Wagner Road Capital Management

Coronavirus Crash & Recovery: Foresight and Hindsight in 2020

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Contents

Introduction 2
First Quarter Commentary: Expectations and Uncertainty 3
  The Point 5
Second Quarter Commentary: False Hope 5
  The Challenge for Retail Right Now 7
  The Berkshire Hathaway Annual Meeting 8
  The Essential Businesses 9
  Moving On-line 9
  Video Games 10
  The Point 10
Third Quarter Commentary: The Uneven Recovery 10
  The Point 12
Fourth Quarter Commentary: Hindsight in 2020 12
  The Final Point 14

Introduction

Part of my responsibility as an investment manager is to keep our investors informed about my expectations and my understanding of the risks created by major news events. Almost every quarterly investor letter includes some kind of relevant current event, updates that are specific to portfolio companies, and an industry review. For most quarters, the industry review becomes the quarterly blog post, but I'm making an exception for this one. The news for the past year is too big to ignore.

The story of the year—the pandemic—is one that covers every part of life in every part of the world. But our interest is primarily the economic effects and the market impact in the United States.

I started following the Coronavirus sometime in January of 2020. My view at the time was that the world should easily get it under control. I hoped, at worst, that it would be another SARS. It was a reasonable expectation that a similar disease outbreak would lead to a similar global health outcome. But one small change has made all the difference.

SARS, if you're not familiar, was a disease from 2002 caused by a strain of Coronavirus called SARS-CoV-1. The SARS outbreak only lasted about a year, and it only infected a few thousand people, with less than 1,000 deaths. None of those deaths happened inside the US.

COVID-19, as you probably know by now, is a disease caused by a strain of Coronavirus called SARS-CoV-2. This outbreak has caused millions of infections and will cause millions of deaths by the time it ends. The United States has consistently been one of the worst in the world.

SARS was more deadly, but COVID-19 has killed more people. So what's the difference? There are many reasons why the world has struggled to get it under control, but I think it can be simplified into how the two diseases are spread:

- People who got SARS could not spread the disease until after they started feeling sick. When they felt sick, they were more likely to stay home, stopping the spread.
- People who get COVID-19 can spread the disease before they know they are sick. They don't feel sick, so they don't stay home.

This minor difference explains why it is more challenging to face COVID-19 than SARS. It is much harder to slow down and prevent the spread of a disease that can be spread

by "healthy" people. COVID-19 has been worse than my initial expectations. It has become more like the 1918 pandemic than like SARS.[1]

As more information came in, my expectations had to be adjusted to reflect a more depressing reality. It quickly became obvious that this version of Coronavirus would not go away easily, and most forecasts were too optimistic. But after a bad summer and an even worse winter, the vaccines are finally coming.

It will take a few more months to get everything under control, but this feels like the right time to end my version of the story. This quarter is devoted to reviewing my comments on the Coronavirus as the situation developed throughout the year. There is some editing for length, and a few details have been transformed into summaries, but the core messages have been preserved.

First Quarter Commentary: Expectations and Uncertainty

April 6, 2020

When I first came up with this portfolio, I thought about what would happen during market crash and a recession, but I never imagined anything like this. We now have a pandemic, an oil price war, and a market crash, and a recession is virtually inevitable (a depression is a real possibility).

As Mike Tyson once said before a major fight (and investors everywhere keep repeating), "Everybody has a plan until they get punched in the mouth." I think that's a good description of how the Coronavirus (more formally known as COVID-19) has affected stock portfolios around the world—the Dow Jones benchmark had its worst quarter since 1987, and the worst first quarter in the entire 100+ year history of the Index.

I will not describe the global health impact of the Coronavirus. There are many other places to find that information, and I assume that most are obsessively following that part of the story. This discussion is only about the financial and economic impact as it relates to our portfolio. For the market, the past quarter has been dominated by variations of two headlines, especially the first one (there are other major headlines, but they are generally connected to this news).

- Stocks fall on fears of Coronavirus impact.
- Stocks rise on hopes of response to Coronavirus.

[1] There is obviously more to the story. This bad outcome does not excuse the policy responses from different countries throughout the world—it's not impossible to prevent a disaster, it's just more difficult. Many countries were not capable of handling this kind of crisis. In some cases, this came from a lack of resources. In the most extreme failures, it came from a lack of leadership.

Hopes and fears can affect prices, but they do not make an investment better or worse. These emotions can infect every investment process in the same way that a virus can infect any person. When it becomes too powerful, it transforms into a panic—the market version of getting punched in the mouth.

