



Wedgewood Partners Third Quarter 2021 Client Letter

I, Pencil

I am a lead pencil—the ordinary wooden pencil familiar to all boys and girls and adults who can read and write... I, Pencil, simple though I appear to be, merit your wonder and awe, a claim I shall attempt to prove....Simple? Yet, not a single person on the face of this earth knows how to make me. This sounds fantastic, doesn't it?... Pick me up and look me over. What do you see? Not much meets the eye – there's some wood, lacquer, the printed labeling, graphite lead, a bit of metal, and an eraser... Actually, millions of human beings have had a hand in my creation, no one of whom even knows more than a very few of the others... Here is an astounding fact: Neither the worker in the oil field nor the chemist nor the digger of graphite or clay nor any who mans or makes the ships or trains or trucks nor the one who runs the machine that does the knurling on my bit of metal nor the president of the company performs his singular task because he wants me... I, Pencil, am a complex combination of miracles: a tree, zinc, copper, graphite, and so on. But to these miracles which manifest themselves in Nature an even more extraordinary miracle has been added: the configuration of creative human energies – millions of tiny know-hows configuring naturally and spontaneously in response to human necessity and desire and in the absence of any human masterminding!... The lesson I have to teach is this: Leave all creative energies uninhibited. Merely organize society to act in harmony with this lesson. Let society's legal apparatus remove all obstacles the best it can. Permit these creative know-hows freely to flow. Have faith that free men and women will respond to the "Invisible Hand." This faith will be confirmed. I, Pencil, seemingly simple though I am, offer the miracle of my creation as testimony that this is a practical faith, as practical as the sun, the rain, a cedar tree, the good earth.

– Leonard E. Read, 1958.

Review and Outlook

For the third quarter of 2021, our Composite (net)ⁱ gained +2.75%. The S&P 500 Index gained +0.58%. The Russell 1000 Growth Index gained +1.16%. The Russell 1000 Value Index fell -0.78%. Year-to-date, our Composite (net) gained +20.39%. The S&P 500 Index gained +15.92%. The Russell 1000 Growth Index gained +14.30%. The Russell 1000 Value Index gained +16.14%.

Q3 Top Contributors	Avg. Wgt.	Contribution to Return
Alphabet	9.45	0.90
Edwards Lifesciences	7.03	0.60
Motorola Solutions	6.94	0.49
Tractor Supply Company	5.47	0.44
Keysight Technologies	4.91	0.39

Q3 Bottom Contributors

PayPal	5.69	-0.60
Progressive	3.38	-0.26
UnitedHealth	0.50	-0.19
Taiwan Semiconductor Manufacturing	2.88	-0.17
Facebook	8.14	-0.17

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Top performance detractors for the first quarter include PayPal, Progressive, UnitedHealth, Taiwan Semiconductor Manufacturing, and Facebook. Top first quarter performance contributors include Alphabet, Edwards Lifesciences, Motorola Solutions, Tractor Supply Company, and Keysight Technologies.

During the quarter we trimmed Alphabet, Keysight Technologies, and Starbucks. We increased our position in Taiwan Semiconductor Manufacturing and purchased UnitedHealth.

PayPal reported +40% growth in total payment volume to \$311 billion during the second quarter's most recent report. In spite of this impressive growth, the stock detracted from performance as the market became overly concerned about the pace at which its legacy eBay business rolled off. Despite the stock's premium valuation, we continue to hold PayPal as a core position and think eBay represents short-term noise in PayPal's longer-term drive to become a "super-app" with payments at its core.

Progressive reported higher than expected loss trends during the summer months. Much of this was due to inflation in the automobile supply chain. Over the past few years, its policy pricing actions have been relatively benign, so we think the Company has plenty of room with customers and pent-up goodwill with regulators to take up pricing and offset this pressure while maintaining its double-digit policy volume growth. The stock trades at a significant discount to the market, as financials – particularly insurers – are out of favor with "growth technology" investors. Progressive represents the rare financial that can post attractive growth due to its best-in-class ability to segment its markets and leverage its low-cost direct distribution.

UnitedHealth Group detracted from performance due to investor concerns about Medicare premiums as well as post-COVID medical cost trends. Medicare enrollment should continue

¹ Portfolio contribution calculated gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended. Returns are presented net of fees and include the reinvestment of all income. "Net (actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred. Past performance does not guarantee future results. Additional calculation information is available upon request.

to grow at double-digits at UnitedHealthcare. Meanwhile the Company's Optum segment should be able to help bend the cost curve if indeed post-COVID volumes pick up to above pre-COVID levels. In any case, we do not think the long-term normalized trend of medical care in the U.S. has changed substantially and would look to add to our new position on any continuing short-term concerns.

Taiwan Semiconductor Manufacturing detracted from performance as the market attempted to price in a downturn in the semiconductor cycle. Although there are some signs that memory markets might be somewhat oversupplied, we have yet to see any tangible signs that logic semiconductors – particularly at the leading-nodes where the Company dominates – are in anything but short supply. In addition, and as a result of this strong demand, the Company should be able to pass through price increases to help fund very attractive returns on the rare leading-edge capacity that serves this demand.

Facebook detracted from performance despite posting a staggering +56% growth in advertising revenues. Much of the stock's underperformance was driven by nonoperating concerns that we view as mostly political in nature. The Company's digital properties command a massive audience of over *2.7 billion* daily users, so any government or state actor would be able to wield tremendous power by controlling that audience and it should not be a surprise when those actors attempt to do that. However, Facebook has invested aggressively in its content curation capabilities that address many of the concerns raised by media and political critics. We continue to carry Facebook at our maximum weighting as the stock is trading in line with a market multiple despite unrivaled competitive positioning and rapid growth, representing one of the best risk-rewards available in the market.

Alphabet's core Google search business accelerated to multiyear highs, up nearly +70% driven in part by advertisers rushing to the Company's Android platform. We estimate Android runs on nearly three-quarters of all smartphones; however, its share of ad spend is lower. Recent policy changes to Apple's iOS operating system have made it more difficult for advertisers to get a return on its ad spend across the Apple ecosystem. These changes should help close the gap between Android and iOS advertising share and sustain Alphabet's torrid growth.

Edwards Lifesciences returned to a double-digit 2-year growth rate during the quarter. Life-saving medical procedures, such as severe aortic stenosis valve replacement, got back to some semblance of normal in the late stages of the pandemic. The Company is still in the early years of leading the charge of replacing open surgical procedures with minimally invasive transcatheter therapies. As medical visits continue to return to normal, Edwards should be able to expand its lead, particularly after a major competitor has had issues with product efficacy. Edwards should be able to maintain its market leadership by focusing its higher than peer average research and development budget on just a handful of product lines.

Motorola Solutions revenue grew over +20% as pent-up project spending returned at its public safety and corporate customers. Many of these state and local government customers will likely receive relief funding thanks to the federal American Rescue Plan Act of 2021. The

public safety and communication budgets of the Company's customers has proven to be very resilient in past economic downturns as emergency responders need Motorola's mission critical networks to operate regardless of GDP growth. However, added state and local funding from the federal government should enable more budget flexibility which could accelerate network upgrade plans that utilize more high-margin software and services offered by Motorola. (See more on Motorola below.)

