EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

June 30, 2021

HIGHLIGHTS

- Short-term, we can envision an inflationary environment with a pullback in stock valuation. But in the long-term, quality companies will continue to grow earnings and trade at strong multiples, driving price appreciation.

- As part of our investment process, we determine if a company's human resources practices limit the ability of that company to thrive. Employees are the most valuable resource that any company has, and firms must compete to retain skilled employees.

- Donor-Advised Funds hold more than $140 billion in assets, a fact which has not gone unnoticed by members of Congress. On June 9th, the Accelerating Charitable Efforts ("ACE") Act was introduced in the Senate on a bipartisan basis, seeking to compress the time interval between funding a DAF and distributing assets to charity.

2nd Quarter 2021 Investment Commentary

Supplies, Inflation and Monetary Policy

The stock market had a strong April but a weaker May and June. A couple of overriding macro concerns driving the market are:

1. **When will the Federal Reserve start tightening the money supply?**
2. **Is the recent uptick in inflation temporary?**

The factors are linked, and one cannot be discussed without the other.

A tighter money supply leads to higher interest rates. When less money is available in the financial system, those in need of money must pay more (higher rate) for that access. While higher interest rates would be a welcome development for savers, it does not benefit equity investors. The intrinsic value of a stock is the present value of expected future earnings. As interest rates move higher, the more an investor must discount expected future earnings, resulting in a lower current price of the stock. As we have discussed in previous commentaries, this reality manifests itself in a lower market P/E multiple. This is especially important when considering the market's current elevated multiple.

After the Federal Reserve's June meeting, the benchmark interest rate was left near zero, but there are signals a tightening is coming. The Fed will begin discussions about scaling back its $120B in monthly bond purchase, which keeps interest rates low. The forecast for monetary tightening accelerated, i.e., the estimated number of rate increases grew, and the timeline for the moves shortened. The consensus now expects 2 rate increases by the end of 2023, and the odds for an increase in 2022 increased, even if below 50%. Stocks did not react positively to this news.

If the Fed's mandate were to manage the stock market, the solution would be keeping the money flowing and interest rates low, but this can lead to inflation. Inflation is worse for the market than high interest rates, as it introduces more uncertainty to the market, which means even more discounting of future earnings.

Inflation in May was up 0.6% when compared to April (seasonally adjusted), which was lower than April's advance of 0.8%. These numbers might seem low, but April's core number (excluding food and energy) of 0.9% was the highest since 1982. While these numbers are high, the underlying factors driving the increased inflation have led many following the market, including the Fed, to conclude this higher level of inflation is transitory.

Supplies, Inflation and Monetary Policy continued

April's historic highs were driven by goods tied to the transportation and travel sectors. Hotel prices were up almost 9%, as the supply lags behind the increasing demand from re-opening economies. Used vehicles, up 10%, were another big driver. Demand for used cars has surged, as rental companies meet the needs of returning travelers and as other drivers return to jobs. Again, supply needs to catch up to demand.

On the other hand, housing, the largest component of the inflation calculation, has so far experienced benign inflation. The month over month increase in housing was 0.4% in April and 0.3% in May. This is higher than the 0.2% average over the previous 24 months, but not out of the 0% to 0.4% range experienced over that time. The counter is, there are signs of a home shortage and worry that investors are buying up homes to rent them out at ever increasing rates.

The troubled global supply chain may be the biggest driver of inflation going forward. Federal Reserve Chairman Jerome Powell recently commented, "It turns out it's a heck of a lot easier to create demand than it is to – you know, to bring supply back up to snuff." This comment coincided with the Fed raising their year-end inflation forecast from 2.4% to 3.4%.

The supply chain issues being experienced today are rooted in the efficiencies gained pre-pandemic. Companies used Just in Time inventory management, which keeps costs down when the supply chain is working properly, as money is not tied up in inventory. Investors cheered this development as margins increased. But this leads to trouble when the supply chain is disrupted, as there is no back-up supply.

The current inability to source parts has multiple causes. For example, factories being shut down for COVID reasons, clogged ocean ports, the Suez Canal blockage earlier this year and the February 2021 winter storms in Texas. If a company cannot get a hold of the parts it wants, it must build with what it has on hand. This could mean switching the factory lines every day to manufacture a different vehicle in the product line up or even sending products to dealers without all the parts and delivering the parts later. This reduces efficiencies and increases costs per product.

The lumber market is a good example of a squeezed supply chain, but also one that may be working itself out. The housing and renovation boom drove up lumber prices, peaking over $1,600 per thousand board feet in early May. The price is now less than half that amount. Mills started increasing production and driving up supply by adding shifts and restarting previously closed mills. Meanwhile, the high prices curtailed demand. The increase in supply and fall in demand have resulted in the price of lumber falling. The note of caution is, prices are still much higher than the 2009 to 2019 average of less than $400 per thousand board feet.