The obvious distinction for this financial news is that Coronavirus hopes and fears are compared to the expectations of business disruptions. Entire countries have shut down to prevent it from spreading too fast, including most of the US. The market is trying to predict how bad the economic damage will be, and is desperately trying to get ahead of any signal that it will become better or worse. The result will be the same as any economic crisis: some businesses will be punished while others will benefit. In the overall market, we're seeing the behavior that I summarized in my first letter: "Everyone is overconfident and terrified at the same time; they know that *their* investment choices are the right ones, but they're ready to run away as soon as they see everyone else begin to flee." The stampede has arrived.

From a trader's perspective, the best time to get out is *before* it gets bad, and the best time to get in is *before* it starts to get better. And I expect it get much worse before it starts to get better. But I'm not trying to time these reactions, because I don't use a trader's perspective. Our investment philosophy is not intended to avoid a pandemic or a market panic—it is created to withstand them. We rely on the quality of the businesses that we own, while trusting the management teams to make the right financial decisions. This is the comfort and confidence that comes with high quality investing. It can be painful to see the stock numbers move the wrong way, but it should not be devastating. There is no doubt that this will be a difficult year for everyone, including our own portfolio, but we were prepared for something bad to happen.

For example, two of the companies in our portfolio each have more than $120 billion in cash. Both of these companies have long been criticized for holding so much money when it could be invested or distributed. *That criticism has ended.* They are not getting praised for their caution, but these piles of cash are no longer considered a burden; this cash is now considered an irreplaceable safety net. And as the market continues to be volatile, new business or investment opportunities will surface. We just have to trust that their long track records of good decisions will continue through this crisis.

In a more general sense, specific to the health scare, I expect the video game industry to be relatively unaffected, as video game sales come primarily from online sources (Steam, an online video game service, is reporting new records for the number of

players online at one time). Our largest holding is now a video game company, and this is the perfect timing for such a position. People play games when they can't go outside.[2]

I also expect discount retailers to be a source of safety over the next year.

On the other hand, I expect our clothing retailers to be the most affected. Nobody likes to shop when there is a significant health risk, and our portfolio, tilted to retail, is sensitive to this change in behavior (these stores are closed anyway, so nobody could shop there even if they wanted to). It is still too early to know how big the short term effect will be, but the market clearly believes that it will be severe, and I agree. However, these businesses were also selected for their ability to manage a recession, and a recession is expected to follow the health crisis.

For the rest of the portfolio, this year is the best test of what it means to be invested in high quality companies—our objective is *stability first, and then growth.* The past decade has been good for growth first, and then growth again. But growth without stability will not survive this kind of crisis. We are about to see a lot of bankruptcies, and I'm confident that none of them will be in our portfolio.

From a business perspective, if we're looking at the long term prospects of what we own right now, these disruptions should be temporary. If they turn out to permanent, then we have much bigger things to worry about. You might feel sick from the market's recent moves, but you should be more concerned about getting sick from the virus. My advice is to stay safe now and worry about the portfolio later.

The Point

Getting prepared for a bad time always looks like a bad idea—until something bad happens.

Second Quarter Commentary: False Hope

July 1, 2020

In the long run, every business that we have invested in will be fine—safety and security is the primary concern. However, some of this security has been shaken, and we *do* care about growth as well. The fundamental economic changes that came with the pandemic will delay the growth of some industries, and clothing retailers will be one of

[2] A satire news group joked that the world has become a gamer's paradise where nobody goes outside, sports have been canceled, and social interaction is banned.

the worst. Since the portfolio was tilted towards retail, I had to take a hard look at what the world might look like over the next few years. Here is what I expect.

This time is different. That's what I think.

That phrase is always wrong, but this recession *is* different. It's not from banking, or oil, or housing, or any of the traditional causes. I could summarize the economic data, but that's not necessary because this is a health problem. And this means that any forecast of economic changes needs to account for how severe the health problem will be and how long it will last. Both of these factors have been routinely underestimated and continue to be underappreciated. People seem to have moved on, but this will go on much longer than anyone is hoping for. There are three reasons to be cautious:

1. **Historical comparison.** While not as deadly as the 1918 pandemic, COVID-19 may follow the same pattern, with three major waves over two years that require multiple lockdowns. This first wave has already caused unprecedented economic destruction, but a second wave could be catastrophic for an already weakened economy.

2. **Global comparison.** Other regions that are earlier in the process have so far found it difficult to fully reopen their economies. When they do reopen, business has been slow to return, and some have been forced to close again. This experience provides a preview of what we'll see in the US a few months into the future (and has already happened in some parts of the US). There will not be a fast recovery.