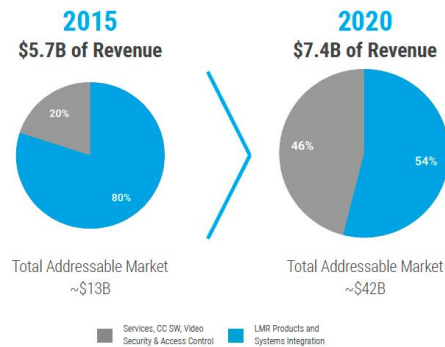
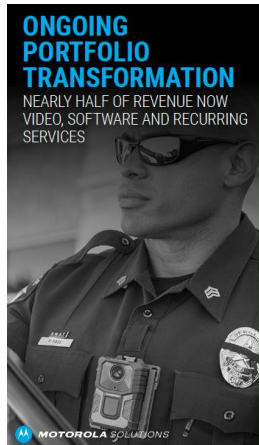
Tractor Supply had a dominant business model before COVID, but COVID has only made it better by driving more customers into its arms and providing windfall profits that allowed them to accelerate a variety of initiatives in omnichannel as well as store upgrades and remodels. We continue to expect a premium business, that has had some long-term secular tailwinds handed to it by the pandemic should trade well above the current market multiple; however, Tractor Supply is trading just about at parity with the broader market and around the upper end of its longer-term historical range. For a great business that became sustainably better as a result of the pandemic, along with a multiple that we think is too low, we continue to hold the Company in an overweight position.

Keysight's revenue and earnings growth surged as a combination of easy comparisons and pent-up demand converged with excellent execution in the face of widespread competitive supply chain disruptions. Keysight primarily serves research and development labs across most industries, providing hardware and, increasingly, software content that enables bleeding-edge product testing. Many of the technologies that Keysight helps enable will not come to market for several years, so Keysight must develop many of its own custom parts, especially microprocessors. The Company's captive fabrication plant has helped it avoid many of the shortfalls seen at companies that rely on more off-the-shelf silicon. As customer R&D budgets move inexorably higher, we expect the Company to grow its share of wallet and drive attractive growth for the next several years.

Company Commentaries

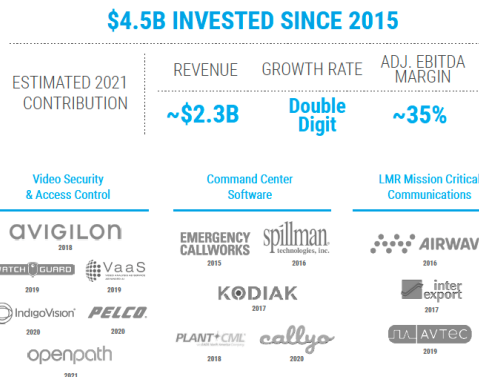
Motorola Solutions

We have owned Motorola Solutions for more than two years and have been happy to see the Company continuing to execute on the strategy that attracted us to the stock. As a reminder, Motorola is the dominant market leader in its core Land Mobile Radio (LMR) business: providing infrastructure, handsets, and related software and services for customized, highly resilient, secure networks for global police and emergency services, a variety of government and military applications, and other commercial and public safety applications where security and reliability are of the utmost importance. The Company has continued to find success in using its entrenched position in these mission-critical networks to layer in faster-growing and higher-margin software, service, and video products. Although Motorola has some credible competition in these ancillary products, in contrast to its dominance in the LMR business, it is the only player capable of fully integrating the entire service offering with its core LMR network backbone.



Source: Company Presentation

Motorola has assembled this stable of complementary products and services largely through acquisition, using the steady, recurring cash flows the LMR business has provided. These purchases not only have been attractive strategically; they have been extremely attractive financially, as well. The Company recently pointed out it had made \$4.5 billion of acquisitions since 2015; those businesses currently, in 2021, generate roughly \$800 million in EBITDA, with margins and organic growth both running well ahead of the corporate average. This works out to a notional total purchase price of just over 5.5X the EBITDA these businesses are now generating, whereas Motorola’s stock currently trades over 20X this year’s anticipated EBITDA. While this is only one way to evaluate the Company’s acquisition strategy, we believe this data illustrates how well the Company has used its strong competitive and financial position in LMR to evolve into an even more attractive business.



Source: Company Presentation

While the first part of our ownership went according to our expectations, we did not, of course, anticipate a pandemic. Despite the fundamentals of the Company holding up quite

well relative to the broad market during the massive economic downturn that ensued, the stock underperformed for much of 2020. We believe some of this was due to the market's general lack of familiarity with the Company. We also believe some highly politicized police funding debates led to irrational pressure on the stock, as did misplaced worries about public safety customers' budgets in the middle of the severe recession that temporarily accompanied the pandemic. We, on the other hand, know the company provides an absolutely critical service to its public safety customers, and it cannot be turned off if, for example, police funding is diverted elsewhere, or if sales tax receipts fall off for some period of time. Furthermore, it was very clear to us that the pandemic had created additional long-term opportunities for the Company.

While some investors were worrying about customers' lower sales tax receipts, the U.S. federal government has been creating (and continues to create) massive stimulus funding for state and local governments, as well as other Motorola customers such as FEMA, school districts, and airport and transit operators. Although this funding typically does not appear immediately and may take some time to find its way from a news headline to an actual customer's budget, the Company has highlighted funding already available to customers in the region of \$350 billion for state and local governments, \$170 billion for education, and \$38 billion for airport and transit. The Company has begun to see significant interest from these customers in deploying some of these funds in much needed upgrades to its emergency call centers (known as Next-Gen 911 or NG911), school security, and airport security, among other areas. Motorola has said only a minimal amount of this government funding has actually appeared in its results as of yet – these funds are just starting to reach Motorola's customers. Those customers are only now deciding how they wish to allocate the funds. The Company expects to see the benefit of this funding through 2024, when the current rounds of stimulus expire. As we are sure you have noticed, however, political debate continues about staggering potential sums of additional government funding, much of which eventually will find its way to Motorola's customers' budgets.

Looking at the opportunity in NG911 alone, Motorola has pointed out many times that approximately 80% of 911 call centers still are only capable of receiving phone calls – in 2021, the vast majority of 911 centers still can't even receive a text message. This means, of course, that they also cannot receive pictures or videos; therefore, they are unable to pass any of this potentially useful data on to responding officers in the field.

This highlights an additional problem with these outdated call centers, which unfortunately was brought into sharp focus by the pandemic: with their lack of capabilities in mobile data or video, and a lack of software or cloud connectivity built into the call centers, public safety customers realized their shortcomings in being able to coordinate their responses among the call center, police officers, emergency medical personnel, schools, or hospitals. Imagine, for example, trying to coordinate a dinner reservation for six people without your mobile phone, without the ability to send group texts, without access to Google, and without the ability to make a reservation online. Now consider that 80% of America's emergency response call centers were trying to handle something as critical and complex as a response to a pandemic without the most basic of modern technology resources.

We note that not only in these NG911 upgrade initiatives, but also in use cases beyond the traditional call center business, including areas such as school or airport security, Motorola's newer capabilities in areas such as video and software have worked hand-in-hand with integration into its highly reliant, highly secure LMR networks to create opportunities for the Company, allowing Motorola to present a full solution to a customer looking to solve many of these issues that were highlighted by COVID.

