Monthly Depth Report – February 2023

Partly Right, Partly Wrong, and Still Making Money

Plus - Argentina

I'm writing this from Buenos Aires, Argentina. It's a charming city with lovely people, and a terrible inflation problem. As noted many times in this space, I believe there is tremendous value to embracing the stress and friction of living a different life in a new location complete with exposure to other languages, cultures, and people. More on that later in this letter.

I'm going to start this letter with an apology. We've been working to make DKI content more approachable and understandable. Deep Knowledge Investing's primary goal is to help our clients and subscribers earn better returns in the market, but in order to do that, you need to understand my view on complicated matters. This letter is going to be more technical than most, but I promise that if you stick with me, you'll gain clarity on a key aspect of portfolio management and risk control including how to make money when you're "wrong".

If you have questions about any of this, I'm reachable at IR@DeepKnowledgeInvesting.com

A Description of "*Alpha*"

Alpha is a way to quantify risk-adjusted performance against the market. Simply stated, it's a measure of a stock-picker's skill. Let's go through a few examples.

1) Imagine the market is up 10% for the year and your money manager also returns 10% while staying fully invested. That manager has demonstrated no skill during the year and you could replace him with an S&P 500 index fund. *Alpha* generated is zero.

2) Now imagine the market is up 10% for the year and your money manager also returns 10%. However, in this example, he's 50% long and 50% short for net exposure of zero (50 long minus 50 short equals zero). This manager generated a 10% return with no market exposure

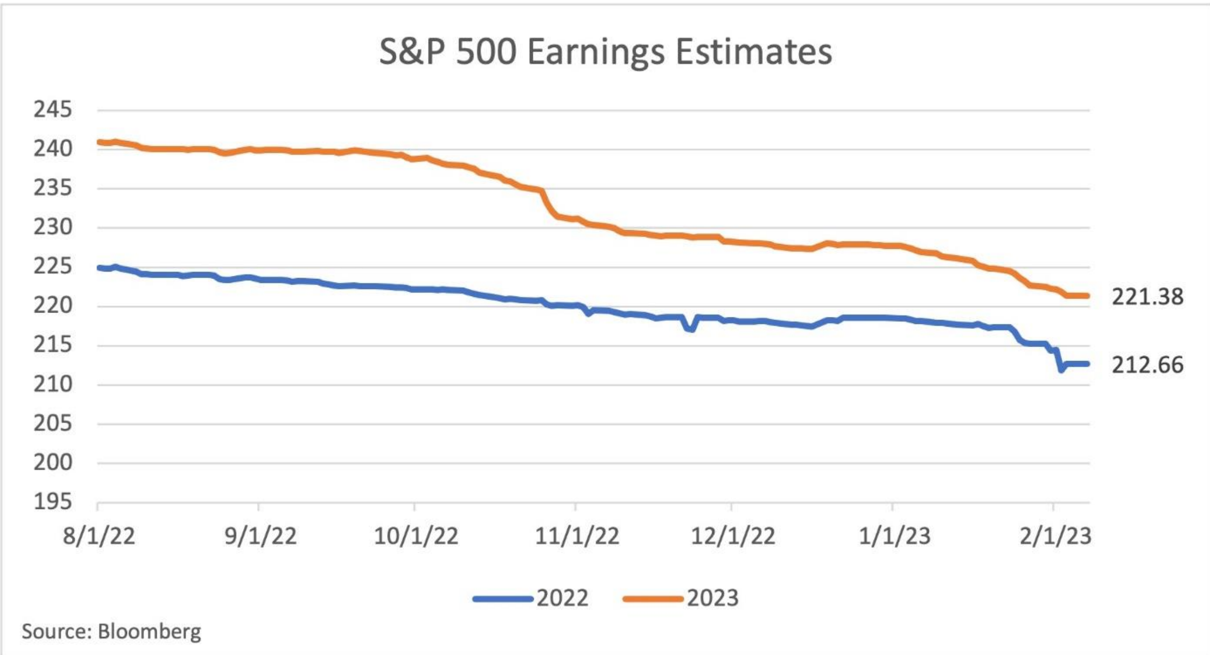
and demonstrated excellent skill. He has generated return with less risk. *Alpha* generated is 10% or 1,000 basis points.

