MV CAPITAL MANAGEMENT

Weekly Market Flash

Due Diligence Is Due for a Comeback

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The year 2022 is winding down to a close. In the world of financial markets that primarily means one thing: predictions, predictions, predictions. Everybody has an opinion about what 2023 will bring to stocks, bonds, oil, the dollar, cryptocurrencies and everything else under the sun. The vast majority of these predictions will turn out to be way off the mark, for the simple reason that nobody knows which of the many threats and opportunities out there, known and unknown, are going to be the ones that matter and which way they will drive asset prices. Who was baking a global pandemic into the cake in December 2019? Or a Russian invasion of Ukraine in December 2021?

Predictions Are Silly, But We Still Make Them

Despite the high probability of being wrong, though, there is a reason why we all persist in prognosticating about the year ahead – and yes, that "we" most certainly includes us at MV Financial and the "Year Ahead" outlook we publish every January. That reason has much less to do with outcomes than it does with process. Making a prediction forces us to organize many strands of disparate and often contradictory information into a coherent argument supported by logical reasoning. It also, collaterally, necessitates that we identify (as well as we can based on what we know at the time) the risks that could produce alternative outcomes to our base case.

We will have more to say about the particulars of our 2023 outlook in our report next month. Meanwhile here is one development we see as highly likely, thanks in part to some of the spectacular bust-ups of 2022. Due diligence, that plodding and time-consuming exercise of determining the characteristics of an asset ahead of making an investment decision, is due for a comeback. In the past couple years there seems to have been a conspicuous absence of due diligence, including among some of the world's supposedly smartest investors (hello, Sequoia Capital and Temasek), as an alternative evaluation process called FOMO – fear of missing out – ruled the roost.

From "Uber of X" venture capital plays (X being whatever imagined industry sector was about to experience an Uber-like disruption) to cryptocurrencies to the nosebleed price-to-sales ratios of companies in the ARKK Innovation Fund, the name of the game was to get in quick before you miss the boat. "Have fun staying poor" was the taunt made to anyone arguing that an investment in any of these shiny baubles required a compelling real-world use case and careful analysis of the fundamentals. The FOMO mentality will never go away completely, of course, but we think it is on its way to the back seat while good old fashioned due diligence retakes the wheel.

When The Tide Goes Out

It was Warren Buffett who purportedly said that when the tide goes out it's easy to see who is swimming naked. The "tide" in this case, of course, is the reversal of the easy monetary policy that held sway for the better part of twelve years. A lot of things can make some kind of sense, if you squint hard enough, when interest rates are zero or even negative. Throw in a bunch of stimulus money and bored people punting on Reddit memes while working from home, and it's easy to see how the mania of 2021 happened. But now even Japan, the ur-practitioner of negative interest rates, has started to move back towards something approaching sanity. The Bank of Japan's decision this week to allow the 10-year Japanese

Government Bond to fluctuate by as much as half a percent (as opposed to one-quarter of one percent) may be baby steps, but the market seemed to get the message.

It is very unlikely that we will see a return to the strange worlds of ZIRP and NIRP (zero and negative interest rate policies, respectively) any time soon, if in fact ever. This implies a structurally higher cost of capital that should set a higher bar for yea or nay on any given risk asset. At the same time, the stunning amount of outright fraud that accompanied the collapse of erstwhile crypto “genius” Sam Bankman-Fried and FTX Capital (again, hello wise investors Sequoia and Temasek) should give one pause before credulously buying into the next charismatic dude playing video games while pitching a can’t-miss thing.

So what does this translate into, investment strategy-wise? Not necessarily, we think, into one category or another like value versus growth or international versus domestic. Strong and sustainable cash flows, a value proposition that makes sense, a sensible ratio of debt to equity – all the boring stuff that comes up during the due diligence process, on a case-by-case basis. That, we predict, will matter again in 2023.

We wish each and every one of you health and happiness in whatever holiday you and your loved ones are celebrating this season.

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