Businesses, Not Stocks

March 31, 2023

Can you believe we've made it to the end of the first quarter of 2023? This year has taken everyone by surprise (as they normally do), and as we cope with the current banking turmoil, we need to address things that nobody had on their radar screen a few months ago. Going into the year the primary worries were inflation, interest rates, recession, and war, but the past few weeks have had investors grappling with concerns over the banking system while getting an education about FDIC insurance coverage! Fortunately, there are significant differences between today's economic crisis versus what was taking place back in 2008 and 2009. Back then there was a real concern of financial markets freezing up due to bad debt (real estate related) and legitimate insolvencies, whereas today, we have a mismatch between time deposits against U.S. Government bonds with maturities at ten years or more. This time around, there is no credit concern with the debt, mind you we are referring to U.S. Government Treasuries and other direct obligations - they will be money good - but only if held to maturity. There is some angst because the Federal Reserve has hiked interest rates dramatically in a relatively short period of time. The duration mismatch between what many banks own relative to when depositors might demand their money has created an imbalance in the banking system. Overall, this has raised the level of anxiety amongst investors and we are here to address what we believe to be the fallout from this particular situation.

First and foremost, the collapse of Silicon Valley bank does not reflect the general health of the banking system. Per the Wall Street Journal; "In a world of near-zero interest rates, SVB (and others) put the money in long duration fixed-income assets in search of a higher return." Now that the Fed, Treasury, and FDIC have recognized this, they have reacted in a prudent, thoughtful manner, and have responded quickly. The Fed also created a banking facility to provide capital to banks if necessary to address this situation. Understand, like any bond that you might have purchased a year or two ago, as interest rates rise, the value of that current bond you own has declined in value, but as long as you hold it until maturity, you will receive your full principal back plus, of course, the interest earned along the way. That, in essence, is what is happening here across the board. However, some view smaller banks perhaps in a different light now. Large banks and super regionals seem to be the beneficiaries as money has been flowing from these smaller institutions to the bigger ones. Charles Schwab would be included in the beneficiary list as they have seen fund flows increase over the past few weeks.

Our belief is that Corda core holdings, which include Charles Schwab, U.S. Bancorp, and Bank of New York Mellon, remain sound. The 2008 banking crisis was driven by the fact that no bank understood the extent of losses on each other's balance sheets. Those managing credit counter-party risk on trading desks halted trading with other banks as they feared what was known as jump-to-default risk, the risk that the other bank could default in the near term. Commercial paper markets froze, interbank lending stopped, and things

ground to a halt. Today, banks do not have the same size holes in their balance sheets as they did then, and the hole is of much different quality. Last time it was low-quality mortgages and collateralized debt obligations. Once the housing bubble popped, these assets were pennies on the dollar. Today, the losses on long-dated U.S. Government bonds are much less. If a 10-year U.S. Treasury bond was bought at the historically low yields of 2021, it is worth closer to $0.80 on the dollar today. Again, if held to maturity, there is no loss.

There are reasons to believe Silicon Valley Bank (and a handful of others) were uniquely positioned for a bank run, but the likes of our Schwab, U.S. Bancorp, and Bank of New York are much more diversified in their business activities. From a macro point of view, the market is grappling with the impact to lending and overall economic growth. Borrowing costs to businesses may further rise if banks are pressured to reduce their lending or raise their costs to consumers and borrowers. A weaker economy could result in lower free cash flow and thus increase potential bankruptcies. Borrowers with riskier profiles may not be able to rollover debt when it matures. A severe economic contraction could impact consumer spending. These are all what ifs and unknowns. If a contraction takes place, near term earnings would be impacted, but, in a downside scenario, lower earnings in the short term do not reduce the intrinsic value of a company. Yes, that's right! The value of a stock is the present value of all of the free cash flow it will generate over its lifetime. The present value may decline slightly, but it will be limited as the cash flows grow back over time once the economy regains its footing.

The key is to ask, what is priced in? We view this as an opportune time to look for businesses that have been unfairly dragged down in the carnage of the financial sector. We remain committed to long-term value investing. It's been our investing experience over decades that the best course of action in times like these is to not overreact. Panic is not a strategy.