So while the stock lagged the market for much of last year, we saw clear longer-term catalysts emerging as a result of the pandemic, leading us to take a few opportunities to increase our position size significantly last summer, after the stock retreated roughly to our original purchase price.

Finally, a core component of our original thesis was that the broad market was not familiar with this Company – in fact, even in financial news services, many of the news stories we see tagged with “MSI” still have nothing to do with MSI and instead are about the long-divested mobile phone business. We continue to expect Motorola Solutions' fundamental performance to attract more investor attention and to lead to expansion of the Company's valuation. We would note that the stock has in fact seen some multiple expansion during our holding period, but this has mostly mirrored the seemingly eternal multiple expansion in the market as a whole. Since the Company's growth and financial return profile remains superior to the broad market, we still see plenty of opportunity for the stock's valuation to move favorably relative to market multiples.

UnitedHealth Group

UnitedHealth Group is the largest healthcare service provider in the U.S., managing over \$250 billion in healthcare spend and serving over 165 million people. The Company has first-mover advantage at providing integrated service offerings aimed at bending the cost curve of providing access to care that improves the health outcomes for its members. Over the past five years or so, the Company has aggressively expanded beyond traditional health benefits by making several key acquisitions in large and adjacent healthcare verticals including pharmacy benefits, walk-in care clinics, specialized outpatient service providers, and physician practices. As much of the industry plays catch-up to United's solutions, we expect United's addressable market will continue to expand, along with the aging of the general U.S. population. The Company should be able to drive double-digit earnings growth, through a combination of competitively differentiated operating performance as well as capital deployment at attractive multiples.

After making several important acquisitions over the past 5 to 10 years, UnitedHealth Group segmented its business into two well-known subsidiaries: Optum and UnitedHealthcare. Like much of the healthcare benefits industry, the Company formerly had a heavy reliance on contracting with outside service providers for care. The Company's health care benefits group now more exclusively relies on its internal Optum group to increasingly provide value-based care, rather than fee-based, while Optum offers its services to all comers often on a fee-basis. For example, Optum acquired urgent care facilities to help address all the patient

issues that might require something more than a regular doctor visit yet are not serious enough for the emergency room (ER). By routing UnitedHealth plan members to Optum-owned urgent care clinics, those patients receive proper care while the health plan incurs substantially less cost than the ER visit. Many healthcare plans still do not cover this sort of outpatient “gap” in care and are at a disadvantage compared to UnitedHealthcare. Of course, while the Company’s plan designs often exclusively rely on Optum, Optum is still free to offer its services to outside healthcare plans, which helps the Company maximize the utilization of those Optum assets. For example, the Company has over 26 million people covered by its employer and individual plans; however, the entire Optum umbrella consists of nearly 100 million customers. Many of those outside plan customers come to Optum via the pharmacy benefit manager ([PBM] OptumRx) which the Company has scaled into one of the largest PBMs in the U.S. through acquisition and share gains.

UnitedHealth Group serves a couple of very large addressable markets that remain relatively underpenetrated. OptumHealth generated \$40 billion in revenue during 2020 and has a nearly \$1 trillion addressable market. The subsidiary employs (or is affiliated with) 53,000 physicians, more than double the number from 5 years ago, and the Company expects to add another 10,000 physicians during 2021. This aggressive consolidation of the highly fragmented physician market has helped drive out administrative and operational inefficiencies (costs) while maintaining or improving the health outcomes of patients. OptumRx is the Company’s PBM that pools together over \$100 billion in purchasing power to lower the net cost of drugs for beneficiaries. After acquiring Catamaran in 2015, the Company insourced its pharmacy benefit from Medco Health (now part of Cigna) and turned the business into one of the top-3 scale buyer of pharmaceuticals. OptumRx is focused on faster growing segments such as specialty pharmacy and infusion services, and although margins are often lower than the rest of the business, our experience is that PBMs are not particularly capital intensive and generate high returns as a result.

As for UnitedHealthcare, they handle roughly 20% of the U.S. Medicare Advantage plan population. With over 10,000 baby boomers aging into qualifying for the U.S. Medicare system every day, enrollment growth has compounded at over 10% for the past 5 years and should continue at similar rates through 2025. The Company achieves this market share and growth by consistently maintaining medical costs that are below traditional Medicare. The Company also serves about 26 million employer and individual members, one of the largest private payer books in the industry. Many of these members eventually find their way into the Company’s Medicare Advantage program, which enables the Company to have a much more detailed picture of member health status over time, allowing for more personalized, effective, and lower-cost care.

The combined scale of the Company’s business segments along with supportive demographic trends in the U.S. should help the Company sustain double-digit earnings per share growth for the next several years. UnitedHealth Group should be able to supplement this growth through continued consolidation of the highly fragmented healthcare industry. The stock currently sports a below-market multiple, despite peer-leading profitability metrics and unrivaled scale, which made it an attractive addition to the portfolios during the quarter.



“I, Pencil” has long been a favorite soliloquy on and celebration of free market economies for over 60 years. We offer it in our Letter as not only a compelling treatise on the mind-numbing complexities of making, well, a simple pencil but also a juxtaposition against the truly unfathomable complexities of our modern day, just-in-time global supply system. We hope by comparison we can convey our worries that Corporate America and Jane and Joe Consumer will continue to face uncharted waters of a mismatch between soaring consumptive demand and near-structural matériel and finished-goods shortages in *everything!* The manifest combination of COVID-related global shutdowns and the spun-off symptoms of labor shortages, raw material shortages, intermediate and finished goods shortages, double and triple ordering masking true demands, chain-reaction transportation gridlock, innumerable commodity, manufacturing, and labor inflation spikes has, as our greatest fear, both structural supply shortages and systemic (not *transitory*) inflation, that grinds well into 2023.

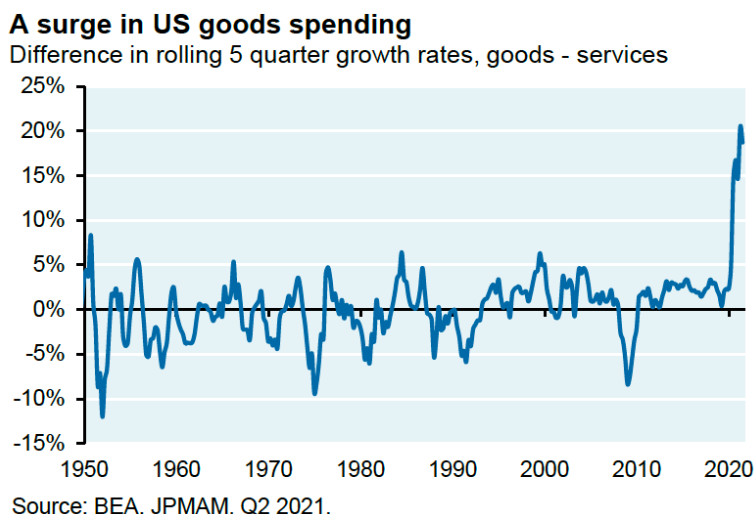
If compound interest is the 8th Wonder of the World, the Just-in-Time Inventories surely ranks a close 9th. When does the U.S. economy (and the global economy) get back to Normal? What is Normal? Is Normal post-COVID, 2019? 2018? Could 2021...2022...2023 be the New, New Normal? Yes, unfortunately, we think so.

