of 0% to .25%, up to a range of .75% to 1%. Given that we see inflationary pressures moderating this coming year, we believe there will be less pressure to try and combat inflation with interest rate hikes. We do believe the Federal Reserve will raise short-term rates in 2022, but we do not believe they will need to act as quickly as some believe. **Therefore, we forecast one or**

two interest rate hikes in 2022 and not three. This means a Federal Funds rate of .50% to .75% by year-end.

Long-term rates:
For 2021, we forecast a slight steepening of the yield curve with the 10 year Treasury reaching 1.5% by year-end. Given that we're in the last week of December and the 10 year yield is 1.48%, we will also take a full point for this forecast as well.

Last year we observed that the Federal Reserve has historically made significant hikes to interest rates as a reaction to run-away inflation, not as an attempt to head it off at the pass. We believe this mindset will persist. We see long term interest rates rising a bit in 2022 in some reaction to the bump up of a discount rate hike or two. However, the dramatic rise in the money supply and lack of velocity has created an environment where money is available without having to leverage up balance sheets. **As a result, with velocity of money still low, we see long-term rates staying in a narrow range for most of the year. While they may experience an emotional spike higher at some point, we do not envision the 10 year yield above 3% at any time and see it ending the year around 2.5%.**

Inflation:
For 2021 we saw inflation staying sub 2% for the year. No point here.

Last year we wrote: "*Growth in money supply is normally the fuel to drive inflation and this has increased dramatically with the CARES act and other stimulus measures recently passed. All of this results in upward pressure on inflation. At the end of the day, money supply is the fuel and velocity of money is the fire. Right now, we have conditions in place that could certainly lead to meaningful inflation but it would take a rather extensive shift in perspective from consumers and businesses alike. When you have a universal embrace of excess and rampant risk-taking, that is when we believe inflation will run rampant. Fortunately, we're exiting a period of massive uncertainty and fear that has resulted in rather prudent risk taking by consumers and businesses alike. Further, even before COVID, governments around the world already proved that merely creating more money does not lead to economic prosperity*"

We could reiterate much of this for 2022 but also come to a slightly different conclusion than last year. What we did not see happening is the impact of supply chain disruptions and simultaneous increase in demand. Economics 101 - when demand is greater than supply, prices will rise. Of course the opposite is also true, when supply is greater than demand, prices will drop. As previously discussed in our economic forecast, there are several items we're closely monitoring. We do believe there will be a point when supply disruptions are worked through. Many businesses are in the process of adjusting their operations to warehouse a certain amount of parts rather than having "just in time" inventory force whole plants closures due to supply disruptions. After these inventories are built, there is a real possibility that excess supply has been ordered and we may see prices for many items fall rather dramatically. A key concern is the possibility of a negative feedback loop where rising wages are needed to offset rising prices and this continues to translate into persistent inflation above what was expected.

As all these forces compete, we believe the main, long-term driver impacting prices will continue to be this massive, mega-trend we're in the midst of – disruptive technology. As technology impacts industry after industry it has a deflationary effect. This is why we believe it's far too early to extrapolate the current inflation figures well into the future when we haven't gotten back to normal yet. As the year progresses, we believe the inflation recently experienced may settle back into a more normal, historic range. Transitory may wind up taking years and not months, but it may still be transitory to a degree. **We believe by the end of 2022, year over year inflation comparisons will be moving down and may be in the 4% range.**

Oil:

For 2021, we forecast two items. First, our belief that oil and gas investments will no longer be viewed as a core, long-term holdings in a portfolio. Second, that price would be range bound between $45 and $65 a barrel, with the occasional spike higher. The continued addition of sustainable energy assets, battery storage systems, and booming demand for electric vehicles, does signal a shift in psyche as to what the definition of energy is. Prices spent the first half of 2021 near the lower end of our range and the second half of the year above our range resulting in an average price of approximately $62 per barrel. **Full point**

For 2022 we believe geopolitical, economic realities of oil producing countries will be a key driver of price. Most OPEC countries need oil to be at or above $80 per barrel to have balanced budgets or be able to significantly invest in sustainable energy assets to drive their economies into a future where oil is no longer the cash cow it is now. As climate conversations continue to ramp, sustainable energy sources are adopted more and more, and demand for internal combustion engines continues to fade, we feel that OPEC will see the need to keep **the price in the $80 area on average for the year.**

Commercial Real Estate:

For 2021 we forecast that Commercial Real Estate would have another year of nice, positive returns from rents and appreciation in a low inflation, low interest rate environment. With the NAREIT index up over 30% in 2021 the sector outperformed even our optimistic forecast – Full point.

