Second Quarter 2021 Commentary

Optimism grew in the second quarter, as we creep ever closer to the end to the pandemic. More Americans became fully vaccinated, and states continued to relax their COVID-related restrictions. Investors cheered the news by sending the stock market to new record highs. The S&P 500 rose 8.5% in the quarter, while the Dow Jones Industrial Average jumped 5.1%. It was the fifth consecutive quarterly gain for both indexes.

To be sure, we are not out of the woods yet. A stubbornly high percentage of the U.S. population refuses to get vaccinated, thereby giving the virus opportunity to mutate and prolonging the pandemic's impact. Some social media news feeds seem to promote misinformation, willful ignorance, and cynicism over scientific achievements, statistical evidence, and personal sacrifice for the common good. Nevertheless, we are confident that sooner or later we will reach herd immunity—whether it comes the easy way (vaccination) or the hard way (infection).

Five More Years of Mistakes

During the second quarter, Inkwell celebrated two significant milestones: we passed our tenth anniversary, and our client assets under management surpassed $100 million for the first time. Since our founding in 2011 with $7 million under management, old clients and new have added a net $48 million in cumulative capital over the last decade, and we have accounted for another $49 million in growth through our portfolio management services. Some of our investments have worked out better than others, and some of them have been not so hot; but the net result, after tallying all our gains and losses, is that $49 million worth of growth.

Every so often we like to go back and look at the investments that didn't go well. We find that success does not offer as many opportunities for improvement as does failure, so we like to examine where we went wrong and see what lessons we can derive. If all goes well moving forward, we won't repeat any of the same mistakes twice. We're sure that we will continue making mistakes as long as we play in this game, but hopefully each mistake we make in the future will at least be novel.

We conducted a similar exercise after our fifth anniversary, in which we looked at the biggest stinkers we were responsible for over the course of our first five years. (For more on that, see the January 2017 memo on our website entitled *The Sins of Investing*.) Here, then, are the biggest lessons learned—a.k.a. mistakes made—over years six through ten. In honor of the Olympic Games starting later this month, we present them in medal order.

Bronze Medal Mistake

IBM: Melting Ice Cubes Always Get Smaller

In November 2011 Warren Buffett appeared on CNBC to announce that he had recently spent $11 billion acquiring the stock of IBM. This made it the second-largest holding of Berkshire Hathaway, behind only the $14 billion position in Coca-Cola, and just barely larger than Wells Fargo in the third spot also with $11 billion. When Warren Buffett spends $11 billion on something, we take notice. We immediately set to work trying to reverse engineer Mr. Buffett's thought process, to see if we agreed with him that IBM was being under-valued by the market. Alas, try as we might, we couldn't quite figure out how it was a big enough bargain for us to also purchase at that time. It certainly didn't seem *over*-valued to us, but we still couldn't justify buying it.

We did continue to monitor the situation, though. Two years later, IBM's revenues and profits had hardly budged from where they were when Buffett first bought it. However, the share count was lower (since IBM had been buying back its own stock on the open market), and the dividend was higher. With paltry few other bargains presenting themselves in the stock market, we decided to buy on faith that Mr. Buffett knew what he was doing. Those first few purchases we made in the latter half of 2013 were at an average price of about $173, just a hair above the $170 Buffett had been paying in 2011.

As IBM's stock began a long, slow decline, we continued to buy more. We bought more in 2015 at $155, then at $145, then again at $135, and finally at $130 in early 2016. All told, our average cost basis was around $155, which was around 10% lower than Berkshire's.

By the time 2018 and 2019 rolled around, IBM's revenue and cash flow were still flat-lining, while those of its competitors had been soaring. We finally admitted defeat on the trade, selling out at around $140 in late 2018 and early 2019. In all, the loss itself was not terrible: an aggregate capital loss of about 12%. This was made much easier to take because of the dividends we received during our period of ownership, making the overall aggregate loss only about 3.3%.

The true loss with this mistake, though, was the opportunity cost. During the five years we owned IBM, instead of having our stake slowly melted away, we could have owned other technology-related stocks that fared much better.