What's odd about the recent Jay Powell (Chair of the Board of Governors of the Federal Reserve System) press conference after the 0.25% rate hike on March 22nd was his continued hawkish stance on inflation and the economy. The Fed's forecast itself now concedes a recession is probable, putting its dot plot completely at odds with what the market is pricing. Powell's hawkishness today is the opposite to where he was in 2021 with inflation accelerating, when he said the Fed was not even "thinking about thinking about" raising interest rates! They were far too easy then. Is it possible the Fed stays too tight this time around? Powell even admitted a tightening of financial conditions due to bank stress is equivalent to a Fed rate hike. Some pundits argue the stress in the banking system could be equivalent to a full percentage point increase in the fed funds rate. As Professor Jeremy Siegel was recently quoted, "The risk of recession has increased. Maybe the markets will knock sense into the Fed. And I do think the Fed will be lowering rates by the end of the year."

There's much more to confront in the next 6-12 months. However, you can be assured we will steward your capital like we do our own, and we expect to have good results. We are not going to invest based on what the Fed may or may not do, and the same goes for those sitting in the White House or halls of Congress. Our #1 priority is creating the best financial outcome that we possibly can and doing everything within our powers to ensure you are secure. Our hope with this letter is to share the optimism and conviction we have at Corda and how we are prepared to successfully navigate the markets in the months ahead.

We by no means have a crystal ball, but we purposely build a portfolio of diverse businesses in a well thought out manner where we put the power of owning high quality assets in play and let the magic of equity ownership and the sharing of profits drive our returns in the long run. We own businesses, not stocks. It's simply the force of equity ownership that will drive our returns in the long run.

Equity ownership of any kind - public or private - certainly brings with it a wide assortment of outcomes that includes the potential for loss, but if you diversify across businesses and industries and think longer-term, you reduce the risk of permanent loss and place your cards strongly in the camp of creating lasting profits.

If you seek to own predictable and stable businesses run by competent and skilled management, your odds go up substantially. The longer your time horizon, the more likely you will be successful. A business with the traits of high cash flows, less debt, good returns on capital, insider ownership, and a sustainable business plan increases your chance of long-term gains against any economic backdrop.

Recall these snippets of timeless wisdom from Warren Buffett, the Oracle of Omaha:

- **Stock prices are erratic:** "It's crucial to understand that stocks often trade at truly foolish prices, both high and low. 'Efficient' markets exist only in textbooks. In truth, marketable stocks and bonds are baffling, their behavior usually understandable only in retrospect."

- **Businesses, not stocks:** "...we own publicly traded stocks based on our expectations about their long-term business performance, not because we view them as vehicles for adroit purchases and sales. That point is crucial. Charlie and I are not stock-pickers; we are business-pickers." Much in alignment with Buffett and Munger, our suggestion is to ask yourself, 5 years hence, how your 2028 self will feel about the purchase prices that can be had here in 2023? Morgan Housel reminds us that "all past declines are viewed as missed opportunities, but future declines look like risk!" Below, Mr. Buffett shares an example of how investing in great companies (as opposed to bonds) has been a wise choice over the long-term. By the way, all of these quotes are directly attributable to his recent shareholder letter dated February 25, 2023.

- **Thinking Long Term:** "In August 1994, Berkshire completed its seven-year purchase of the 400 million shares of Coca-Cola we now own. The total cost was $1.3 billion — then a very meaningful sum at Berkshire. The cash dividend we received from Coke in 1994 was $75 million. By 2022, the dividend had increased to $704 million. Growth occurred every year, just as certain as birthdays...

At yearend, our Coke investment was valued at $25 billion...

Assume, for a moment, I had made a similarly-sized investment mistake in the 1990s, one that flat-lined and simply retained its $1.3 billion value in 2022. (An example would be a high-grade 30-year bond.) That disappointing investment would now...be delivering to us an unchanged $80 million or so of annual income."

Never Bet Against...

If you are able to view the world through the prism of a glass half full – *NEVER BET AGAINST AMERICA* - the bank stress and economic uncertainty will be a short duration event, and businesses most willing to adapt, change, and move quickly will be rewarded for their efforts in the coming years. With every recession and/or past economic upheaval in our nation's history, new companies are formed and later thrive as economic expansions take hold. Creative destruction is at work, the weak get left behind or are acquired, while the strong flourish and soar to new heights. Why would it be any different this time around?