Last year we believed office space would be challenged due to the impacts of COVID, people reassessing their business model, and employers embracing more work from home options going forward. Our thoughts appear to be correct as the office sector was in the bottom four performing REIT sectors in 2021. We continue to see a challenging environment for the office sector as long term leases start to rollover in the next few years. It is a sector with too many unknowns for us to be comfortable allocating capital to yet.

For 2021, we believed retail would be challenged due to oversupply and the impacts of more and more commerce going online. This is partially being offset by repurposing some retail space and companies embracing an omni-channel experience using physical stores as warehouse/distribution centers. Challenges were reflected in distressed valuations in the space heading in 2021. As the year unfolded, malls and shopping centers were actually two of the top three performing sectors in the REIT index as

the market embraced traditional “value” investments with nice yields and low multiples. Long-term, we are still concerned with the sector and believe 2021’s solid performance will not be repeated in 2022.

2021 was a solid year for data centers as returns were in the middle of the pack. The number of constituents is now only 6 as there was yet another acquisition in the space. We’re also seeing large infrastructure players committing significant capital to the space. We continue to believe that our constantly evolving digital world will only require more data centers and not less – at least until we can store data in DNA. Yes, this is being worked on and in our high growth sleeve of portfolios we have a position in the company looking to make this reality.

For 2022 we will continue to focus the bulk of our REIT allocation in the warehouse, industrial, and manufactured home sectors. The common theme here is strong demand, the ability to raise rents is evident, the addition of value through development is present, and the trends are long-lived. We may also add a greater allocation to infrastructure as well.

The largest challenge for the commercial REIT sector will be rising interest rates. The accepted yield on the sector is directly tied to the yield on the 10 year bond. If/when yields starts to rise, then the question will be the pace of the increase in yields. If rent increases can keep pace (and dividend increases therefore keep pace) then the principal value will be static (unlike a fixed income investment with a static coupon which will decline in value). If rental increases are slower than the rise in long-term interest rates, then prices will decline until the rents catch up with the higher rate environment. As REITs are generally long-term investments, this drop in price would not be a long-term concern as a higher interest rate environment will be eventually be overcome by higher rents. In our mind, REITs, as an alternative to long-term fixed income, seem to warrant a higher portfolio allocation in a potentially rising interest rate environment. For 2022 we see a slight increase in the 10 year treasury yield. We therefore believe the bulk of returns from our REIT investments will come from management adding value through development opportunities, rising rents in portfolios, and the cash flow generated to the investor by rising dividend income. **Overall, for 2022 we see a slightly positive year for the commercial REIT index.**

Residential Real Estate:
For 2021 we forecast residential real estate prices should continue to increase with lower-cost, desirable areas of the country appreciating faster than high-cost areas. The S&P Case-Shiller 20-City Composite Index rose from 242.2 at the end of 2020 to 279.0 at the end of October 2021 – and prices have most likely increased since then as well. We’ve certainly seen higher prices across the country. However, high cost areas have actually outperformed low cost parts of the country. While we were right on the direction, our timing of the move towards affordability was not correct. We’ll be harsh on ourselves and not score a point here.
Source: Factset

We note that some real estate truisms of the past are still holding true today. Demand will be strong in areas with employment opportunity. Being close to one's roots and family are important. Eventually, economics are reflected in prices with the direction of those prices not always being up. Much of this has been on full display recently. Areas dedicated to key industries such as manufacturing in Austin, Texas, technology in Silicon Valley, biotechnology in Massachusetts, and banking and financial services in Raleigh / Durham, North Carolina have enjoyed tremendous real estate price appreciation. Add to this space constrained cities like New York and Los Angeles where the population is still attracted to the large employment base and you get prices that have skyrocketed.

Frankly, it reminds us a bit of the run-up in prices during the 2005 to 2007 era. Median prices in many cities in the Seattle, New York and Los Angeles markets are well over $1,000,000 now! According to US Census Bureau statistics, national home prices have increased 118% since 1965 yet median household income has only grown by 15%. Even with today's historically low mortgage rates it is estimated that the average income needed to buy the median house in America is above $144,000 – much higher than the median household income of $69,178. Obviously, affordability varies greatly by location as the following graph demonstrates.

