

The common 60/40 portfolio of stocks and bonds has been in the red only seven years out of the past 50. This year makes eight. And at -14% through August, 2022 is actually the worst performance on record. Yet business revenues and profits are still growing and the economy is on firm footing – still adding 250k+ jobs each month! Financial assets can be funny like that because prices incorporate so much more than ‘*things are good*’ or ‘*things are bad*’. Interest rates matter, foreign exchange rates matter, expectations matter, bond spreads matter, etc. And this year we have gotten just the right blend of factors that have made stocks and bonds both go down together. Historically, stock and bond prices move opposite one another, so a balanced portfolio minimizes risk – well, 43 out of 50 times. When things don’t go their way quickly, every investor has the urge to do something different – but we’ve found that zooming out a bit and having patience pays off.

A fun exercise that keeps us grounded is thinking back to consensus ideas from the recent past. Remember after March 2020 at the initial Covid shock when forecasts for air travel were a full recovery by 2025? *Over Labor Day weekend, American Air flew double the passengers of ’21 and a bit more than 2019.* How about just last summer when the new covid delta variant sparked renewed lockdown fears? *I feel like I haven’t talked about Covid in forever at this point.* And [this article](#) from last September talked about cooling inflation. Literally just a few months ago folks believed gas prices would be high with no end in sight. *Prices have come down every single day for 80 days since then.* The point here is that investors can be really quick to extrapolate current conditions deep into the future, when in reality things can change **much** quicker than we appreciate. Headline inflation has been above 8% for a few months but is headed back down. Interest rates aren’t going up to crazy levels. And diversification isn’t dead forever, the anomaly of the 60/40 portfolio in 2022 will be just that. **Sometimes waiting out the storm is the hardest thing to do, but having patience and keeping perspective can be exactly the right move when things seem to be veering way outside of the norm.**

Economic Outlook – to be honest, it’s fairly unchanged from our note in June. Economic data since then has been better than expected so I’d say we are marginally more favorable to the upside scenarios now versus June. Corporate earnings for the second quarter were better, and checks so far through Q3 are solid. Inflation is cooling quicker than expected – gas prices, [food prices](#), used car prices, [freight](#) and durable goods prices. Plus, leading indicators of rent inflation are coming down which will be a tailwind for inflation data in 2023.

However – we still view the remainder of the year to be volatile and range bound. The Federal Reserve is going to keep pushing hard in their inflation fight and downside risks are unlikely to abate. We can see the other side of this adversity (2023?) and maintain that fundamentals are holding up well, underpinning our call for patience.

Financial planning and investing are emotional. Making money prompts “what if’s” and losing money prompts “if only’s”. We know that being long-term investors can manifest success, but it’s hard in practice because it requires you to constantly look through all the reasons to not invest, i.e. “the wall of worry”. Maintaining discipline and keeping patience is especially tough in down years like this one, which is why we fall back on our confidence in the companies we invest in.

You’ve seen us write it before: “*we’re focused on high-quality businesses*”.... “*we see our investments like owners of the business*”. But today I’ll go a little further and explain what ‘high-quality’ means and why our positions give us confidence going forward.

Setting the stage: High-quality – I’ll admit it’s a general term that can mean plenty of things. At Doxa, we are usually looking for a couple of key attributes:

1. A strong secular demand tailwind or a large business moat (*quasi-monopoly*).
2. Best in class operating margins and high returns on capital (& ROIC).
3. Big shareholder returns or big compounders, i.e. *the company invests back in itself to continue strong growth*.
4. A strong management team with an articulate strategy for the medium term.

Positions: a few notes we filed on some of our positions post-Q2 conference calls and model updates. I’m not going to add too much background for brevity, but will add some links if you’re interested. *All these notes are internal, so you can also get a feel for how we think through quarterly updates!*

Google (GOOGL): Has a monopoly on search and is the powerhouse of digital advertising. **A core holding.** ‘Other bets’ of Verily, Waymo, Nest aren’t included in the valuation. Cloud continues to perform, search slowed down in some places because of lapping big 2021 numbers and a strong USD. Travel is accelerating. 2023 operating leverage will come through. Free cash flow (FCF) compounds at 20%+ a year. Return on Invested Capital (ROIC) is 31%.

Icon (ICLR): a leading clinical research org (*they run clinical trials for pharma companies*). High return, low capital business with big tailwinds from more complex trials/technology/drugs and an aging global population. Pharma funding environment still solid despite macro uncertainty – showing their non-cyclicality. Seeing demand normalize from the Covid vax trial bump. Their merger with PRA Health is ahead of schedule and synergies are coming in higher than expected. Margins will expand back to peer highs when merger is completely integrated and multiples will expand. ROIC of NewCo ~25%. [IR Slides](#)

Constellation Brands (STZ): the owners and distributors of Corona, Modelo, & Pacifico + a wine & spirits [portfolio](#). STZ plays the role of a lowering volatility in the portfolio as a consumer staple (something people buy regardless of the economy) – but also has a much better growth profile than peers. They aren’t seeing any consumer trade down to date, and costs are largely hedged out into 2023 (glass & water). FCF will be lower through 2025 while they expand their beer capacity, then will be back to historical norms, compounding around 11%. Strong shareholder returns are consistent (increasing dividend and buybacks).