To overcome the tendencies to be out of sync with the market, we are guided by three primary tenets.

1. We buy businesses. We do not own slips of paper, but fractional ownership interest in an actual business, with an underlying value that does not depend on its share price. In most cases, if the income streams continue year in and year out, (and in most cases grow over time), capitalism would be a failure if the value of that business did not increase over time.

2. You should engage the market only to the extent that it serves your interests. The market will provide you with prices; your job is to decide whether it is to your advantage to act on them.

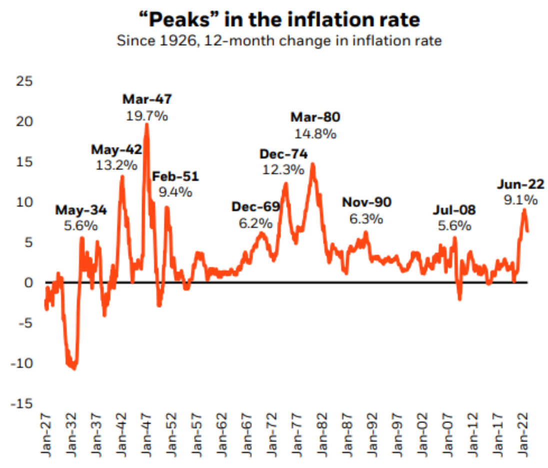
3. Intrinsic value is key. Price is what you pay, value is what you get. If you understand the underlying value of a business, you can invest with a margin of safety or seek to buy at a sufficient discount. Attitudes will change, as they often do on Wall Street, and at some point, the enduring businesses with stable cash flows, balance sheets, dividends, and long-term potential, will thrive. Utilizing these three tenets of value investing will help you stay disciplined and instill confidence to manage through these times when it is so typically elusive for most investors to win the day.

We've discussed the banking turmoil, but are we making progress on inflation? That remains to be seen, and we are monitoring things closely. What we do know is that when inflation peaks, returns are particularly good. See *Exhibit #1* from Blackrock's Student of the Market presentation:

Exhibit #1: Performance following peaks in inflation

PEAK INFLATION AND PERFORMANCE

Performance following peaks in inflation



Returns following "peak" inflation rates
Since 1926, returns for the next 12 months

Peak Inflation	Next 12 months	
	Stocks	Bonds
May 1934	4.8%	6.3%
May 1942	57.6%	2.0%
Mar 1947	5.3%	0.9%
February 1951	13.6%	0.3%
December 1969	4.0%	16.9%
December 1974	37.0%	7.8%
March 1980	40.1%	13.1%
November 1990	20.3%	14.4%
July 2008	-20.0%	7.9%
Avg.	*18.1%*	*7.7%*
June 2022	6.1% (8 mo.)	-2.6% (8 mo.)

Source: Morningstar, Bureau of Labor Statistics as of 2/28/23. U.S. bonds represented by the IA SBBI US Gov IT Index from 1/1/26 to 1/3/89 and the Bloomberg U.S. Agg Bond TR Index from 1/3/89 to 2/28/23. U.S. stocks are represented by the S&P 500 Index from 3/4/57 to 2/28/23 and the IA SBBI U.S. Lrg Stock Tr USD Index from 1/1/26 to 3/4/57, unmanaged indexes that are generally considered representative of the U.S. stock market during each given time period. **Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only.** You cannot invest directly in the index.

You might ask how long do inflation cycles last? *Exhibit #2* from Blackrock's The Student of the Market edition addresses that question as well:

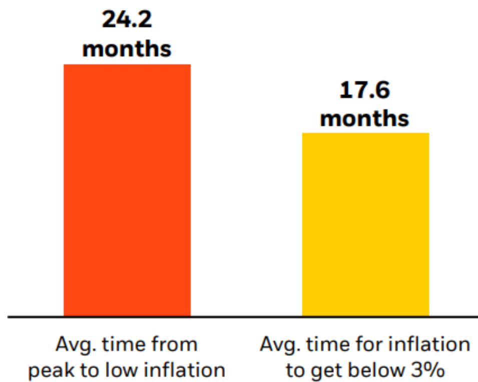
Exhibit #2: Historical Inflation Cycles

INFLATION CYCLES

How long have inflation cycles lasted?