Silver Medal Mistake

Schlumberger and National Oilwell Varco: Trouble in the Oil Fields

From a high of $118 in mid-2014, the stock of Schlumberger (SLB)—a well-run company providing services to oil and gas drillers around the globe—began a fairly steep slide. Any time the stock of a good company takes a nosedive, we pay attention. We started buying it in March 2015 when the stock was in the low $80s, or about 30% lower than its recent high.

This was nearly identical to what happened to another world-class oil services company two years earlier. National Oilwell Varco's (NOV) stock dipped suddenly from the high $70s to the low $60s and high $50s in early 2013, at which point we began buying.

Between the two companies, we eventually bought a little over $3.3 million of their stocks across all our client accounts. By the time we wised up to our error and sold out of both stocks, including dividends and other disbursements we were only able to recoup $2.6 million of our original principal. For the typical client, this represented a net loss of about 20% of our original outlay. Because these two stocks together accounted for approximately 5% of each portfolio that we manage, the total hit to a typical portfolio was about 1%.

That's a bad result which is roughly similar in magnitude to the gold medal mistake you're about to read about, but there is one important difference between the two situations. We sold NOV at a price of $43 and SLB at prices ranging from $34 to the low $50s. As of this writing in early July 2021, NOV stock is at $15 and SLB is at $31. So at least we were able to get out when we did, otherwise the pain would have continued to worsen.

But what was the original error we made with these two stocks? We were focused more on the jockey than the horse. That is, we knew that SLB and NOV were led by talented executives, and we believed they could do a good job in any economic environment. But when the price of oil went from $100 a barrel in 2014 to around $50 by 2018/19, it became exceedingly difficult for any oil-related company to do well. And now we know, if you put a world-class jockey atop a stubborn mule with bad knees, a poor result is almost guaranteed.

<u>Gold Medal Mistake</u>

General Motors: Impatience is Not a Virtue

We started buying General Motors in December 2014. We felt like it was being unfairly punished for being a stodgy old-school auto maker, when the only automotive stock most market participants wanted to own was Tesla. GM generated cash flows of around $8 billion, year in and year out, during the time of our ownership. Its market cap was so low, though, that its Price/Earnings ratio languished in the single digits. We thought the market had to eventually reward our patience, so we started buying and waiting. And waiting, and waiting.

After the dust of the market turmoil caused by the coronavirus pandemic eventually started to settle in April and May 2020, and the economic stimulus payments started to wind their way through the system, we watched the stocks of many beleaguered companies start to rise. From the depths of late March, Delta Airlines was up about 25%, the cruise lines were up more than 30%, and other auto-related stocks like Carmax were up 50%. And yet General Motors, the stock we had so patiently waited on, had only budged about 10% higher.

In the second quarter of 2020, we threw in the towel. We sold GM at an average price of $22 per share, after buying it many times over the years for an average aggregate cost basis of $33. A 34% loss in total, a staggering $600 thousand out of our original investment of $1.8 million. Then, to add insult to that injury, our original thesis played out exactly as we had envisioned it: starting in July 2020, GM's stock began to rise, first to $30 by the end of the third quarter, then to $40 by the end of the year, and then to $60 over the first quarter of 2021, where it still stands today. Simply by not being willing to wait another three or four quarters, we snatched defeat from the jaws of victory.

Not to take anything away from the magnitude of that mistake (it *was* a big one), but we'd like to point out two important silver linings to this dark cloud. First, thanks to the miracle of diversification, nearly every account we manage only suffered about a 1% reduction in principal due to this mistake. That is, if GM were the only stock we owned, our portfolios would have all been down about 34%. Thankfully, GM was only one of several dozen stocks owned, and it never represented more than about 3% of any portfolio. And, since 34% of 3% is about 1%, that was the extent of the damage done.

The other silver lining was that we received quite a bit in the way of dividends during the time we owned GM. Each year we got back about 5% of our initial outlay in the form of a quarterly dividend, which in aggregate effectively cut our loss in half.