Over the past few quarters, we cannot recall a single earnings conference call when the forecast or question of “getting back to normal” was not either prophesied or queried very early on in the call. Without fail, the forecasted or answered “Normal” continues to be “2019.” To be fair to corporate managers, this new, new operating environment circa-2021

is well beyond their collective career experiences. In essence, they are collectively flying by the seat of their pants. Charles Lindbergh they ain't.

The psychological desire of investors and Corporate America to get back to a time pre-COVID is quite powerful. (Well, that goes for the lot of us too.) Once the pandemic began, the global economy suffered through unprecedented rolling shutdowns over the past 18 months, along with the concomitant collapse of the economic miracle of a just-in-time global supply chain – which we now realize was truly a modern economic miracle. Our evolving answer to the “getting-back-to-Normal” question is that today, 2021, is the New, New Normal. In all of its symphonic logistical elegance, 2019 was, in brutal hindsight, perfectly Abnormal. The year 2019 was Spinal Tap at 11 – 2019 was, indeed, perfectly unprecedented.

We are all brutally aware of the collapse of global supply chains due to COVID shutdowns. Product orders in 2019 to be manufactured by early 2020 were never manufactured, completed, or shipped. Once global economies staggeringly reopened, backorders began to be filled, slowly at best. Then came a wave of unprecedented demand as trillions of fiscal stimulus checks flooded the market. All at once, global consumers who were locked down at home were denied the usual services (travel, vacations, restaurants, movies, and theater) decided *en masse* to cure their collective cabin fever by splurging on capital goods (cars, trucks, decking, pools, home repair). It didn't take long to lay bare the shelves of capital goods – particularly home goods. (How goes that new kitchen you were promised would be completed back in February?) The modern global supply chain has never had to deal with collapsing supply, coupled with surging demand. Price increases across the commodity complex have exploded at rates of increase rarely seen by the current class of corporate managers. In addition, rolling factory reopening plans have been countlessly delayed due to spikes of the Delta COVID variant across the globe.



Consider the last two reports from The Institute of Supply Management (ISM); they reported the August PMI at 59.9% and September PMI at 61.1% -- both within market expectations.

That said, it was the survey's respondents' remarks that really caught our eye, capturing the global zeitgeist better than we can tell the unfolding story.

WHAT RESPONDENTS ARE SAYING

- "The **chip shortage** is impacting **supply** lines. So far, we've been able to manage it without impacting clients." [Computer & Electronic Products]
- "Some **factories have been impacted by COVID-19 cases**. Malaysian government says factories can operate at only **60 percent of capacity**." [Computer & Electronic Products]
- "We continue to see extended lead times due to **port delays** and sea container tightness. Manufacturing capacities are impacted by a **lack of workers reducing output**. Several chemical facilities have experienced fires, explosions and spills, further challenging suppliers' ability to deliver on time and in full." [Chemical Products]
- "Strong sales continue, but production is limited due to **supply issues with chips**." [Transportation Equipment]
- "**Supply chain functions** have been relentlessly challenging. All things from freight (both over the road and ocean), already constrained labor forces are further exacerbated by COVID-19 absenteeism. Also, **high prices** everywhere are wearing our employee base down." [Food, Beverage & Tobacco Products]
- "**Oil prices have remained higher** than planned and is helping to secure capital funds and project sanctions for 2021-22 projects." [Petroleum & Coal Products]
- "Bookings/sales continue to be strong. **Persistent supply issues** — including availability of materials, freight/logistics/containers, and allocation of key commodities — continue to hamper production ramp to meet demand. Also struggling with **lack of labor** in several factories. Commodities are still inflationary, but price increases have leveled." [Furniture & Related Products]
- "Business is strong. **Part shortages** are our largest business constraint. We cannot fulfill orders to customers in reasonable lead times. Now booking out into 2022, and it will get worse as we hit our cyclical high demand in the fourth quarter." [Electrical Equipment, Appliances & Components]
- "Business is going strong, but **raw material prices still under increasing price pressure**. Labor is still an issue." [Plastics & Rubber Products]
- "Continue to be unable to hire hourly personnel or machine operators due to **few applicants**. Steel and aluminum remain in **short supply**. New business continues to grow and come in. Unable to handle influx of orders without staff, both hourly and salaried." [Fabricated Metal Products]
- "Customer **order backlog continues to climb** because we are unable to raise production rates due to **supplier** parts and manpower challenges. Continue to see price increases with key commodities, and logistics is an ongoing challenge that has no end in sight." [Machinery]

WHAT RESPONDENTS ARE SAYING

- "Many electronic components and assemblies **shortages** showing up (due to) port issues, lack of containers and other issues. Problematic, but nothing completely shut down yet. Watching COVID-19 restrictions country by country." [Computer & Electronic Products]
- "The impacts from Hurricane Ida on the petrochemical industry has put additional stress on an already **fragile supply chain**. Logistics with intermodal containers and motor carriers continues to be a challenge for planning deliveries of materials." [Chemical Products]
- "In the U.S., **labor availability is the most significant supply challenge** for our company, with raw materials just behind. Plastic resin, polyurethanes, small-volume steel purchases and electronics are the biggest material challenges." [Transportation Equipment]
- "**Lack of labor** and **escalating costs** from **every direction** are very concerning." [Food, Beverage & Tobacco Products]
- "Ocean **freight delays** creating disruptions in many areas. Southeast Asia **supply** continues to be **challenged** due to COVID-19 outbreaks." [Furniture & Related Products]
- "Delivery and availability of **raw materials**, primarily carbon steel, are becoming **more and more difficult to source**. This has resulted in delaying order deliveries. Computer numerical control (CNC) machining services are at a premium; it's difficult to get the deliveries needed to complete jobs. Traditional in-house machining now has to be outsourced due to a lack of experienced machinists. All this has had a negative impact on production throughput." [Fabricated Metal Products]
- "Customer demand continues to swell as we prepare for the fourth quarter, and overall growth has been extremely good for the year. **Supply chain concerns are growing** beyond electronics and chips into most other commodities. Lead times are extending, shipping lanes are slowing, and **we will not see an end to this in 2021**." [Electrical Equipment, Appliances & Components]
- "We are still amazed by the labor market. **We used to have 100 applicants for an opening; we are now seeing about 10 — and often, the applicant does not show for the interview**." [Paper Products]
- "Our company's entire **supply chain** continues to have **significant challenges getting manpower**, which is impacting production of parts and ability to meet daily build schedules. Additionally, the logistics problems — especially port delays and a shortage of shipping containers — are significantly impacting inbound and outbound shipments. **Raw materials costs** still are at **record highs**, and we have **raised customer pricing, with additional increases in the near future due to labor costs going up**. Huge customer orders are nine months out (due to) backorders. Seeing this domestically and internationally." [Machinery]
- "**Global supply chain constraints** are still a major concern and focus. Inventory builds continue to compensate for potential **supply disruption**." [Miscellaneous Manufacturing]

Nearly a century ago, the sunset at Long Beach, California, was blocked by Signal Hill oil rigs. Today, the ports of Long Beach and L.A. are clogged with record numbers of container ships (+70 as of this writing) at anchor waiting to unload +500,000 containers. Ports around the country are queued up at record levels as well. The cost of containers traveling to the West are so high that *empty* containers are being rushed back to Greater Asia instead of waiting to be loaded with U.S. exports.

