July 28, 2021

For the first half of 2021 client accounts were substantially ahead of both the S&P 500 and a risk weighted benchmark (individual returns are provided on personalized client letters). For reference the S&P 500 rose 15.2% and the Barclays Aggregate Bond Index declined 1.6%. Our investments in smaller businesses were the primary contributor to the strong first half result.

I remain optimistic about the outlook for both the US economy and our investments. With roughly half of the US vaccinated and Covid cases down, demand for travel and hospitality is rebounding, which should help employment. And while Covid cases are increasing among the unvaccinated, I think we're unlikely see the broad restrictions imposed a year ago.

Another positive for the economy is that last year Americans deferred spending while also receiving stimulus payments, leading to record levels of savings. Those savings should support higher spending in the months ahead.

Indeed one of the market's concerns is that consumer spending could accelerate too quickly, outpacing the supply of goods and leading to inflation. Prices have risen substantially for certain products, such as new homes and used cars. My best guess is that those higher prices are incentivizing businesses to add capacity, which will moderate further price increases. There's also evidence that consumers are deferring purchases of the most impacted products.

Should inflation prove to be more persistent than I expect, it could lead the Federal Reserve to raise interest rates, which is generally bad for stocks. That said, given the quality of the businesses we own and my expectation that they will grow at healthy rates for a long time, I think any interest rate driven setback will prove temporary.

<u>Notes on our Holdings</u>

Our investment in Steel Partners more than doubled in value this year, contributing to our strong first half performance. Steel Partners owns a portfolio of slow growing but financially stable businesses. The largest of these makes fasteners and adhesives for commercial roofs. Steel's shares were undervalued when I bought them, and even at today's higher price they remain inexpensive.

Alphabet, one of our largest holdings, roughly doubled its earnings for the March quarter from the prior year. That performance is particularly remarkable given Alphabet's large size. Most of Alphabet's earnings are from the digital signage displayed on the Google search page, as well as fees that Alphabet collects brokering and placing ads on other websites. The company also owns fast-growing businesses that should contribute more to earnings in the years ahead. These include YouTube, Google Cloud, and Waymo, the leading developer of autonomous driving technology.

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While Google holds a dominant market position in internet search, its business faces competition. For example, consumers increasingly use the Amazon website to search for merchandise. Consumers also go directly to websites and apps that perform category searches, for example Yelp, Expedia, and Wikipedia. Eventually Apple may introduce its own search engine on Apple devices. Alphabet's challenge in the years ahead will be to continually enhance the usefulness of its search engine, such that it remains a frequent starting point for internet browsing.

I think Alphabet will rise to this challenge. However, I am even more optimistic about the outlook for its other businesses, in particular YouTube. YouTube is the most watched video platform in the world, with billions of videos seen daily by a vast global audience. The business generated six billion dollars in revenue last quarter, which was only a fraction of the sales generated by Alphabet's search business. However, YouTube's earnings should grow significantly in the years ahead, partly through higher advertising sales, and partly by facilitating online commerce. For example, in a cooking video, with a click of the mouse you could buy ingredients and kitchenware. Similar opportunities exist across a wide range of instructional and entertainment videos.

I recently purchased shares of Avid Technologies. Avid is the leading developer of video and audio editing hardware and software. The company's products are used by film and recording studios, broadcasters, and concert venues. While Avid's business held steady through the pandemic, it should get a lift this year as film production and live events ramp up. Longer term, the company is shifting its sale of software from periodic licenses to recurring annual subscriptions. That transition should improve the predictability of the company's financial results.

Avid's business is split between sound editing tools, where it is the clear market leader, and video editing tools, where it competes with Adobe. Avid's video editing tools are preferred by professional users while Adobe's are preferred by non-professionals. Recently Avid introduced lower priced products to compete more effectively with Adobe in the non-professional market. Early results are encouraging. While the company's share price has risen in recent months, I continue to like Avid's longer-term prospects.

As always, please contact me with any questions.

Doug

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