Average Inflation cycle length and time it takes to get inflation below 3%

Since 1926, in months



Individual inflation cycles through history

Since 1926, in months and CPI percentage reported

Peak Inflation	Inflation Low	Time from peak to low (months)	Time to get below 3% (months)
May-34 5.6%	May-36 -0.7%	24	2
May-42 13.2%	May-44 0%	24	19
Mar-47 19.7%	Oct-49 -2.9%	28	24
Feb-51 9.4%	Jan-53 0.4%	23	12
Dec-69 6.2%	Jun-72 2.7%	30	30
Dec-74 12.2%	Nov -76 4.9%	23	NA
Mar-80 14.8%	July-83 2.5%	40	39
Nov-90 6.3%	Jan-92 2.6%	14	11
Jul-08 5.6%	Jul-09 -2.1%	12	4
Avg.		*24.2*	*17.6*

Source: Morningstar, Bureau of Labor Statistics as of 2/28/23. **Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only.** You cannot invest directly in the index.

Another thing to keep in mind about higher interest rates and inflation is that it doesn't necessarily mean equity returns are poor. Consider the 70's and 80's when 3-month Treasury Bills averaged between 6.3% and 8.8% during those two decades. Equity returns were good in those years. See *Exhibit #3*, it shows 10 year Treasury yields, 3-month T-bill yields, and stock market returns by decade. It's a good reminder that interest rates have been far higher.

Exhibit #3: Average Yields

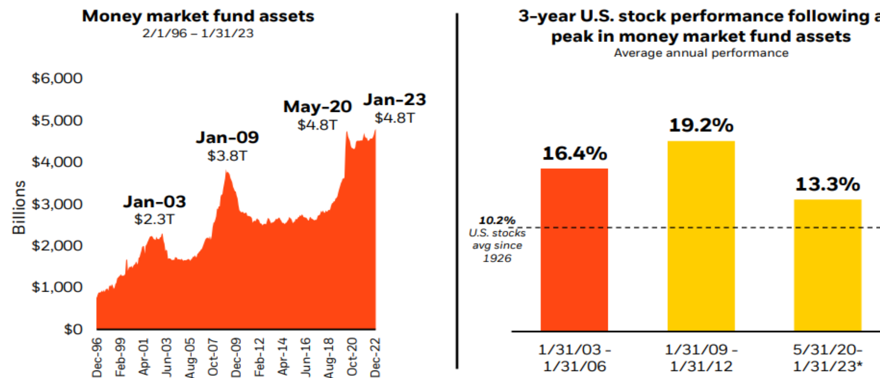
Average Yields

Decade	10 Year Treasury Yield	3-Month T-Bill Yield	Stock Market Returns
1940s	2.3%	0.5%	8.5%
1950s	3.0%	2.0%	19.5%
1960s	4.7%	4.0%	7.7%
1970s	7.5%	6.3%	5.9%
1980s	10.6%	8.8%	17.3%
1990s	6.7%	4.9%	18.0%
2000s	4.5%	2.7%	-1.0%
2010s	2.4%	0.6%	13.4%

Sources: Shiller, FRED

Did you know during past crisis' money market funds became extremely popular? It's no different this time around. Recent data suggest there is now about $5.1T in money market funds, an all-time high. However, per *Exhibit #4*, as of January 2023, it was $4.8T. Now with all that cash parked on the sidelines, guess what's going to drive up share prices in the years ahead?