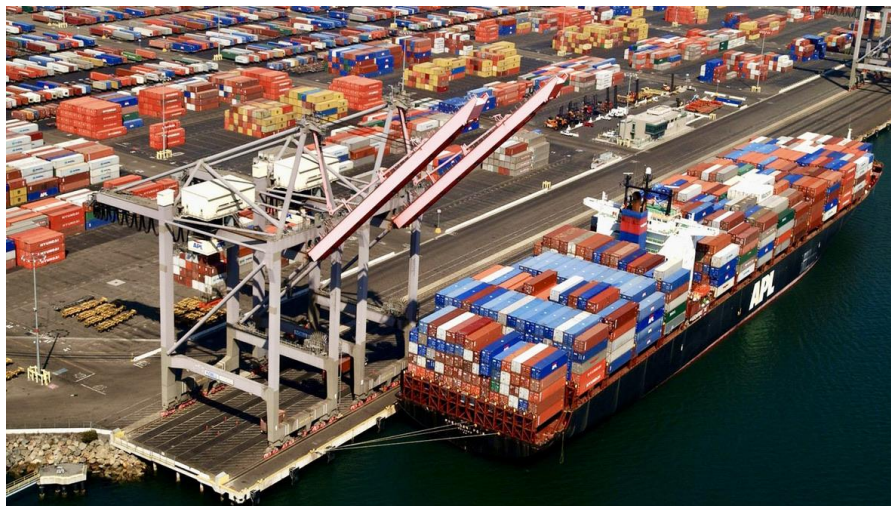
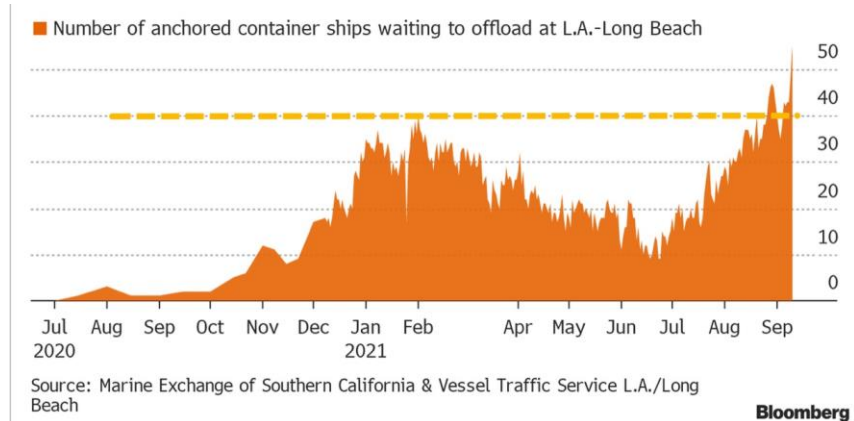


Source: Los Angeles Public Library photo collection



Source: Bloomberg

As of this writing, Marine Exchange of Southern California reports the following: “Ship report 10/8: 154 total ships inport Port of L.A. and Long Beach, includes 86 at anchor or drift areas & 68 at berths. Of the 154, 90 are container ships including 60 at anchor or in drift areas & 30 at berth. 30 vessels in drift areas; 20 container ships, 4 tankers, 6 bulk, 0 general cargo.”



Source: Getty

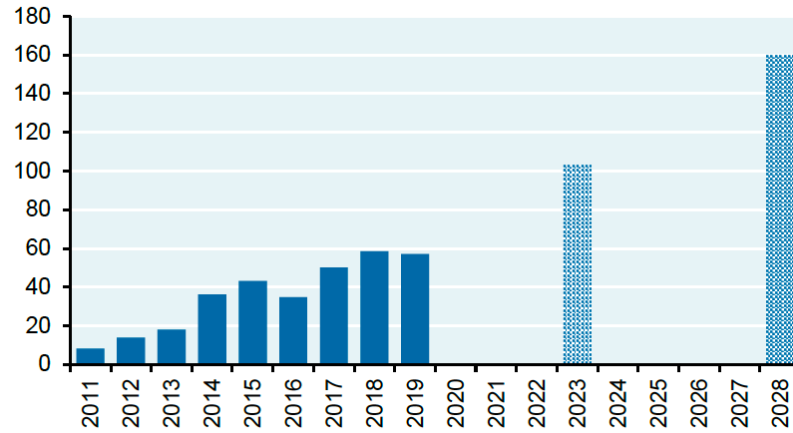
A date to watch next summer is the July 1 expiration of the current labor contract between the West Coast dockworkers union. The last contract negotiation was quite contentious and lasted months. During those negotiations, container ships piled up in ports.

As far as container ships go, the expected new orders have surged since last year. However, according to Maritime Strategies International, the vast majority of the tonnage on order won't be delivered until late 2023 at the earliest. Even if such tonnage could be delivered today, that wouldn't solve the problem in the U.S. of land-based capacity shortages – far too many container ships would arrive at terminals that are at max capacity today, plus there

would be capacity issues (and critical labor shortages) down the transport chain of rail, trucking, and warehousing.

US truck driver shortage

Thousands of drivers



Source: American Trucking Associations. 2019. Dotted bars = forecasts.

Source: J.P. Morgan

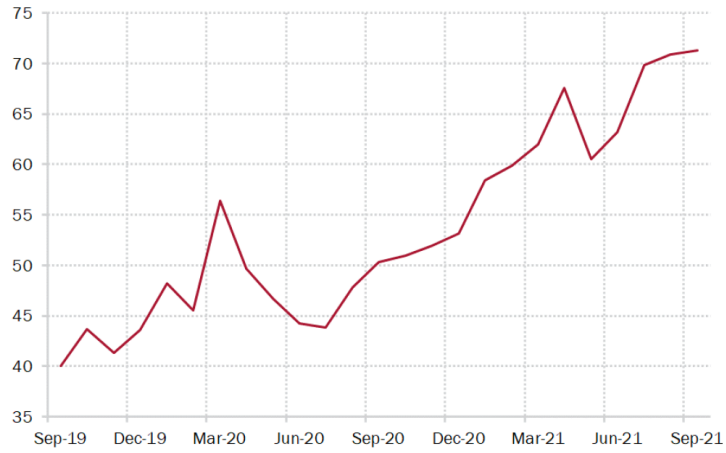
The following graphics put an exclamation point on the current tale of woe, plus the *non-transitory* creeping inflation. Again, the current crop of C-suite executives and their associated purchasing managers, inventory managers, operation managers, logistic managers, suppliers, and end customers have little to no experience in this New, New Normal. Better start shopping for Christmas...yesterday!



Source: Flexport

CHART 5: China to U.S. Transit Time

Global
(number of days)



Source: Freightos

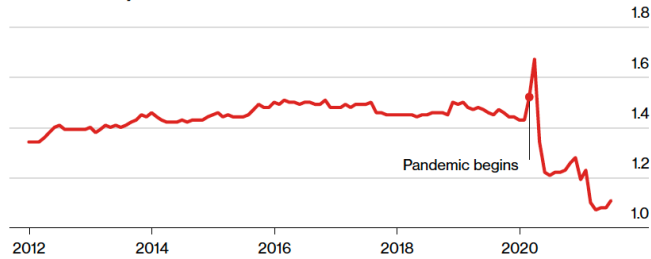


Source: Zero Hedge

Enough Stuff?