3. **American response.** The most disappointing part of this pandemic is that large parts of US are treating it like a course of antibiotics—they stop the treatment when they feel better, instead of using the fully recommended dosage. Even without the first two items on this list, the American response by itself ensures a prolonged recession and a delayed recovery. Pretending that there is no problem does not mean that there is no problem. It only makes things worse.

The economy, however, is not the same as the market. The Federal Reserve's response has been swift and decisive, using the same tools that rescued the market during the 2008 mortgage meltdown—pumping money into the economy, activating lending programs, and supporting businesses on the edge of bankruptcy. These actions prevented a collapse and pushed the Dow Jones market index to its best quarterly return since 1987,[3] but they have also enabled financially irresponsible companies to thrive, and they have disconnected the markets from the real economy (the market rises while the economy shakes). Providing more debt to companies that already have too

[3] The other market benchmarks reached similar milestones.

much debt is a deeply concerning long-term risk. Someday that debt will have to be repaid.[4]

The only thing that would bring everything back to "normal" is a vaccine, and even the most optimistic forecasts predict that this won't come until January. The most realistic suggest that it will be about four years, with the potential that we might *never* get a vaccine (despite all the money thrown at this disease, you still have to wait for results). Put it all together, and states could be opening and closing for more than a year, possibly up to four years.[5] Even the optimistic case is bad, and the Federal Reserve has warned that the long-term economic damage could be worse than anticipated. The Fed also admits that its power is limited in the context of a health crisis. *This is not over.*

The Challenge for Retail Right Now

As states open and close, so will retail stores. But some of the stores will never reopen, and that's the problem.[6] Fortunately, we were already protected against that possibility, because we invest in financial strength, but even the strong companies in this industry are seriously suffering.

This is true for our investments too. Our retail clothing companies temporarily closed all of their stores and borrowed money to sustain their business during the closure. The challenge is that one of them is a premium brand, and premium brands are generally the first to be abandoned when budgets are tight. It also had the weakest financial position of all our investments.

During a normal recession, that would be fine, because the stores would still be open. But the store closures, and the extra money that was borrowed to maintain them, pushed the company's financial position far beyond my very strict standards, and it will cause extensive delays in the company's plan to expand. In addition to these changes, the risk of a "second wave" of Coronavirus is too substantial to ignore.

The thinking behind the discount clothing retailer was a little different. It had a much better financial position and has a much easier path to recovery. The recession that follows the crisis will also bring in more cost-conscious customers. But the timing is still unknown, and the magnitude of these effects is still uncertain.

Long-term, the company will be fine, and the extra debt is manageable so far. However, I remain cautious about the clothing retail business. It might sound strange to focus on

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[4] This Forbes article provides a great summary of how severe the debt situation has become: https://www.forbes.com/sites/antoinegara/2020/05/21/inside-the-25-trillion-debt-binge-that-has-taken-sp-500-titans-including-boeing-and-att-from-blue-chips-to-near-junk/#1a9896e7a1f0

[5] Everyone staying at home sick is functionally the same as a forced closure.

[6] I stopped counting after 5 major clothing retailers went bankrupt during the quarter.

something so short term, but you have to be willing to change your mind when the situation changes.

The Berkshire Hathaway Annual Meeting

I am not the only one who thinks that this time might be different. At the Berkshire Hathaway (BRK) annual meeting—livestreamed from an empty stadium this year—Warren Buffett began his presentation with a history lesson on the 1929 stock market crash and the Great Depression. For someone who is perpetually optimistic, that is extremely unusual. The subtext is that he is worried that we might have another Great Depression (although he will never explicitly say this).

Just as unusual was his announcement that BRK sold all of its airline stocks. Buffett rarely abandons an investment so forcefully, and I have *never* heard him talk so much about a position that he sold. His reasoning, like mine, was that "the economy has changed" and the old thesis is no longer valid. Here are the facts at the time of his decision to sell:

- Depending on the source, air travel has fallen 95% to 99%.
- Airlines cannot survive on such low volume, and require outside funding despite already carrying substantial debt.
- Nobody knows how long it will take to get back to "normal" or if that will ever happen.
- Demand for airline travel could be permanently lowered by the more widespread use of videoconferencing services. Many businesses are realizing that extensive travel is not necessary.

The reality for airlines is that investors may not get any of their money back, and he sold to avoid taking such a big risk. But the problems for the aviation industry spread much deeper than that. It cascades through the supply chain. It goes like this:

1. Demand for air travel has gone down. This hurts the airlines, and they stop ordering new airplanes.
2. Demand for airplanes goes down. This hurts the airline manufacturers, and they order fewer airplane parts.
3. Demand for airplane parts goes down (for example, airplane engines and the parts for those engines). This hurts the airplane parts manufacturers, which includes some BRK subsidiaries.