3) Now assume the market is again up 10%, and your money manager also returns 10%. However, he used leverage and invested 500% of your money in long equities. This means that it took 5 times as much capital as you invested to deliver the same performance as the market. That's a lot of additional risk to deliver the same return as the market. This manager has demonstrated poor skill in this year and has generated **negative** *Alpha.*

We'll come back to this concept in a bit.

<u>DKI's Thesis on the Market:</u>

Two months ago, DKI wrote that we believed earnings estimates were too high and that sell-side analysts were waiting for companies to issue weak first quarter and 2023 guidance to lower estimates. Subscribers knew we were hedging 75% of our equity positions excluding energy because we thought that a month of declining earnings estimates would be negative for the market. We were partially right and partially wrong.

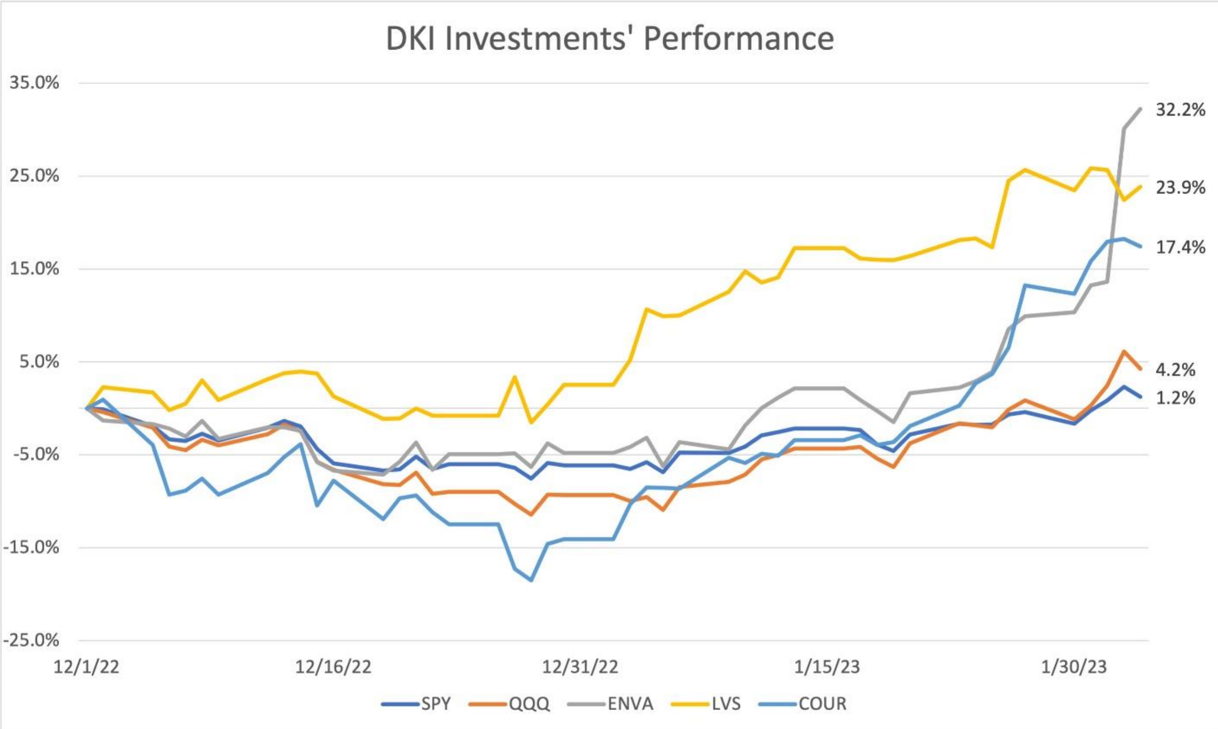


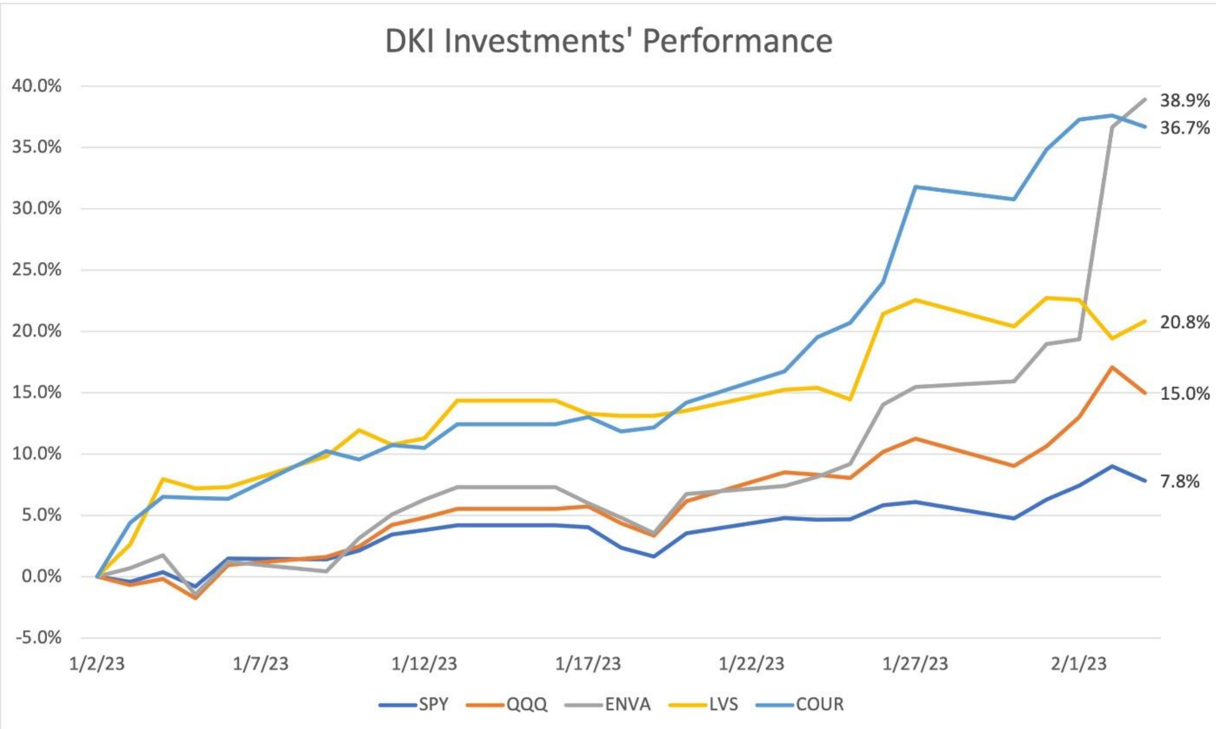
In general, corporate earnings for the fourth quarter were ok, and guidance for 2023 was poor. Earnings estimates have been coming down as we predicted. So, were we right? Not entirely.

The market has been much more focused on a potential Federal Reserve “pivot” to lower interest rates than on corporate earnings and both the S&P 500 (ticker: SPY) and the NASDAQ (ticker: QQQ) rose throughout January. We got the analysis right, but the direction of the market wrong. That meant we lost money on the market short or “hedge”.

Still Making Money:

The thing we did get correct was the individual stock picking. DKI picks Enova (ticker: ENVA) rose on great earnings, Las Vegas Sands (ticker: LVS) rose on the Macau reopening, and Coursera (ticker: COUR) rose with the NASDAQ after being unfairly punished for most of last year. A graph will make this all much clearer. We chose to show you two time periods. One starting on December 1 because that’s the month DKI made the prediction and a second starting January 1 because we said estimates would come down in January. We chose last Friday as the closing period because it included both the announcement from the Federal Reserve and the generally poor results from the mega-cap tech companies.