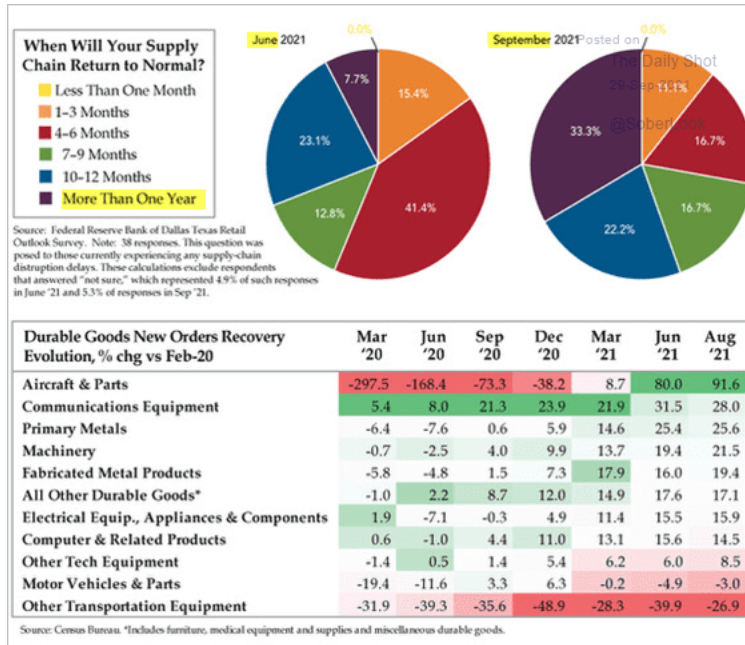
Inventories at U.S. retailers are way below historical levels

Retail inventory to sales ratio



Source: U.S. Census Bureau

Note: This ratio indicates the number of months of inventory that are on hand. For example, a ratio of 1.5 means that retailers have merchandise to cover one-and-a-half months of sales.



Source: Quill Intelligence



Source: Flexport

Charlie Bilello @charli...
 Commodity prices over last year...

- Natural Gas: +141%
- Heating Oil: +120%
- WTI Crude: +101%
- Brent Crude: +100%
- Gasoline: +93%
- Coffee: +79%
- Cotton: +65%
- Aluminum: +64%
- Sugar: +46%
- Copper: +42%
- Corn: +42%
- Wheat: +27%
- Lumber: +24%
- Soybeans: +22%
- Silver: -8%
- Gold: -8%
- Palladium: -20%

US: High inflationary pressures

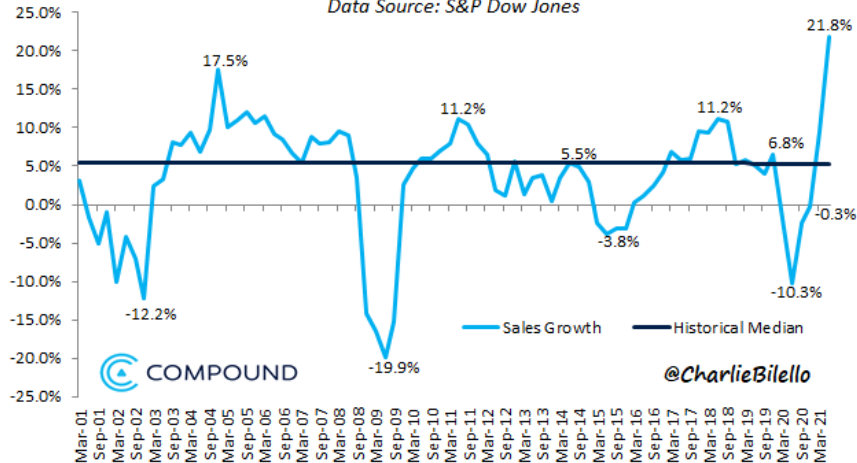


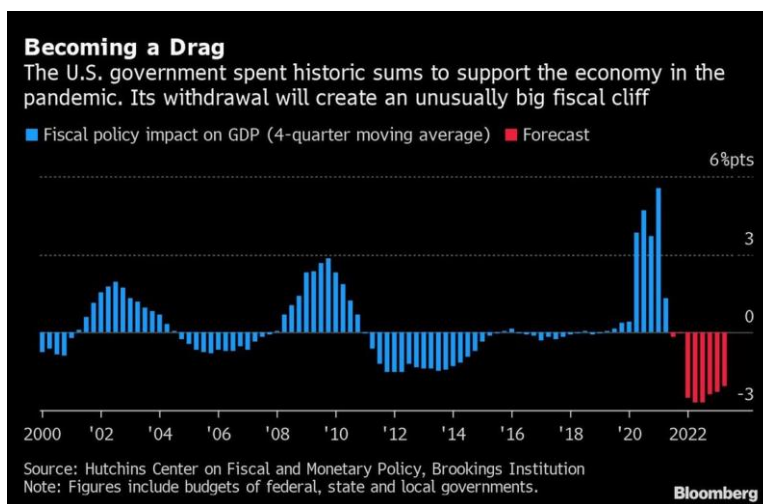
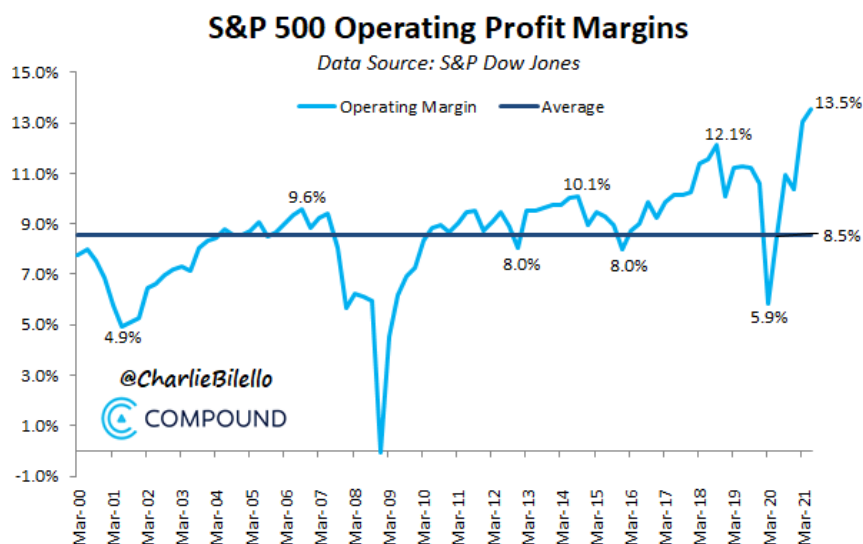
Source : Oxford Economics/Haver Analytics

The New, New Normal could not be unfolding at a more inauspicious time. Corporate America post-COVID sales growth has been booming at a record pace, plus profit margins are at sharp records as well. We believe the stage is set for one of the most difficult operating environments for Corporate America since the Great Recession of 2007-2008. Never before have global economies been shuttered as if flipping a switch. Again, the sheer economic impossibility of a global demand boom, coupled with a global supply shock, is certainly not a staple in economic textbooks. As both corporate purchasing and logistics managers scramble frantically to source products, to meet backlog demand we expect that current demand indicators may not be as strong as current readings may indicate due to double and triple ordering. Plus, don't discount the first and second order effects when Washington turns down the fiscal spigots.

