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Dear Fellow Investors,

We suppose Yogi Berra was right in saying that it's tough to make predictions, especially about the future. When we prepared our annual letter entering 2022 we didn't have much new to say. We thought the world would largely enjoy a breather as life gradually returned to normal. We saw a strong possibility of a very welcomed, uneventful year. Our hope was of course obliterated when Russia invaded Ukraine as discussed in our Q1 commentary. Improving supply chains, inflation getting under control, and central banks able to raise rates because of a good reason in recovering economic strength, has all been thrown out the window. This has led to an abrupt shift in sentiment with fear and pessimism now ruling the day.

As we've said before, when things happen these days it seems to be on a historic scale. 2022 is no exception with the first half off to one of the worst starts in market history. It has been absolutely brutal for young, innovative companies as funds have rotated to more defensive industries and predictable business models. However, even these mature and steady businesses have seen their stock prices hit. Further, flocking to the safety of bonds hasn't worked either as interest rates have spiked. The crypto space has seen absolute carnage with "stable coins" breaking their pegs and exchange failures taking place. The decline in wealth is estimated to be $15.5 trillion in stocks and bonds and another $2 trillion in crypto. TINA (There Is No Alternative to stocks) has quickly turned to there is nowhere to hide.

Although it is easy to be pessimistic and scared, it is important to keep perspective. We've been through tough times before. Let's take a look at Blake's career which began towards the end of 1979. Despite all the uncertainty of the past decades, the market (as measured by the S&P 500), has gone from 108 points in 1979 to 3,800 (as of today). That's an increase of 35 times over 42 years, showing the power of investing in entrepreneurs and human ingenuity. This return works out to an annualized rate of approximately 8.97%. When you factor in reinvestment of dividends the annual return climbs to 11.85%.

We are long-term investors, not market timers or traders. We focus on where we believe the future is headed, not necessarily what has led in the past. We have a disciplined approach to find and hold stakes in what we believe to be high quality businesses with lasting competitive advantages. Those advantages can vary from technological superiority, massive scale and distribution, or impeccable brand reputation – just to name a few. These businesses produce various products and services ranging from a nice cup of coffee, spices for your food, timberlands to produce lumber, goods for your home, the smartphone in your pocket, high-powered computer chips, electric vehicles, and entertainment for your family. We have a high degree of confidence that these business will continue to produce goods and services that people value, and will continue to grow over time.

When we view the world with a lens towards the future, we remain very optimistic about the market, our country, the world, and humanity. Certainly there are issues and challenges that we will face, but we've always had issues and challenges to deal with. The long-term compounding that leads to wealth creation takes time and patience. Looking back through Blake's career you've had periods of high inflation, high interest rates, global conflicts, debt crises, currency crises, terrorist acts, low inflation, low interest rates, and numerous bouts of panic and fear. Yet, investing in quality businesses continued to produce exceptional wealth for those with the ability to not act on emotion and exercise patience.

During market declines there is a strong temptation to just do something. This is typically a bad decision resulting in investors chasing past, short-term outperformance. Today, there are numerous hot takes discussing market crashes, rampant inflation, stagflation, and how to protect yourself with gold, oil, commodities, and even cans of tuna! Portfolio positioning like this (excluding the cans of tuna) has looked like a good decision if measuring over the past six months, but less so when measured over ten years, and certainly less so when measured over four decades. In many ways, this positioning is a bet again human ingenuity and advancement, where stuff remains broken, and costs spiral out of control. Falling victim to the impulse to merely act can be devastating to long-term returns as evidenced below. Let's compare how a hypothetical $10,000 investment made at the start of Blake's career (1/1/1980) would have done in US Stocks (represented by S&P 500 Index), gold, and commodities (represented by the S&P GSCI Commodity Index) up through the end of last month (5/31/2022):

$10,000 Investment	**Value today**	**Multiple earned**
S&P 500 with dividends reinvested	$1,156,990	115 X
S&P 500 without dividends reinvested	$382,822	37 X
Gold	$34,983	2.5 X
S&P GSCI Commodity Index	$59,424	5 X

There are a couple of fascinating takeaways from this illustration:

- At first glance, hearing that you earned 2.5 X or 5 X on your investment sounds pretty good. However, the return from gold and commodities pales in comparison to investing in a collection of some of the greatest businesses in the world.
- If you were to continue earning the S&P 500's long-term average of 10% on the current portfolio value, that would mean approximately $115,000 of gain this year. One year's worth of return would be more than 3 X the entire value of your investment in gold and nearly 2 X the entire value of your investment in commodities that took 42 years to accumulate!