REALTORS® Affordability Distribution Curve & Score

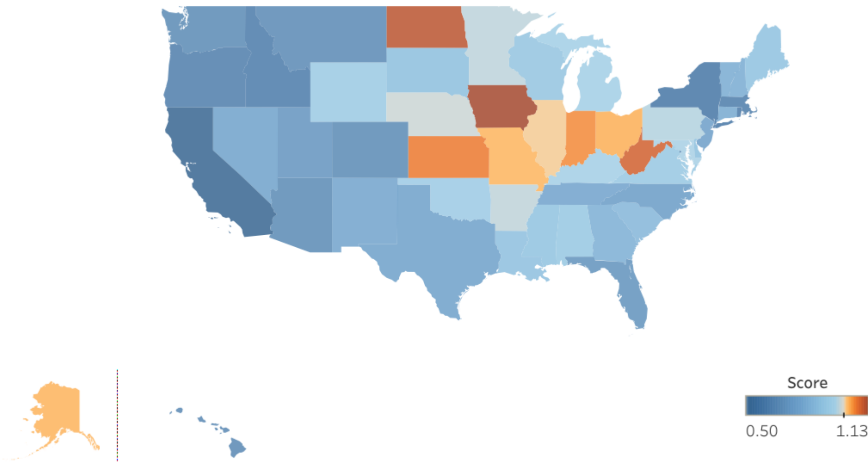
July 2020 (by state)

Select a month (from the slider)

7/1/2020

United States REALTORS® Affordability Score: **0.81**

See below the Score for each state (by hovering over the map)



Most Affordable States

Iowa (1.13)
North Dakota (1.11)
West Virginia (1.09)
Kansas (1.06)
Indiana (1.05)

Least Affordable States

California (0.50)
New York (0.58)
Rhode Island (0.59)
Idaho (0.60)
Massachusetts (0.61)

For 2022 we forecast many will follow the job growth, especially when it means relocating to areas with favorable weather and tax policy. As the disparity grows between high price markets such as California and New York, there will continue to be a migration of those seeking affordability. Further, for baby boomers who may need to tap into the dramatic growth of their home equity to help fund retirement plans, there will be a certain amount of migration due to economic necessity. This trend has already started and will become more pronounced in the years to come in our opinion. **On a short-term (one year) basis, we forecast the S&P Case-Shiller index will increase again in 2022, mostly from the rest of the nation catching up rather than a continuation of the dramatic increases in a select, few markets. Year over year October price increase will be in the range of 10%.**

Special Fun Forecasts:
We touch on a few non-investment forecasts every year to broaden our thought process. Last year we forecast the first autonomous rideshare service would be launched somewhere in the United States. In September 2021, the California Department of Motor Vehicles approved autonomous vehicle deployment permits for both General Motors-backed Cruise and Alphabet's Waymo allowing them to operate on public roads in certain parts of select cities. In December 2020 Nuro become the first autonomous vehicle developer to receive a permit to run commercial deliveries with retail partners. **Full point.**

Our second fun forecast was that gene editing will actually "cure" certain diseases. During 2021, Intellia Therapeutics received FDA orphan drug designation for their investigational CRISPR therapy for the treatment of Transthyretin Amyloidosis, a rare, progressive, and fatal disease. Later in the year, Beam Therapeutics received FDA approval to begin human trials in regards to their investigational new drug application using base editing (which is a next-generation form of CRISPR capable of making single base changes without creating double strand breaks in DNA) to treat sickle cell disease. The FDA trials are long and costly but the fact that human trials are underway gives us hope. Maybe a little generous but we will take a **Full point** on this one.

Our third fun forecast for 2021 was that space exploration will become one of the most talked about human experiences possible. We will quote a Washington Post article released just a few days ago to summarize our recap of this one. "The year 2021 will probably go down in the annals of space history as a turning point, a moment when ordinary citizens started leaving earth on a regular basis. Multiple crews lifted off on several different spacecraft, and for a brief moment there were a record 19 people in the weightless environment of space – and eight of them were private citizens." **Full point.**

Our Fun forecasts for 2022

Forecast #1
Demand for NFTs will drive mainstream adoption of blockchain technologies. It wasn't that long ago that terms like blockchain and distributed ledger first became part of everyday speech. Many of us are now familiar with the terms used to explain how cryptocurrencies work and how they're built on a distributed system lacking the need for a central authority that provides "trust". The 2008 white paper by Satoshi Nakomoto pioneered a movement with breathtaking speed. From just a handful of coins

about a decade ago, we now have over 6,000 today! We've seen interest boom from both individual and institutional investors alike and even seen some major corporations redirect cash equivalents from their balance sheets into cryptocurrencies. However, despite the surge in popularity, we find most people still don't see the need to own any other than for price speculation. We've seen volatility turn off the masses to investing in stocks. Price swings in crypto is like volatility on steroids but with the added stress of the trading exchange never being closed. With wild price swings and a product that lacks a clear use case, it's no wonder why we're continuing to see a significant amount held by a concentrated few. While Tom Brady may want his paycheck in crypto, we've found most are content with their direct deposit of US dollars into their traditional bank accounts.

