Arrowside Capital Q4 2022 Letter to Investors

Performance

The portfolio returned 3.2% for the fourth quarter of 2022, which compares with a 7.1% return for the S&P 500, a 6.6% return for the Russell Midcap Growth, and a return of 3.8% for the Russell 2000 Growth.

Market and Economic Commentary

The fourth quarter of 2022 saw global markets stabilize after a tough first three quarters of the year. Investors keyed on the sustained level of inflation, the actions of the Federal Reserve, and the possibility of a recession. These served to put a lid on the level of valuations in the quarter. As has been the case for the whole year, all eyes were on the Federal Reserve. The Fed raised rates two times to a Fed Funds rate of 4.25-4.50%. This is the highest the Fed Funds Rate has been in 15 years. It has been well publicized that the Fed has been raising rates aggressively to combat inflation. They have made it clear that they will keep rates high for an extended period until they are satisfied that inflation is under control and back down to a sustainable level. This has been bad news for equities this year. Higher rates mean more alternatives to equities, and a rethinking from investors about capital allocation. This initially caused valuations to come way down from elevated levels, and now is keeping them from rising.

Inflation likely peaked in the quarter, showing a deceleration in the rate of change from 9.1% in June to 6.5% in December. Energy prices came off their highs in the quarter and the global supply chain is showing signs of normalizing. In addition, there are signs that China is beginning to reopen, which will also add to overall supply, taking one more burden off the supply chain. For risk assets such as equities, this is good news, as there is a chance that we are getting closer to the peak interest rate for this cycle. However, in our view, it does not mean that the Fed is finished raising rates as some may be hoping for.

One other development in the quarter was widespread layoffs in the technology industry. During the pandemic, the service sector went through a deep recession, one that crippled businesses and closed restaurants and retail locations. At the same time, technology companies enjoyed a significant increase in activity and many companies hired thousands of employees to keep up with demand. As it turns out, some level of demand was pulled forward and now many of these same companies are seeing a slowdown in growth or a contraction. As a result, they are laying off a significant number of workers. The technology sector is experiencing its own recession now, one which we believe will be more muted than the one that the service sector experienced, but nonetheless will mean some level of pain.

The technology sector has already entered a form of a recession. Between lower levels of business activity and layoffs, it is safe to say that technology spending and activity has receded. Investors had a long period of expansion in this past cycle, and it became easy to forget that technology spending is susceptible to cyclicality. This part of the cycle can be somewhat painful for the stock prices and for employees, as returns on option grants and restricted stock are worth less than in past years.

The question on investors' minds seems to be whether we enter a recession in 2023 or 2024. This depends on how broad or narrowly one wants to define this and what metric one wants to use to measure. Most certainly, we will see lower levels of business activity in 2023 and will experience an earnings recession. The depth and duration have yet to be determined, but we see lower business activity throughout the year and an opportunity for a rebound in 2024.

The significant downdraft in equity prices came as a result of already high valuations and the rapid rise in interest rates due to persistent inflation. While we think that some level of weaker demand is priced into the market right now, it is unclear how much a worse or longer downturn in business activity is priced in currently. It seems more likely that any recession is more targeted toward the sectors that were beneficiaries in the pandemic, namely for the technology, consumer and financial sectors.

We do believe that we are in the bottoming process right now, with wide dispersion among individual stocks at the highest level in quite some time. This is good news for active investors, as dispersion has been very low since the Global Financial Crisis more than a decade ago. This type of dispersion is an important part of the bottoming process, as investors sort out who the winners and losers are going to be going forward and look for pockets of leadership to pull us out of the downturn. The bottoming process does not have a typical duration, but it does take some time especially absent any macro catalysts, such as rate cuts. We believe that the opportunities presented in the bottoming process are best found in high quality companies that generate cash flow and have solid balance sheets. In these types of periods, it is important to note that the best managed and best positioned companies are well positioned to be stronger on the other side of these issues. Companies that are weaker and not as well managed will struggle in the years that follow because they had to make adjustments to just survive this period. By focusing on the best in class companies, we believe that we are uniquely positioned to own the new leaders in the next bull market.

Outlook

It is hard to predict with precision what will happen in equity markets in 2023. Investors for the first time in a while have the choice of some yield, which makes the riskier assets classes such as equities seem less attractive. Equities also face tough comparisons from a business perspective in the first half of 2023 versus the same period in 2022. This should serve to make returns more muted in the short term as we chew through the bottoming process. The things that investors will key on will be inflation and its sustainable level, interest rates, corporate earnings, and the possibility and depth of a recession. All of these are seemingly negative for markets, but the sentiment is poor and markets start to discount a rebound before the rebound happens. So, we are cautiously optimistic that we will see some strength during the year and while the exact level is not clear, this would set the tone for the next few years. The pace of innovation continues to be very fast and companies are creating exciting new products and services. There is a lot to be optimistic about relative to investing in change over the long term. This is especially true for the next few years once we get through the bottoming process and establish a new bull market. We expect this to begin in 2023 but it is hard to know from what level and what the timing is exactly. As a result, we do not time the market. Rather, we stay invested in the best in class companies creating change and look through the short term noise to maximize long-term returns.

About

Arrowside Capital's mission is investing in innovation with a ton of discipline. Established in 2022, Arrowside Capital has one strategy that invests in best-in-class companies that are creating change. The Founder and CIO, Tucker Walsh, has more than 30 years of experience in investing in small and midsized companies. Arrowside Capital believes that investing in innovative companies creating change builds the most value over time. The firm's rigorous investment process searches for companies that are innovative and profitable. Companies in the firm's concentrated portfolios have durable competitive advantages, superior margins and returns on capital, and ample reinvestment opportunities. The combination of great conditions plus great management behaviors leads to the most intrinsic value growth over the long-term. Arrowside Capital favors small and mid cap companies in order to take advantage of the market inefficiencies resident in these types of companies.