We're hesitant to say something is impossible, but in our opinion, the narrative that this is the point in time in which human progress stops, seems improbable. With fear and uncertainty rampant, we believe it is helpful to focus on some areas that we do have a high degree of certainty about:

- **We've been conditioned to expect the worst (recency bias)**: during a recession, 3 of the top 5 worst market declines occurred during the past 22 years. Not during the Great Depression or during a World War, but during the past 22 years. In our opinion market participants have been conditioned to expect busts and likewise lost sight of the market's ability to produce many multiples of growth (see Muck and Up). The recently released consumer sentiment index has never been more pessimistic.

- **This is not the dot.com bust**: A great majority of today's young, innovative companies that have come public are legitimate businesses. Growth rates have slowed due to difficult year-over-year comparisons, but growth is still occurring within the technology sector. The dot.com bust was an actual contraction in business led by the non-recurring network / physical infrastructure buildout. Eventually, today's ultra-scalable, digital first business models took advantage of this computing power and connectivity. This is where we stand today with virtually every business embarking on their digital transformations and entire industries being reshaped by technological advancement.

- **This is not the Great Recession**: leverage and loose lending standards were rampant during the build-up to the great recession. The entire financial system was overleveraged along with most households. Today, many corporations are in excellent shape, the financial institutions are well capitalized, and many households have shored up their personal finances during COVID when there wasn't much to do.

- **Excess is clearing**: we did warn about some of the more speculative behavior going on in the market. EVs are a great example where numerous companies came public at a Tesla-like valuation without ever building a product. SPACs gave companies access to capital far too early in their corporate life. Much of crypto has yet to prove their market fit. When investing seems easy, it's typically about to get much harder. This is where we are now. We are surprised that many of the higher quality businesses have been lumped in with the lower quality ones as well. However, we believe over time this clearing will separate the strong from the weak, talent will flock to strength, and the strong will get stronger.

- **US markets are impatient**: There is a good and bad to this. The bad is that we tend to be short-sighted. The good is that we don't let things linger. We can see this in regards to today's biggest worry - Inflation. Markets want action yesterday, to move on from the worry, and start looking towards the next expansion. A slow response from the Fed has not been welcomed. We believe market action played a role in the Fed hiking 75bps last meeting which has actually led to some stability in stock prices. We will see how much higher the Fed needs to hike, but the fact that they're acting swiftly is a welcome change in their tone.

- **Inflation** – there is mounting evidence that inflation has indeed peaked. Here are a few items we're watching and how prices have declined from their recent highs (Source: Factset):

    - **Lumber** -61% from peak in May 2021
    - **Copper** -23% from peak in October 2021
    - **Shipping rates (Baltic Dry Index)** -60% from peak in October 2021
    - **Oil (WTI)** -14% from peak in March 2022

  We're hesitant to say this time it's different but COVID truly is a unique event in modern history. Markets have been thrust out of equilibrium and been met by additional challenges with the war in Ukraine and continued lockdowns in China. However, as more time passes it appears these out-of-whack markets are starting to normalize.

FORECASTS

As we're half way through 2022, let's check in on our forecasts for the year**.** Our forecasts from the beginning of the year are in **bold** with current updates in *italics*.

- **Economy: by the end of Q3 the economy will once again be strong and eclipse $24 trillion –** *We actually eclipsed $24 trillion in Q1 which is up from $22 trillion in Q1 2021 and $21.5 trillion in Q1 2020 (Source: Factset). We discussed potential headwinds being inflation and interest rates. We forecast this year would see the normalization of supply chains, COVID being less disruptive, and the long-term deflationary impact from disruptive technology eventually leading to inflation approaching a more normal level somewhere near 4%.*

- **S&P 500: an earnings driven advance with the index reaching 5,060 by year end –** *The Russia / Ukraine war and persistently high inflation readings has dramatically changed sentiment. Rising interest rates have shifted from being implemented to find normal to now combating inflation. Continued economic expansion has quickly shifted to potential recession. While earnings forecasts have remained relatively strong and significantly above where we first started the year (EPS estimates on S&P 500 as of 12/2021: $222, as of 6/2022: $227 – Source: Factset) sentiment has seen significant multiple contraction as we now trade at approximately 15 X 2023 estimates.*

- **Short-term rates**: **one or two hikes believing that inflationary pressures moderating** – *Incorrect here. Inflation has remained persistent, only now are we seeing potential signs of significant slowing with copper, lumber, shipping costs, oil starting a significant decline.*

- **Long-term rates**: **staying in a narrow range for most of the year with a potential emotional spike higher at some point, but the 10 year now eclipsing 3% at any time –** *Finding normal has shifted to fighting inflation. Yields have spiked well above 3% and have just recently fallen back below this level.*