Exhibit #4: Money market fund assets

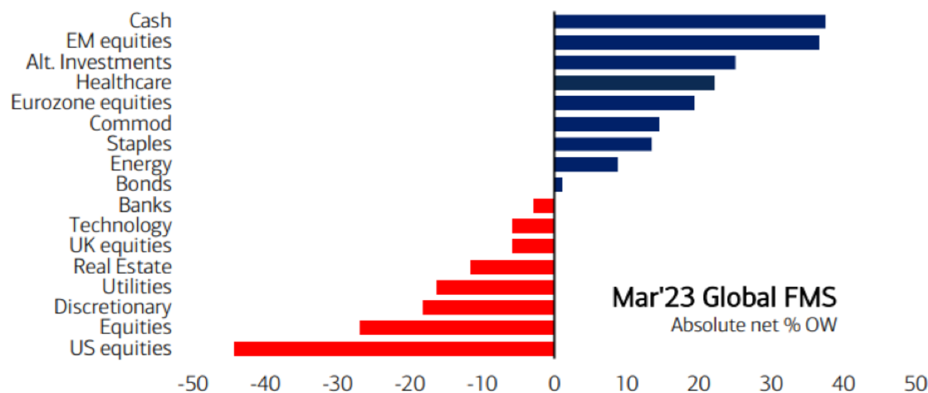


Source: Morningstar as of 1/31/23. U.S. stocks represented by the S&P 500 Index, an unmanaged index that is generally considered representative of the U.S. stock market. **Past performance does not guarantee or indicate future results.** Index performance is for illustrative purposes only. You cannot invest directly in the index. *Not a 3 year period but a 2 year and 8 month time period.

See how the spike in money market funds occurred in 2003, 2009, 2020, and again here in 2023 – those time periods were probably good buying opportunities for equities, yes?! It may take years to bleed off the vast amounts of cash on the sidelines. Here's our question to you: What if interest rates decline substantially in the next year or two, will this be sticky money, or will it flow back into equities? Is it possible this future buying power will keep markets stable and we don't have to have a large recession drawdown, especially if everyone sees it's coming?

The recent Bank of America Global Fund Manager Survey (FMS), shown in *Exhibit #5*, depicts something quite similar.

Exhibit #5: Global FMS absolute net % OW



Source: BofA Global Fund Manager Survey

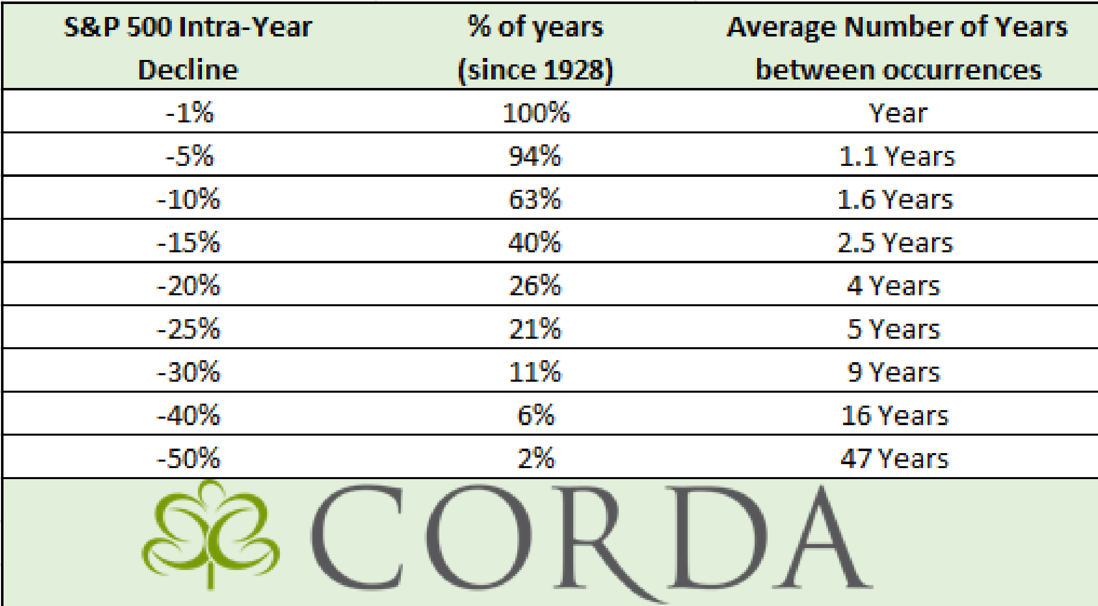
BofA GLOBAL RESEARCH

Note how fund managers are most overweight (OW) cash and the most underweight (UW) U.S. equities. This is quite the contrary signal, is it not?! As General George Patton once said, "if everybody is thinking alike, then somebody isn't thinking!"

Bottom line, as we once touted during the pandemic - are we going to wallow and moan or are we going to take advantage of the opportunities in front of us? Things may not be the same going forward in the banking community, but when it comes to capital flows, creative destruction, and money moving from weak to strong hands - these concepts are still very much alive and well in this world of ours. We plan to be on the right side of that equation. We'll let our businesses navigate the landscape and pivot to where the marketplace is going. We don't see why most if not all will one day have higher revenues and profits and therefore greater dividends and higher share prices. We'll be patient with the exact timing of that because we know it's unpredictable. The key is to not let your emotions get the best of you and scare you out of long-term assets. Be on guard as the market wants to fool you time and time again. Nobody ever said investing was easy!