S&P 500 Sales Growth (Quarterly, YoY%)

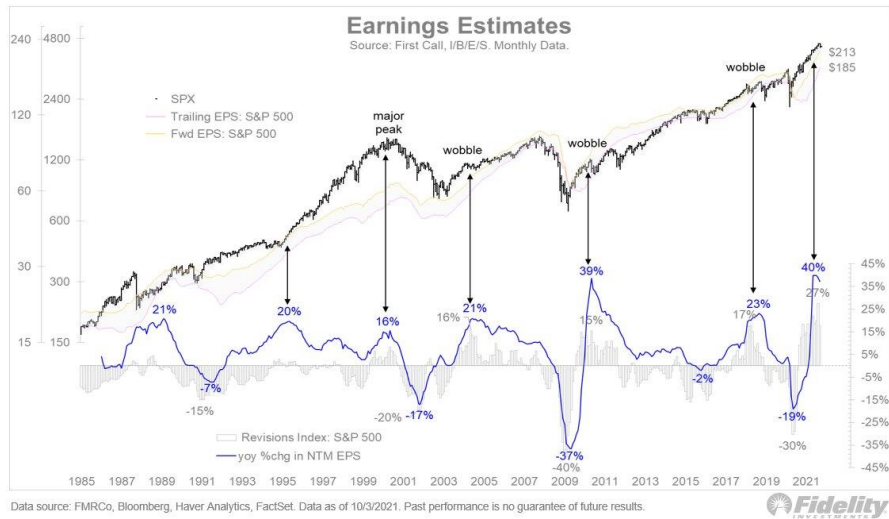
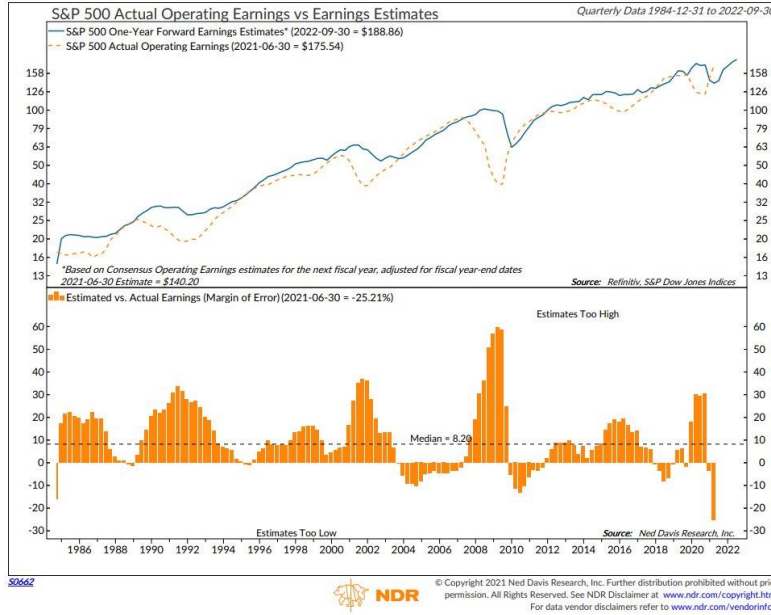
Data Source: S&P Dow Jones





What has emerged in the New, New Normal is a scramble to build inventories. This has long been anathema in the long era of just-time inventory management. We suspect too that a long-tail structural change in inventory management will source away from Greater Asia and back to the U.S. That will take years (and many billions) to build manufacturing plants.

In the meantime, over the next several quarters, we are preparing ourselves for enormous pressure on corporate revenues, profits, and ultimately, earnings estimates. Wall Street analysts were late to catch up to the immediate late-pandemic corporate earnings boom - +54% in Q1 and +96% in 2Q. We expect the reverse to unfold on the downside in the New, New, Normal. Whispered fears of the *ghosts of stagflation* might spook the markets just in time for Halloween. Buckle up.



October 2021

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ⁱ Returns are presented net of fees and include the reinvestment of all income. “Net (Actual)” returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.

I, Pencil

By Leonard E. Read

I am a lead pencil—the ordinary wooden pencil familiar to all boys and girls and adults who can read and write.

Writing is both my vocation and my avocation; that's all I do.

You may wonder why I should write a genealogy. Well, to begin with, my story is interesting. And, next, I am a mystery —more so than a tree or a sunset or even a flash of lightning. But, sadly, I am taken for granted by those who use me, as if I were a mere incident and without background. This supercilious attitude relegates me to the level of the commonplace. This is a species of the grievous error in which mankind cannot too long persist without peril. For, the wise G. K. Chesterton observed, “We are perishing for want of wonder, not for want of wonders.”

I, Pencil, simple though I appear to be, merit your wonder and awe, a claim I shall attempt to prove. In fact, if you can understand me—no, that's too much to ask of anyone—if you can become aware of the miraculousness which I symbolize, you can help save the freedom mankind is so unhappily losing. I have a profound lesson to teach. And I can teach this lesson better than can an automobile or an airplane or a mechanical dishwasher because—well, because I am seemingly so simple.

Simple? Yet, not a single person on the face of this earth knows how to make me. This sounds fantastic, doesn't it? Especially when it is realized that there are about one and one-half billion of my kind produced in the U.S.A. each year.

Pick me up and look me over. What do you see? Not much meets the eye—there's some wood, lacquer, the printed labeling, graphite lead, a bit of metal, and an eraser.

Innumerable Antecedents

Just as you cannot trace your family tree back very far, so is it impossible for me to name and explain all my antecedents. But I would like to suggest enough of them to impress upon you the richness and complexity of my background.

My family tree begins with what in fact is a tree, a cedar of straight grain that grows in Northern California and Oregon. Now contemplate all the saws and trucks and rope and the countless other gear used in harvesting and carting the cedar logs to the railroad siding. Think of all the persons and the numberless skills that went into their fabrication: the mining of ore, the making of steel and its refinement into saws, axes, motors; the growing of hemp and bringing it through all the stages to heavy and strong rope; the logging camps with their beds and mess halls, the cookery and the raising of all the foods. Why, untold thousands of persons had a hand in every cup of coffee the loggers drink!

The logs are shipped to a mill in San Leandro, California. Can you imagine the individuals who make flat cars and rails and railroad engines and who construct and install the communication systems incidental thereto? These legions are among my antecedents.

Consider the millwork in San Leandro. The cedar logs are cut into small, pencil-length slats less than one-fourth of an inch in thickness. These are kiln dried and then tinted for the same reason women put rouge on their faces. People prefer that I look pretty, not a pallid white. The slats are waxed and kiln dried again. How many skills went into the making of the tint and the kilns, into supplying the heat, the light and power, the belts, motors, and all the other things a mill requires? Sweepers in the mill among my ancestors? Yes, and included are the

men who poured the concrete for the dam of a Pacific Gas & Electric Company hydroplant which supplies the mill's power!

