Sterling Partners Equity Advisors
Portfolio Commentary-Winter 2021

2020 Hindsight


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Welcome to 2021. This letter would be so much better if we knew the future. That skill would have been useful a year ago in predicting how good 2020 would be. It was, of course, a wildly tumultuous year, unlike any of us had ever seen before, and that came after a tumultuous year the year before that. Now it seems we are off to another one. There may be a pattern here. Apparently, the future is always unknown and as a species we tend to worry about it. This seems odd because in many respects the present has never been better.

Our small cap value strategies had a good 2020. The performance and commentary about our top and bottom contributors we discuss later in this letter. The key to our performance this year was not particularly different from other years: predict the future well and invest in the unexpected winners. The future came a little sooner than usual in 2020. Many longtime themes in the portfolio built around sector economic share gains in healthcare, leisure, digital distribution, and logistics, moved toward fair value in 2020. The typically slow march of faster, better and cheaper product and service offerings taking share over the course of a generation, all were adopted quickly in 2020 because there was no choice. It may prove to be the biggest lurching of per capita productivity since the wheel, or perhaps something more recent like electricity or cars. (We wrote about this in our Fall 2020 letter.)

As usual, this time of year, again we have TV pundits and economists at big firms telling us about the Fed and interest rates, inflation and volatility, trade wars, currency devaluations, defaults, etc., and how bad everything could be soon. I would love to join in, but I see the opposite. [*See the attached charts for a sense of how often sentiment is correct about the direction of the economy*. Note: They don't get it right very often - just a 16% r-squared!]

I admit there are bad economic periods, but they are decreasing in frequency and they are also unpredictable. There have been anxious pundits all through history, so that is not different. What is different, a lot different, is the growing percentage of the economy where the incremental cost of creating product, promoting product, and distributing product, have all moved toward zero -- and this is unprecedented.

Near zero incremental cost means we get economic growth while freeing up labor to do other things, likely leading to additional growth. Interest on interest as we used to say in finance. Historically, idle labor required capital to be productive, capital to buy tools. The industrial revolution was all about a giant leap in productivity, but the tools were expensive and required armies of commuters to operate. Economies of scale were directly related to the capital that was to be invested in manufacturing, distribution, and promotion. That's different now.

First, the cost of capital has never been cheaper. In some parts of the world, it is now profitable to be in debt. Real estate moguls always knew this, but now it is turning literal in some quarters. Why? The world has never been wealthier due to hundreds of years of compound investment returns, which of course adds to the supply of capital, and, we are printing a lot of money, which also apparently adds to the supply of capital.

Second, not a lot of capital is needed these days to add capacity in a growing number of businesses. Computers are cheap and outsourced services are available on a per hour or per unit basis. This is in part why the cost of money is so low. The demand for capital to grow capacity has never been lower at the same time that we have the most cash-rich world in history.

As a result, economic growth does not really require much capital anymore. This has rarely been the case in history. Driving productivity is now more about idea generation,

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*Top and Bottom Contributors were calculated by Sterling Partners Equity Advisors using data available for the holding's contribution to composite performance taking into account its composite weight, on an annualized basis.

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