Nice work on the graphs by DKI Intern, Dylan Kogan

This is why I started this letter with a discussion about *Alpha*. You can see that while we gave up profits in the short market postitions, we outperformed the market with lower exposure and less risk. While I'm not going to put the entire DKI portfolio in this letter, if we hypothetically assume that we had an equal position in each of the three individual stocks and shorted the two indexes in equal size, here's what we would have:

	December & January	January
Market Return (SPY & QQQ)	2.7%	11.4%
DKI Stock Picks' Return	24.5%	32.1%
Hypothetical Portfolio Return	22.5%	23.6%
Net Exposure	25%	25%

We note that this is hypothetical performance and DKI has other picks including energy and alternatives. This example is here to show the value of individual stock picking even in an environment where we give up some profits on the short position which is known as the hedge. In December and January, a DKI subscriber who had copied our positions whould have shown profits of 22.5% which was far above the average market return of 2.7% despite only having one quarter of the market risk. In January, the same subscriber would have shown returns of 23.6% which was far above the average market return of 11.4% again with only one quarter of the market risk.

This is what DKI exists to do. Our goal is to help our clients and subscribers earn better risk-adjusted returns.

This also explains the title of the letter. Our analysis of the earnings was right. Our expectation for the market direction was wrong. And our individual stock picks were good enough that we still made money.

The Federal Reserve and Bad Data:

I've written extensively about the Federal Reserve for over a year. The market is more focused on the Fed than on individual company performance. Chairman Powell has indicated there will be multiple additional rate hikes coming and has also encouraged the market by acknowledging that the rate of inflation is declining.

The market is going to be focused on the consumer price index (CPI) which rolls up inflation into one number. We think that's going to be an error and will be introducing the idea of Bifurcated Inflation in a premium post soon explaining how we're viewing the situation. For those of you who want to better understand the one issue that's more responsible for driving market performance for over a year, we invite you to subscribe.

Investing Lessons from Argentina and Inflation:

A year ago, I wrote the story of Ivan Paz, a doctor from Buenos Aires who explained that inflation was so bad that he couldn't afford to live in his home any longer. He told me why it was impossible for anyone who wasn't very rich to buy a house. The story was reminiscent of what happened in the US housing market in 2008 complete with the government backing bank losses.

The situation has not improved. In order to keep this letter a reasonable length, I'll refer you to my Twitter posts explaining the situation.

To read about my cab drivers' experience with inflation and the incredible things Argentinians do to protect their savings which constantly lose value, you can read the thread here.

To understand how the actions of the US Federal Reserve are affecting people in Argentina, Peru, and Thailand, you can read the thread here.

Very soon, I'll add a new thread describing the difficulty of simply renting an apartment here. The process is so insane that even the insurance that a renter is forced to buy can cost four months of living expenses. You'll be able to read that one soon if you follow me here.

Time to Wrap it up for This Month:

We'd like to thank you for reading this letter and to welcome our new subscribers. January was our best month ever for new members with over 300 new readers. There are about 2,000 of you now and more premium subscribers than ever before. I'm grateful for your time and attention and am happy to have you.

Much of our recent growth is due to the support the firm has received from Michael Gayed of Toroso Investments. He was kind enough to include me on his Lead Lag Report Twitter Space to discuss a possible Japanese sovereign debt default which was timely and is available here.

DKI has a partnership with Toroso Investments (@leadlagreport on Twitter). **If you're a financial advisor with more than $50MM under management, please reach out to us so we can arrange for you to get a premium subscription to Deep Knowledge Investing at no cost to you through Toroso.**

If any of you have questions, concerns, or thoughts regarding issues we should address in a future depth report, please feel free to reach out to me at IR@DeepKnowledgeInvesting.com. If you think a friend, RIA, family office, or portfolio manager would be interested in this monthly commentary, please feel free to pass it on to them.

Thanks for being part of Deep Knowledge Investing,

Gary Brode

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