While we do believe blockchain technology will improve efficiencies throughout our financial system, we question if more efficient financial plumbing will truly drives mass adoption. In our opinion, widespread use (and therefore demand) will need to come from the average consumer. The average consumer enjoys the simple things like movies, music, art, sports, food, cars, etc. Imagine if our likes in life could somehow be enhanced by a unique experience. As we mentioned in our 1st quarter 2021 commentary, this is what NFTs (Non-fungible tokens) offer.

We're in the very early stages of witnessing what the use cases will be for NFTs. Recently, artists like Deadmau5 and Portugal the Man have released songs as NFTs and are backing a decentralized autonomous organization (DAO) MODA that will allow artists to register their music to be streamed. This will give token holders a say in the royalties they receive from music released on the platform completely bypassing the industry leaders like Spotify or Apple Music. There is a group looking to buy Blockbuster by raising initial capital through an NFT mint. They then want to acquire film rights, start their own subscription model, and eventually create original content with the DAO determining which projects to invest in and set budgetary limits. There's another group looking to acquire X Games from ESPN via a similar model as they believe the sports are set up perfectly for an era where athletes would love the ownership of incredible moments via NFTs and fans could enjoy unique access and experiences via X Games NFTs.

When you have the ability to remove the central authorities of trust you unlock the potential to put the profit into the hands of the creators and fans. This can lead to a new level of engagement by feeling sincerely connected to those things we enjoy in life. When these items are digital native, making them easy to create / own / sell / trade, you have the recipe for a new product that's growth is really only limited by people's creativity. Digital assets are rapidly evolving and will have a place in all of our lives in the near future. **For 2022, we forecast (in reality, one year is too short a time-frame for something like this) is that NFTs will go mainstream, becoming part of everyday business and life, as they are adopted more and more.**

Forecast #2
First, Robo-taxis. Next, Robo-Tractors. High-tech farming is on the rise. When you think about technology, the next thought is rarely agriculture, but maybe it should be. Perhaps the space lacks luster to many because it's almost as old as tilled dirt, or maybe it's because most of us are just unfamiliar with it. Nevertheless, agriculture has long benefited from advancements in science and technology. One of

the industry's common goals is to produce more output while using fewer inputs. Working toward this goal is where the potential of high-tech agronomy is actualized.

Let's say you're a farmer today. You're using precision agriculture, where GPS, drones, and satellite imagery offer a wide variety of datasets. Measurements of crop yields, available nitrogen, and soil moisture are all identifiable within a customized field map. These tools help you determine which nutrient, seed, or chemical need to be applied, exactly where, and at what levels. As a result, you're using the right amount of seed and crop protection with higher crop yields: more with less.

Now say that you have an autonomous robo-tractor, which allows you to redeploy skilled labor to other tasks. It's safer, more precise, fuel-efficient, and can run at night. Early versions of this technology already exist. For example, robotic harvesters can determine ripeness and quality in real-time, so they will gently pick the strawberries that meet preset standards. Solar-powered robots can sow seeds and mechanically weed crops, reducing the need for herbicides. **We believe that in 2022 these kinds of innovations will make headway toward mass adoption because it allows farmers to produce so much more with so much less. In an ESG-centric landscape, greener, safer, sustainable, and more efficient technology checks all the boxes.**

CONCLUSION

We will always strive to cull through information, ferret out the important from the unimportant, and take short-term emotions out of the long-term investment process. Our goal is to help our investors achieve their financial independence and the freedom to focus on what they want to do in life and not what they have to do. As always, we welcome your feedback and would love to talk about these and other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. ***Montecito Investment Portfolio's Mission: To provide diversified, disciplined long-term investment solutions, service and guidance to help our clients achieve, and maintain, their "Financial Independence".***

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.

Past Annual letters are available by request. 2016, 2017, 2018, 2019, 2020, & 2021 Letters are available on our website at: http://www.cwam.dadavidsonfa.com/Our-Commentary.4.htm