Honorable Mentions

TotalEnergies and Naspers: When a "Mistake" is Not a Mistake

In October 2018 we sold all of our clients' holdings in Naspers. Our original investment of $1.8 million had turned south and was worth just $1.4 million at the time, generating a realized loss of a little over $400 thousand. This 23% loss on our original outlay stung, and it may have looked at the time to an outside observer as an abject failure. However, the same day we sold Naspers, we used those proceeds to buy Tencent Holdings. The reason for the switch is that the vast majority of Naspers' stock market value was comprised of Tencent stock. Naspers was, and still is, by far the largest outside shareholder of Tencent. Indeed, the reason we originally purchased Naspers instead of Tencent was due to the discount we received by buying Naspers instead. While we are always primarily concerned with the prudent growth of our clients' funds, we also pay attention to taxes. We thought it made great sense in October 2018 to sell Naspers, realize that loss which could be used to offset other gains when the 2018 tax bill came around, and then buy Tencent instead. The bargain paid off, because we eventually sold out of Tencent in early 2021 for a total net gain (i.e., including the loss on Naspers) of about $700 thousand.

A similar story played out during the depths of the pandemic-related stock market panic in March 2020. Some truly astounding bargains presented themselves at the time, and we did our best to take advantage of them. By the latter part of March, though, our portfolios were starting to run low on cash. When the stock of Amazon.com—a company we have long admired and wished to own but were too frugal to ever buy—dropped precipitously, we needed to jettison something from the portfolio in order to be able to take Amazon on board. TotalEnergies (formerly known as Total S.A.) was what we decided to sell, and we received aggregate proceeds at the time of $1.2 million. Compared to our total cost basis of $1.8 million, this meant that our clients would be realizing a 34% loss on their original investment, or about $600 thousand across all client accounts. If we had simply held onto Total, though, that 34% loss would by now have been completely erased due to the dividends paid and the stock's ascent in the meantime. What's better, we did *not* hold onto Total. In addition to realizing that large loss, which helped anyone who owned it in a non-IRA account, the Amazon stock we bought with those proceeds has more than doubled. All told, accounting for both the large Total loss and the subsequent Amazon gain, our clients are about $575 thousand ahead on the deal so far.

From the Past to the Future

We have experienced a lot of change in the last ten years, both personally and professionally, both good and bad (but mostly good). On the personal side, when we started Inkwell in 2011 our families were very small: Aaron was married to Kari with a baby boy (Isaac) on the way, and Felipe was single. Fast forward ten years, and Aaron and Kari have added twins—Nora and Colin—to their clan, while Felipe married Yanelys and they have a girl (Victoria) and a boy (Alexander) of their own.

On the negative personal side, we both lost our dads—Aaron in 2019 and Felipe this past May. While the deaths were expected due to long-lasting illnesses, the loss is still painful. Our fathers served as role models to each of us, and we miss them.

On the professional front, we have seen Inkwell grow from a handful of clients and a few million dollars to now more than 50 clients and over $100 million in assets under management, as of this writing. Our clients range in age from their 20s to their 90s, and they live in all corners of the U.S.—from Alaska to Florida, from Texas to Georgia, from California to New York, and many places in between.

During this time, we have experienced all of Mr. Market's legion emotions—from euphoria to depression, from anxiety to giddiness, and even boredom. We have witnessed flash crashes that lasted mere hours, marveling at how the market can go from jubilation to panic and vice versa in the literal blink of an eye. Throughout it all, we have tried to maintain our discipline, focus, and composure, and to not let the emotions of other market participants dictate our own investing behavior.

We are sometimes asked what goals we have set for the next ten years. Usually the one asking is a Type A, stereotypically hard-charging MBA kind of person who expects us to answer in terms of how many clients we hope to be serving, or how many millions of dollars we hope to be managing, or something like that. But our answer to that question today is the same as it was at the beginning: we hope to carry out our fiduciary duty to our clients in an honorable way. We want to be good stewards of the client funds that have been entrusted to our care. We have always believed that there is no big secret to success; just be honest and do the best you can. That is what we have strived to do for the last ten years, and that is what we will strive for over the next ten. You can count on that.

Thank you for your continued confidence and support. It is our great privilege to serve you, and we are grateful, honored, and humbled by the trust you have placed in us to take care of your hard-earned assets.

Sincerely,

FELIPE

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