The short version is that it's going to be bad (despite some recovery of business, the uncertainty remains, and airlines have begun asking for more money from the market). There will be bankruptcies somewhere in this chain, even with a total bailout—and a total bailout is effectively what the government and the Federal Reserve have promised.

Paradoxically, these bailouts are actually *really bad* for Berkshire Hathaway. During the 2008 Financial Crisis, BRK made several deals with desperate companies that needed cash. I expected the same thing to happen for this crisis, but no one has been asking Warren Buffett for help. Instead, the government already promised to rescue the market, and nobody is desperate for money in this new environment. The Federal Reserve's commitment to low interest rates (expected to remain near zero through 2022) also undercuts the company's competitive advantage—the low cost of borrowing money that BRK enjoys from its insurance operations is currently available to almost everyone.

The polarized opinions on Berkshire Hathaway are currently split into two separate groups. Anyone who is convinced that we'll have a fast recovery believes that Buffett missed his chance to buy cheap stocks. Everyone else agrees with his caution.

The real questions are very simple. How bad does this get? How long does it last? How long does it take to recover? And what does life look like on the other side? I agree with his caution, but I'm also surprised that he didn't find anything to buy. He might get another chance.

The Essential Businesses

Last quarter, I predicted that discount retailers would be a source of safety for investors. It has only been a few months, but so far this prediction has been right. Discount retailers are considered essential businesses, and were not forced to close during the economic shutdowns. As expected, when restaurants and other retail competitors closed, these discount retailers saw a surge in business, but it's hard to determine exactly how much of this new business will continue after the economy returns to normal.

Moving On-line

The "work from home" trade has become one of the most popular points of discussion over the past few months. This is especially true for the teleconferencing businesses, such as Zoom. We are not participating in this trade (as I keep saying, we're not traders). But working from home is only one part of many significant changes that have been accelerated by the pandemic.

The biggest one is the shift from using cash to using cards and online payments. This has been going on for decades, but the pandemic has forced many businesses to stop accepting cash and only take cards or online payments. I believe that this new comfort with digital payments will stick around after the pandemic is gone, because it's a trend that was already in place.

Video Games

One industry I can predict with more confidence is the video game industry. In last quarter's letter, I said that I expected the video game industry to be "relatively unaffected" by the pandemic. But that description understated my optimism. There are many short-term tailwinds for the industry:

1. People play games when they have to stay home.
2. Most video game revenue comes from online sales. When people play more, they pay more.
3. Video game development can be done from home, meaning that new games are unlikely to be delayed.
4. Most importantly, as I outlined in my last letter, the industry cycle will begin at the end of this year.

Video game software sales for the entire industry grew by 67% in May. This is really an anti-COVID industry.

The Point

The context of social safety—determined by the spread of the coronavirus—has affected every possible investment in the market. And it will remain the most important factor going forward. This can be summarized by the one headline that has defined the pandemic in the first half of the year—a headline that I expect will continue through the second half of this year: "A Grim New Milestone."

Third Quarter Commentary: The Uneven Recovery

October 2, 2020

There has been endless discussion on what type of recovery we will see from the economic effects of the pandemic. This is almost always defined by what "shape" the forecasters expect to see in a graph of the data—will it be a U, a long slump followed by a quick recovery, or a V, a short decline followed by a quick recovery? Or will it be the dreaded W, also known as a "double-dip" recession, where the first recovery is quickly followed by another collapse?

So far, if you look at the stock market charts in the right way, the stock market recovery looks like a V. But the stock market is not the same as the economy. Economic activity

does not come back as fast as it went away—the fall is always faster than the climb—so the economic recovery is most likely to look like a checkmark.

That's the simple version of a more complex story. The nuance is that these ideas are using aggregate numbers. They're describing the stock market as a whole or the economy as a whole. In reality, it does not come back evenly. There is another letter that offers a more appropriate picture of the type of Coronavirus recovery that we are likely to see.

An increasingly popular description of this recession's recovery is to call it a "K-shaped recovery" because some groups will benefit while others continue to struggle. The comparison is too simplistic, but the concept is sound. This argument is usually focused on the difference in how each social class will be affected by the recession (people who own assets will do well, but everyone else will not). But it can apply to business as well. The generalized version is that big businesses get bigger while small businesses decline.

At this point, everyone has already figured out who the winners are. If we separate by industries, there are a few that never saw any recession at all, such as video communication services, video games, online retailers, and discount retailers. There is also the group of "Big Tech" companies that includes Amazon, Alphabet, Apple, Facebook, and Microsoft. With highly protected competitive positions and ample cash reserves, the biggest businesses have continued to get bigger, and the investors who own them have done quite well.