Recall, as shown in *Exhibit #6*, corrections and bear markets happen frequently, use them to your advantage.

Exhibit #6: S&P 500 Intra-Year Declines



S&P 500 Intra-Year Decline	% of years (since 1928)	Average Number of Years between occurrences
-1%	100%	Year
-5%	94%	1.1 Years
-10%	63%	1.6 Years
-15%	40%	2.5 Years
-20%	26%	4 Years
-25%	21%	5 Years
-30%	11%	9 Years
-40%	6%	16 Years
-50%	2%	47 Years

CORDA

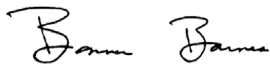
Remember, markets are resilient, and if you can extend your time horizon and understand how the types of businesses you own are durable and extremely consistent in their results, you will more firmly believe in staying the course and not get upset at the fluctuations and noise that comes periodically along the way. The odds are in your favor. One final thing. Charles Schwab. It is both a compelling investment at its current price as well as a safe custodian whereby you can be certain your assets are secure. The folks who manage Schwab have been keeping the investment community well informed and we've attached a copy of a letter written by Schwab CEO Walt Bettinger and founder Charles Schwab discussing recent events from their perspective. It is worth reviewing.

In closing, our promise to you is to continue to do our best to keep you onboard and in the proper allocation where your odds are tilted for a winning outcome.

Stay positive and thank you for being on this journey with us. It's been a unique start to the year and we don't expect it to be any different in the weeks and months ahead.

We appreciate your patience and leave you with this…some of the businesses in your portfolio are trading at over ten-year low valuations on metrics such as price to earnings, cash flow, book value, etc. There are some prices and dividend yields that we have not seen in a very long time. We are invested right alongside you, and we plan to reap the rewards as well.

Sincerely,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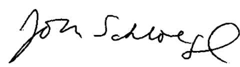
John Schloegel

Brian Raupp

Updated: Our Most Recent Perspective on Industry Events from Founder Charles Schwab and CEO Walt Bettinger.

March 23, 2023

To our clients, employees, and owners:

As someone with an interest in financial markets, you may have seen some of the recent news about the banking sector. If you are like us, you may have also wondered why Schwab has recently been lumped in with concerns regarding regional banks in particular. The fact is we are a different kind of financial firm, which can make us harder to understand. That may help explain many of the misconceptions about us compared to other parts of the financial sector. As such, we want to offer an updated perspective on some of the topics that have come up.

First and foremost, Schwab is a brokerage firm. We exist to help investors and those who serve them. Schwab is the largest public broker-dealer in the U.S. and the most regulated, since we are also regulated by the Federal Reserve. Approximately 95 percent of the $7 trillion clients have entrusted us with is custodied at the broker-dealer and segregated for clients and their benefit. Every client of a U.S. broker-dealer enjoys the same SEC-mandated customer protections. That means these assets are not subject to risk related to banking or credit. Anyone who claims that client investments are at risk from banking issues is ignoring this basic fact. For more information on asset protections, please visit: www.schwab.com/legal/account-protection.

Schwab also owns a bank, though not like other retail banks. Our bank structure exists to help us serve investors' banking needs. It also helps our financial performance, which enables us to better serve our clients and continue to lower costs. As a different kind of firm – a broker-dealer with a banking side – we do not believe one should confuse our business model with regional banks, or any other banks for that matter, that have different business lines, client bases, and geographic footprints.

It is also important to remember that Schwab was built to serve clients through all economic environments. Our broad base of high-quality clients is well protected. Our firm has capital well in excess of regulatory requirements, a high-quality and relatively small loan book, and a conservative investment portfolio of securities backed by the U.S. Treasury and various government agencies. And more than 80 percent of client cash held at Schwab Bank is insured dollar-for-dollar by the FDIC.

