NAVIGATING INVESTMENT SHOALS

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Shoals are the bane of sailors. When a boat is moving fast or in a storm, it can be a recipe for disaster to run aground an elevated piece of land within a body of water. It's humiliating to run aground, even if the boat is moving slowly and merely disrupts the sailors' plans. The challenge to avoid shoals increases during storms because they often divert sailors' attention away from safe navigation.

AVOIDING SHOALS IS THE CHOICE OF SAFETY-CONSCIOUS SAILORS

There are lessons here for investors. One of the best risk-control activities is avoiding investment areas that threaten disruption of capital—or worse—its permanent loss. Within the liquid capital markets, including stocks, bonds, and money market funds, there are two types of investment shoals. The first is paying more for an investment than it is actually worth. The inevitable return to a normal value brings a loss or a long period of sub-par returns. Another shoal can develop when an investment does not perform up to forecast.

ONE OF THE BEST RISK-CONTROL ACTIVITIES IS AVOIDING INVESTMENT AREAS THAT THREATEN DISRUPTION OF CAPITAL—OR WORSE—ITS PERMANENT LOSS.

Most of the time, investment shoals are just annoying (i.e. damaging to the ego) because most stocks are reasonably valued and the overall economy is sound. Every once in a while individual stocks or groups of stocks can become seriously overvalued, setting up the conditions for a catastrophic loss of principal. These are bad shoals; they must be avoided.

In an economic, health and investment storm like the Covid-19 pandemic the potential dangers increase. The investor faces an elevated risk of very poor investment decisions.

It is important to keep dangers at bay. For sailors, preparedness before a storm may be the most crucial activity. Monitoring the weather, heading for safe waters, and briefing a novice crew greatly improves their chances of a safe outcome. The same is true for professional investors. Even if it is well-nigh impossible to accurately forecast the timing or severity of an economic/market calamity, investors can be financially healthy entering the crisis. They can be personally grounded by solid relationships with family and advisors prior to the crisis. And they can have a sound investment philosophy and process in place.

These steps may not prevent investors from being battered and bruised during the investment storm, but they will ensure that investors will be fine after the storm abates.

COVID-19 PANDEMIC

The enduring investment story of 2020 will reflect the preparedness of professional investors prior to the Covid-19 pandemic. At DGI, we entered the Covid-19 crisis very prepared in financial strength, with well-established client relationships and a sound, well-tested philosophy and process.

In the period before Covid-19, our investment team was in flux with new hires, one departure, and promotions—a potential challenge. We recognized in 2019 that these personnel changes could threaten our effectiveness, especially our readiness to weather storms. The entire investment team focused on improving its dynamics and inner workings, as well as mastering new ways of operating once Covid-19 hit. Today, the health of our investment team is the strongest it's been in a decade or more.

Another essential way DGI navigates through the Covid-19 crisis is to rely on our well-vetted philosophy and process for selecting investment, which have been a bedrock throughout our 24 years and many bear markets. The process encompasses three elements: 1) thoroughly understand the company, 2) develop a realistic seven-year forecast for it, and 3) insist that the stock be priced to offer investors a 12 percent or higher expected return over the next seven years. This process helps us invest well while offering unique insights into the perilous shoals of the liquid capital markets.

DANGEROUS MARKET AREAS

Prior to Covid-19, there were two investment shoals to circumvent: very expensive but well-established stocks and bonds, and extremely expensive stocks of fast-growing companies with unproven business models. Covid-19 surfaced the third shoal: companies that fail to adapt to a post-pandemic environment. During the height of the Covid-19 pandemic, we kept these shoals firmly in our minds.

Shoal #1—Seemingly low-risk investments

This shoal includes companies with strong franchises (Facebook, Amazon, Google) and high-quality bonds (US Treasury notes and bonds). These types of investments offer false safety. They will survive Covid-19, but the cost of safety is too high. Simply, investors should understand that the likely long-term returns from these types of investments are poor, that their seeming safety comes at too high a price. Investors must eschew this siren song and not let their fear of Covid-19 drive them into poor long-term results.

Shoal #2—Untested companies flying high

Fast-growing but untested companies whose stocks are selling for sky-high valuations (Tesla, Zoom, Snowflake) became more tempting to some during Covid-19. After all, their prospects are so bright they will power through a recession. While one or two of this type of stock/company will grow fast enough and enhance their business model to support today's valuation, the vast majority will be unable to generate enough fundamental progress to justify their current stock prices. Long-term investment returns in this shoal are likely to be negative.

Shoal #3—Failure to adapt

Another dangerous shoal emerges when companies fail to adapt to a post-Covid-19 world. Covid-19 already has changed consumer and business behavior, and companies need to adjust to meet shifts that might linger. Investing in companies like Sears or JCPenney, which are struggling with these new realities, most likely will provide negative long-term investment returns.

> THERE ARE SIGNIFICANT INVESTMENT OPPORTUNITIES THAT CAN AVOID THE INVESTMENT SHOALS AND OFFER AN INVESTOR REASONABLE ODDS OF AN EXCELLENT FORWARD RETURN

INVESTMENT OPPORTUNITIES THAT AVOID SHOALS

Though everyone has been tested through these challenging times, the seas will become calmer again. The economy of the United States offers major strengths to form a basis for a sustained recovery:

- The U.S. economy was healthy prior to the onset of Covid-19
- The banking system is sound, unlike 2008
- The U.S. is now energy-independent
- The U.S. has long been the most prolific food production country in the world
- Interest rates are too low to restrain economic growth
- There is a surplus of capital for investing
- The U.S. is not at war
- Innovation remains a key driving force

There are significant investment opportunities that can avoid the investment shoals and offer an investor reasonable odds of an excellent forward return. These opportunities offer fertile ground for our research efforts and are centered in three areas:

1) Our traditional bread-and-butter stocks whose underlying companies have been managing their businesses very well before and during Covid-19. These companies have not been in the investor spotlight over the past few years, so their stocks are priced to offer a reasonable forward return: Garmin, Plexus, and Viasat are some examples.

2) Stocks whose companies actually benefit from Covid-19. These are companies that had a prior position in e-commerce, such as Stamps.com. U.S. natural gas producers with low-cost production and strong reserves will benefit from the move to electric vehicles and shut-in oil production due to low oil prices. Southwestern Energy and Cabot Oil & Gas should offer excellent forward returns.

3) Stocks whose companies have been battered hard by Covid-19, but the management teams are excellent. These managers are using their company's financial strength to reposition operations and gain major market share from faltering competitors. These stocks—including Under Armour, JetBlue, and Nordstrom—could be star future performers.

FINAL THOUGHTS

The market pattern over the past year has been uniquely challenging for our process, but we've overcome extreme market and economic challenges twice before. DGI steers through crises by managing our business very tightly, with low fixed costs and strong finances. This financial discipline allows us to make prudent long-term investment decisions on behalf of you, our clients.

Investment success in this environment will be based on minimal exposure to the three dangerous investment shoals, painstaking research on finding those future great companies, uncompromising discipline, and patience. We look forward to the challenge and to serving as your captain through dangerous waters.