What gets left behind is more uncertain. It is already clear that companies with too much reliance on debt (as well as a specific weakness to a pandemic) are not going to recover as quickly, and many of them may not recover at all. Traditional retail, especially clothing retail, continues to face challenges.[7] Commercial real estate is in limbo while big businesses reconsider how much office space they need and small businesses question whether they can pay the rent.[8] And industries related to travel and tourism, such as airlines, are still on edge.

I'm currently focused on two primary themes that I expect to stick around even after the pandemic ends:

- More people are working at home.
- More people are shopping online.

[7] I expected clothing retail to struggle, but I was wrong about the reason why. People are not afraid to shop for clothes. They just don't need to buy new clothes while they're working from home.
[8] Residential real estate is mixed—people have been leaving major cities and moving to places with more space. Markets like San Francisco and New York City have seen significantly lower rents over the past few months, but buyers continue to buy.

None of these trends have changed much since the start of the pandemic, so that's all I have to say about it for now.

The Point

Fortunately, as investors, we get to choose which industries we invest in. There are many compelling options, including my obvious excitement about the video game industry. But, when considering any changes, my intent is to make these choices as carefully as possible. Avoiding major mistakes and preparing for difficult economic conditions is more important than trying to find an investment before other investors see the opportunity. Maintaining this "safety first" perspective has been helpful in the current crisis.

Fourth Quarter Commentary: Hindsight in 2020

January 5, 2021

From all the research I've done, there is one prediction that I hoped would be wrong. I expected the second half of 2020 to continue the "Grim New Milestone" theme that summarized the first half of the year. I also expected things to get worse before they got better, with a real possibility for multiple "waves" of virus infection numbers—waves that last much longer than everyone is hoping for.

The fourth quarter brought worst infection rates of 2020, and represented what can be considered a "third wave" of the pandemic in the US (depending on who you ask). But there is good news. We seem to have made the most optimistic case, getting a vaccine by January. And with several promising vaccines reaching the distribution phase, we now have an end in sight.

But let's start with my predictions from the first quarter:

- Financial strength will be useful for taking advantage of possible opportunities.
- The video game industry will be fine.
- Discount retailers will thrive.
- Clothing retailers will struggle.
- Growth will not be as important as financial strength.

The first four predictions were mostly right. The last one could have been true, but it was nullified by the Federal Reserve's quick response—growth was largely preserved, held up by the promise of nearly unlimited capacity for borrowing money.

The second quarter added some new forecasts:

- A "second wave" could be a disaster for the economy.
- There will not be a fast recovery.
- The pandemic is not over.
- The world will only get back to "normal" with a vaccine, and the most optimistic case for a vaccine is January.
- Premium clothing brands will continue to struggle while discount brands will have an easier recovery.
- The transition to more digital payments will continue after the pandemic is over.

Some of these predictions are difficult to confirm, and some will take more time to play out, but my expectations were generally correct. The complete picture of how each wave of infections affected the economy will not be known for some time (potential government actions can still make it better or worse). And the speed of an economic recovery (and who will recover faster) cannot yet be fully determined. However, the pandemic was certainly not over, and vaccine development was faster than my most optimistic case.

The third quarter was more about looking backwards than making predictions. The short term economic effects and market responses were mostly known by this time, but the end of the story could only come with the introduction of a successful vaccine. And that's where we are now.

From an investment perspective, I followed the pandemic long before it was known as a pandemic, but I didn't fully anticipate the damage that it would do, and I could not predict how fast the market or the economy would recover. I correctly identified which industries would benefit and which ones would struggle, but I didn't make many bold moves to take advantage of this research. My confidence in the portfolio's outcome was built on the quality of the companies that we already owned.

This confidence was proven to be well-founded—financial strength and competitive position were critical tools for surviving this crisis—but the pandemic also accelerated some of the trends that we had already invested in. Even with a long-term view, investing more in those trends would have been a wise move. I might call it a missed opportunity, but I wouldn't call it a mistake. The big picture is that we planned for some kind of crisis without knowing what it would look like or when it would happen, and the

pandemic has confirmed the value of that preparation. I'm satisfied with the investment outcome for this year.

The Final Point

My approach was to prepare for a difficult market in advance and then rely on that preparation to ride it out. At the end of 2020, I can confidently say that this approach was successful. In hindsight, I could have made a few different trades, but I am satisfied with the investment outcome that we had this year. *Stability first, and then growth.*

Andrew Wagner
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