Masco (MAS): owners of Behr paint, Delta plumbing, and Kichler lighting. A repair & remodel company with big tailwinds – the glut of homes built in the mid-00s is turning 20 years old, the prime remodel age. The single-family market is also underbuilt by ~2mn homes as millennials (big DIYers) form families and boomers age in place. Even with higher mortgage rates, Masco is still seeing good demand for their products – Q3 paint volumes are tracking with 2019 levels. Multiples are at the very low end of historical ranges, 14% compounding FCF, and a huge 38% ROIC for their sector. Market is pricing a big step-down in 2023 that we just aren't seeing yet.

[IR Slides](#)

ASML (ASML): the most important company in the world? **A true compounder.** ASML is the globe's only supplier (a monopoly) of cutting-edge lithography equipment (machines that weigh 180 tons that produce the most advance chips in the world and cost \$330 million). To be honest, the best word to describe what ASML does is "magic". History aside, ASML has full backlog coverage through 2023 and haven't seen any cancellations. Underappreciated tailwinds are the rise of GPUs for compute, IoT, and nationalization of chip manufacturing. Operating margins should expand into the mid-30% range. Easy to increase exposure while market is pricing a semiconductor downcycle.

Schneider Electric (SBGSY): a best-in-class [industrial](#) automation company focused on the energy and digital transformation. With a 27% ROIC and clear secular tailwinds, they command a premium over peers. Increased working capital held back FCF in H1 which should reverse in H2. A slow Chinese economy also was a slight drag in Q2 but global demand still came in above forecasts which is incredibly impressive and speaks to the strength of their portfolio. The software mix is gaining revenue share and will continue to push margins higher going forward. They've compounded operating income at 12% over the past 5 years and that's not slowing down.

Total Energies (TTE): a [behemoth](#) in global energy production and distribution. They boast the best balance sheet among all the majors and have breakeven costs around \$30 per barrel of oil – the lowest of the majors. TTE is pure quality and **a core holding**. They are using the immense FCF generated to support billions of dollars of renewable investments, and still have substantial shareholder returns. They trade in line with their historical average of around a 6% dividend yield – but we'll note the investor day on 9/28 may provide an increase in capital return.

Lowe's (LOW): all the secular tailwinds for Masco apply here to Lowes as well, plus the fact that they are pushing hard to close the operating gap between them and Home Depot. They have made big strides over the past few years, aided by the Covid bump as well. We (& consensus) are modeling some Covid give-back in sales, but it hasn't happened yet and pricing remains strong. Maybe DIY spending pulls back in 2023, but there's no sign of a slowdown – just a return to seasonality and moderating demand. *Recently CEO Ellison said, "After July 4th we saw step change in behavior for the better, and that's continued over the last 10 weeks."*

Discover Financial (DFS): Boasting an elite 28% return on tangible common equity for 2023, DFS is one of the highest margin, best run financials in the space. Their loan book is prime, net charge offs are printing historic lows, and delinquencies have yet to tick up. They also have a fortress of capital on their balance sheet that we expect to be released into stock buybacks in 2023, which could immediately boost shares 8%+.

Take-Two Interactive (TTWO): one of our favorite and most interesting [companies](#). Through Covid lockdowns, gaming companies made a boatload of money – without doing anything, just a pure windfall. The question is: “what do they do with all this cash?” TTWO doubled their headcount and R&D budget and bought Zynga – both brilliant strategic moves. Their pipeline is now the largest it’s ever been. The integration with Zynga adds an entire ad-based business to smooth out bookings across quarters and opens the mobile market (an additional billion gamers?) to the leading franchises TTWO owns. The mgmt. team here is unparalleled, they’ve made a ton of investments in the past 2 years and the payoff is around the corner. The stock is just way too cheap here.

Again, just a few quick takes on some of the companies in our portfolio. We wanted to give some insight into how we lean on the solid foundation of these businesses during down markets. We have complete confidence that Google will use their operating leverage the right way, that Schneider will continue to push the digital transformation, and that Take-Two is about to reap the rewards of their huge investing years. For us, these things make it easier to focus on the long-term and have the necessary patience it takes to get there, despite all the noise along the way. As we’ve said before, don’t miss the forest for the trees – zooming out and seeing the whole picture is an investing superpower we like to use to our advantage.

Fun quip of the day:

The comical thing about working at public tech companies over the last few decades is you just do your job the same way each day and investors schizophrenically pick a different multiple on the output.

Chase Lee, CFA
Director of Research

David Mucciario
Director of Financial Planning

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