- **Oil prices**: **most OPEC countries need oil at $80 or above –** *Prices spiked to $130 shortly after the Russia / Ukraine war and have since declined to $106 (Source: Factset). Energy independence is in the spotlight along with the capability of renewable sources to shoulder the load. Germany is a glaring example of what not to do as they gave up their independence, shown their renewable assets are not ready to shoulder the load, and are now firing up coal plants as they've shuddered their nuclear plants. The US has ample reserves but the industry has been vilified and not surprisingly, reluctant to invest in new projects.*

- **Inflation**: **see year over year comparisons moving down and possibly reaching the 4% range by year end –** *with the Fed now acting primarily to bring inflation under control, many commodity prices have declined significantly. As of this writing, we have yet to see this translate into the heavily watched CPI readings. However, we're hearing from retailers that demand is fading and many are faced with significant inventory that will need to be discounted to clear. Further, numerous companies are announcing lay-offs which means the upward spiral of ever high wages needed to offset rising costs seems unlikely. Oil and transportation costs that feed into food costs seem to be the last leg needed to fall to really see inflation readings come back to earth. While our forecast looks wrong so far, we will have to see how the rest of the year unfolds and continue to believe much lower inflation readings are probable.*

- **Commercial real estate**: **a slightly positive year for the commercial REIT index** – *with interest rates spiking, the interest-sensitive REIT sector has been challenged. We still believe areas in demand, companies with the ability to add value through development opportunities, and sectors with the ability to raise rents are the right spots to be in commercial real estate. However, the swift moves in rates has proven too challenging of a headwind in the first half of the year.*

- **Residential real estate**: **an increase again in 2022 mostly from the rest of the nation catching up rather than a continuation of the dramatic increases seen in a select, few markets –** *housing starts and existing home sales started the year strong but have pulled back significantly with mortgage rates rocketing from 3% to 6% for a 30 year loan. The pipeline for new constructions appears solid as we've had a shortage of new homes since the Great Recession. However, with rates significantly higher we are just starting to see signs of price declines as the affordability of a home is drastically altered with borrowing costs now twice as high. We'll have to see how the rest of the year unfolds, but for now, housing prices remain higher from where we started the year.*

- **NFTs will drive mainstream adoption of blockchain technologies –** *the Crypto crash has been brutal and reminiscent of the dot-com bust. With a vast majority of the protocols lacking clear market fit and costs too high, we believe the thousands of crypto projects will consolidate down to the strongest few. NFTs, with the ability to create something unique for fans of things like movies, music, art, sports, and food is just starting to take place. We believe Shopify's recent* *announcement that they will give companies the ability to tokenize things for their customers like exclusive product releases or unique experiences to be the mainstream adoption we were looking for. As this ability was just announced, we look forward to tracking the progress of their more than two million businesses that can now utilize this tool.*

- **High tech farming will be on the rise –** *Deere started off the year by showcasing their autonomous tractors. We've seen machines that can pick strawberries to machines zapping weeds with lasers. The agri-tech industry has continued to make advancements in tightening the links along the food value chain. Gained efficiencies in risk management, supply chain management and traceability work their way down from the producers and processors, to the distributors and consumers. Global financial institutions have already invested billions of dollars to incorporate farmland into portfolios for long-term investment, so we think that the confluence of technology and agriculture will continue.*

In our opinion, the long-term drivers of market appreciation are alive and well. As discussed in our Roaring 2.0's annual letter, human ingenuity creates value and drives return. Eventually, this value is reflected in stock prices. While memories may be anchored in bad times, we urge investors to focus on what's coming in the near future. What humanity can achieve is progressing at an incredible pace. Don't extrapolate today's challenges and let them consume you. With our promising, long-term outlook we are quite anxious to see what the world looks like ten or twenty years from now. We sometimes wish we could press fast-forward and see how our current portfolio holdings navigate the future and whether they're successful in building their visions (and of course what this means for shareholder returns). However, as anxious to know and optimistic as we may be, we would not trade any amount of time just for the sake of being proven correct or knowing what our investment returns turned out to be. Time truly is the most valuable asset, let's make the most of it, and enjoy life's journey.

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".***

Sincerely,

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- Investors cannot invest directly in an index. These unmanaged indexes do not reflect management fees and transaction costs that are associated with some investments.

- Goldman Sachs Commodity Index is a world-production weighted total return index, including reinvested dividends, measuring investor returns from a fully-collateralized commodity futures investment. Due to market fluctuation, the commodities represented by this index may experience of invested principal and are subject to investment risk.

- Gold: London PM is an index based on the price at the end of month close for London gold. This index represents asset types which are subject to risk, including loss of principal.