We hope our long track record, conservative approach, and strong financial foundation is all you need to know to feel confident in our ability to serve clients over the long term. But we do know in the swirl of the past two weeks, some very important points are being misunderstood (or sometimes misrepresented) in the public discussion of what is happening. Here is our perspective on some of the misconceptions that have come up:

1. **Our stock price does not reflect the strength of our business.** Stock prices go up and down and we do not manage our business according to the stock price, but rather according to our long-term view on what is best for our clients and the health of the business. That said, we do not believe recent stock performance reflects our long-term business fundamentals and opportunity. As we shared for the week ending March 17, clients brought to Schwab more than $16 billion in core net new assets. We have attracted core net new assets of approximately $116 billion year to date through yesterday, and have added nearly $1 trillion in the past two years. We see strong flows continuing and remain confident in our fundamentals.

2. **Focusing attention on 'unrealized losses' in our held-to-maturity (HTM) portfolio is very misleading.** These "paper losses" are unrealized and would only be realized if we had to sell those securities. The profile of our depositors is very different from regional banks. Given our significant access to sources of liquidity, there is a near-zero chance we'd need to sell any of our HTM portfolio prior to maturity. That would be akin to assuming a large retail bank would sell a substantial portion of its loan portfolio.

3. **Client deposits may move, but they are not leaving the firm.** As is the case in every cycle, clients make choices about where to best allocate their assets. As interest rates have

increased over the last year, our clients have made choices to reallocate assets within their Schwab portfolios, to reflect their preferences in this market. And in fact, we have actively encouraged them to do so. The important point is that those allocation decisions result in the assets staying at Schwab. Despite the events of the last two weeks, we have not seen any meaningful change in client behavior regarding their cash.

4. **We have taken relatively little risk in our portfolio.** We take very little credit risk. More than 85 percent of our assets are in a high-quality, liquid portfolio invested in government or agency-backed securities. As a comparison, most major banks have a majority of assets in multi-year residential and commercial loans with significant duration, varying credit quality and little liquidity. We feel comfortable that our portfolio carries materially **less credit, duration (sensitivity to rate changes) and liquidity risk** than many of those other banks.

5. **The way we manage our balance sheet is very straightforward and hasn't changed.** We invest in high-quality securities with a portfolio duration that today is around four years, and just over two years in our available-for-sale (AFS) portfolio. Because of the quality of our portfolio, we are able to maintain access to high levels of liquidity that allow us to hold these investments to maturity if we choose. We have taken this same approach since we began offering banking services almost 20 years ago. We did not make a bet on interest rate movements going down or up, and we did not extend our portfolio long term like some other institutions.

6. **We do not forecast Fed rates or make investments based on where rates are going.** In our regular business updates, we have relayed the consensus opinion of the market (e.g., Fed Dot plots) at the time. These are not our predictions; we never base our strategy off our own view of interest rates. We share those market opinions in the context of helping analysts understand our business model and potential financial performance.

7. **Comparing unrealized losses across firms with different business models can be misleading.** Schwab Bank has a different business model than traditional banks. Our

deposits come from transactional cash in clients' brokerage accounts that is swept to our banks. We use about 10 percent of that cash to fund loans to our existing clients and with the remaining 90 percent, we buy securities – the vast majority of which are backed by the U.S. Government. With rates moving up, the fair value of all fixed rate assets – loans or securities – has gone down. But given that our securities are very high quality, we fully expect our securities to reach par at maturity, which means the unrealized "paper" losses will decrease over time. Because a much higher percentage of our assets are securities – and traditional bank loans are not disclosed the same way – our paper losses may appear larger than those of traditional banks. But that assessment lacks the appropriate context. In reality, our portfolio has **less** credit risk and is actually **less sensitive** to changes in interest rates than many large banks.

Not all financial institutions are the same; not even all banks are the same. So, one can understand how many watching the public dialogue on banking issues right now might conflate our brokerage-centric business with that of other banks. That is why it is important we set the record straight on some of these topics.

For more than 50 years, our conservative approach to managing risk has allowed our clients to weather market cycles and successfully manage their wealth. We remain confident in our client-centric approach, the performance of our business, and the long-term stability of our company. We are different than other banks. But it is precisely because we are different that we have grown to earn the trust of more than 34 million accounts across a broad spectrum of business lines in the U.S., Asia, and Europe. With this additional information, we trust you too can see why we are proud to be a firm like no other.

Sincerely,

Charles Schwab
Founder and Co-chairman

Walt Bettinger
CEO and Co-chairman