Don't overlook the ancestors present and distant who have a hand in transporting sixty carloads of slats across the nation.

Once in the pencil factory—\$4,000,000 in machinery and building, all capital accumulated by thrifty and saving parents of mine—each slat is given eight grooves by a complex machine, after which another machine lays leads in every other slat, applies glue, and places another slat atop—a lead sandwich, so to speak. Seven brothers and I are mechanically carved from this “wood-clinched” sandwich.

My “lead” itself—it contains no lead at all—is complex. The graphite is mined in Ceylon [Sri Lanka]. Consider these miners and those who make their many tools and the makers of the paper sacks in which the graphite is shipped and those who make the string that ties the sacks and those who put them aboard ships and those who make the ships. Even the lighthouse keepers along the way assisted in my birth—and the harbor pilots.

The graphite is mixed with clay from Mississippi in which ammonium hydroxide is used in the refining process. Then wetting agents are added such as sulfonated tallow—animal fats chemically reacted with sulfuric acid. After passing through numerous machines, the mixture finally appears as endless extrusions—as from a sausage grinder—cut to size, dried, and baked for several hours at 1,850 degrees Fahrenheit. To increase their strength and smoothness the leads are then treated with a hot mixture which includes candelilla wax from Mexico, paraffin wax, and hydrogenated natural fats.

My cedar receives six coats of lacquer. Do you know all the ingredients of lacquer? Who would think that the growers of castor beans and the refiners of castor oil are a part of it?

They are. Why, even the processes by which the lacquer is made a beautiful yellow involve the skills of more persons than one can enumerate!

Observe the labeling. That's a film formed by applying heat to carbon black mixed with resins. How do you make resins and what, pray, is carbon black?

My bit of metal—the ferrule—is brass. Think of all the persons who mine zinc and copper and those who have the skills to make shiny sheet brass from these products of nature. Those black rings on my ferrule are black nickel. What is black nickel and how is it applied? The complete story of why the center of my ferrule has no black nickel on it would take pages to explain.

Then there's my crowning glory, inelegantly referred to in the trade as "the plug," the part man uses to erase the errors he makes with me. An ingredient called "factice" is what does the erasing. It is a rubber-like product made by reacting rapeseed oil from the Dutch East Indies [Indonesia] with sulfur chloride. Rubber, contrary to the common notion, is only for binding purposes. Then, too, there are numerous vulcanizing and accelerating agents. The pumice comes from Italy; and the pigment which gives "the plug" its color is cadmium sulfide.

No One Knows

Does anyone wish to challenge my earlier assertion that no single person on the face of this earth knows how to make me?

Actually, millions of human beings have had a hand in my creation, no one of whom even knows more than a very few of the others. Now, you may say that I go too far in relating the picker of a coffee berry in far-off Brazil and food growers elsewhere to my creation; that this is an extreme position. I shall stand by my claim. There isn't a single person in all these millions,

including the president of the pencil company, who contributes more than a tiny, infinitesimal bit of know-how. From the standpoint of know-how the only difference between the miner of graphite in Ceylon and the logger in Oregon is in the type of know-how. Neither the miner nor the logger can be dispensed with, any more than can the chemist at the factory or the worker in the oil field—paraffin being a by-product of petroleum.

Here is an astounding fact: Neither the worker in the oil field nor the chemist nor the digger of graphite or clay nor any who mans or makes the ships or trains or trucks nor the one who runs the machine that does the knurling on my bit of metal nor the president of the company performs his singular task because he wants me. Each one wants me less, perhaps, than does a child in the first grade. Indeed, there are some among this vast multitude who never saw a pencil nor would they know how to use one. Their motivation is other than me. Perhaps it is something like this: Each of these millions sees that he can thus exchange his tiny know-how for the goods and services he needs or wants. I may or may not be among these items.

No Master Mind

There is a fact still more astounding: The absence of a master mind, of anyone dictating or forcibly directing these countless actions which bring me into being. No trace of such a person can be found. Instead, we find the Invisible Hand at work. This is the mystery to which I earlier referred.

It has been said that “only God can make a tree.” Why do we agree with this? Isn’t it because we realize that we ourselves could not make one? Indeed, can we even describe a tree? We cannot, except in superficial terms. We can say, for instance, that a certain molecular configuration manifests itself as a tree. But what mind is there among men that could even record, let alone direct, the constant changes in molecules that transpire in the life span of a tree? Such a feat is utterly unthinkable!

I, Pencil, am a complex combination of miracles: a tree, zinc, copper, graphite, and so on. But to these miracles which manifest themselves in Nature an even more extraordinary miracle has been added: the configuration of creative human energies—millions of tiny know-hows configuring naturally and spontaneously in response to human necessity and desire and in the absence of any human masterminding! Since only God can make a tree, I insist that only God could make me. Man can no more direct these millions of know-hows to bring me into being than he can put molecules together to create a tree.

The above is what I meant when writing, “If you can become aware of the miraculousness which I symbolize, you can help save the freedom mankind is so unhappily losing.” For, if one is aware that these know-hows will naturally, yes, automatically, arrange themselves into creative and productive patterns in response to human necessity and demand— that is, in the absence of governmental or any other coercive master-minding—then one will possess an absolutely essential ingredient for freedom: a faith in free people. Freedom is impossible without this faith.

Once government has had a monopoly of a creative activity such, for instance, as the delivery of the mails, most individuals will believe that the mails could not be efficiently delivered by men acting freely. And here is the reason: Each one acknowledges that he himself doesn't know how to do all the things incident to mail delivery. He also recognizes that no other individual could do it. These assumptions are correct. No individual possesses enough know-how to perform a nation's mail delivery any more than any individual possesses enough know-how to make a pencil. Now, in the absence of faith in free people—in the unawareness that millions of tiny know-hows would naturally and miraculously form and cooperate to satisfy this necessity—the individual cannot help but reach the erroneous conclusion that mail can be delivered only by governmental “masterminding.”

Testimony Galore

If I, Pencil, were the only item that could offer testimony on what men and women can accomplish when free to try, then those with little faith would have a fair case. However, there is testimony galore; it's all about us and on every hand. Mail delivery is exceedingly simple when compared, for instance, to the making of an automobile or a calculating machine or a grain combine or a milling machine or to tens of thousands of other things. Delivery? Why, in this area where men have been left free to try, they deliver the human voice around the world in less than one second; they deliver an event visually and in motion to any person's home when it is happening; they deliver 150 passengers from Seattle to Baltimore in less than four hours; they deliver gas from Texas to one's range or furnace in New York at unbelievably low rates and without subsidy; they deliver each four pounds of oil from the Persian Gulf to our Eastern Seaboard—halfway around the world—for less money than the government charges for delivering a one-ounce letter across the street!

The lesson I have to teach is this: Leave all creative energies uninhibited. Merely organize society to act in harmony with this lesson. Let society's legal apparatus remove all obstacles the best it can. Permit these creative know-hows freely to flow. Have faith that free men and women will respond to the Invisible Hand. This faith will be confirmed. I, Pencil, seemingly simple though I am, offer the miracle of my creation as testimony that this is a practical faith, as practical as the sun, the rain, a cedar tree, the good earth.