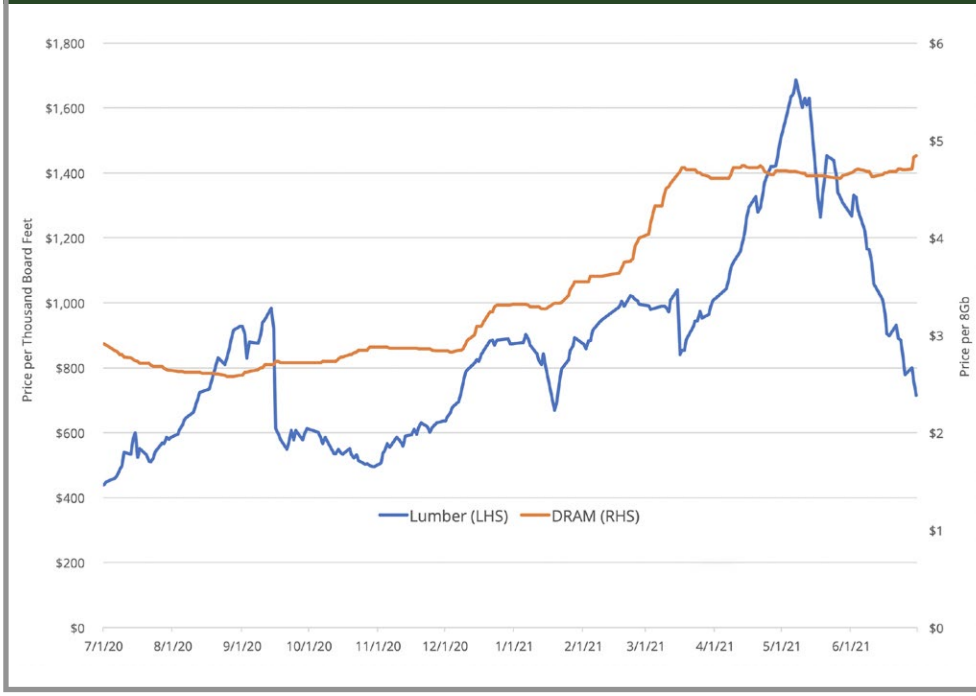
However, the dynamics of the lumber market are potentially more fluid than other goods. Increasing the supply of lumber is easier than increasing the supply of other components that require more technical manufacturing, like semiconductors. The demand for lumber is likely more elastic than the demand for computer chips, which are used in many products essential to daily life, from computers to phones to cars. Putting off building a new deck is easier than putting off buying a new car. The nearby chart shows that while the price of lumber has started to fall, the price for Dynamic Random Access Memory (DRAM), a type of semiconductor memory, has remained high through the second quarter. This points to a disrupted supply chain into 2022.

The troubled global supply chain may be the biggest driver of inflation going forward.

Supplies, Inflation and Monetary Policy continued

Goods inflation could lead to wage inflation. Real average hourly wages were down 0.2% month over month in May and down 2.8% year over year. On the other hand, the job market is improving, even if the United States is still down seven million pre-pandemic jobs. Eventually, consumers will want higher wages to offset the decrease in buying power. Increasing wages can then drive more permanent inflation.

Lumber and DRAM Price



Our response has been to acknowledge inflation could be an issue, but understand that we are not going to be able to time the beginning or end of an inflation boom. Instead, we will focus on investing in quality companies. We constantly remind ourselves that companies are dynamic organisms that will respond to inflationary pressure. Companies will seek to increase productivity, gaining efficiencies to drive down their costs. Companies will also seek to push through price increases. By focusing on quality companies, many holdings can push through price increases due to their strong brands and/or strong market positions. In fact, several have already announced price increases, if not multiple price increases.

There is a lag, as price increases come after input cost increases, so margins fall in the short term, e.g., over the next one to two quarters. But once input prices are stabilized, margins rebound. In addition, any productivity gains remain after an inflationary period, and some price increases become permanent. This leads to higher long-term margins and higher long-term earnings. Short-term, we can envision an inflationary environment with a pullback in stock valuation. But in the long-term, quality companies will continue to grow earnings and trade at strong multiples, driving price appreciation.

Employees: Lifeblood or Fuel?

Every business differs in how it treats its employees, depending on the unique characteristics of that business. Typically, businesses that have low profit margins and do not require highly skilled employees, such as farms with seasonal crops, do not compensate their employees well. On the other hand, highly profitable businesses with small teams of skilled employees, such as Facebook, compensate their employees exceptionally well and provide generous benefits. Amazon straddles these extremes, but the philosophies of Jeff Bezos, the company's founder and chairman, inform a hard-driving culture that prioritizes productivity but produces exceptionally high employee turnover.

Employees: Lifeblood or Fuel? continued

Bezos wants Amazon to constantly manage its enterprise as if it were in start-up or “Day 1” mode, according to his shareholder letter from 2016. Interestingly, Bezos works in a building named “Day 1” to reinforce this mindset. Amazon only enters businesses that it believes it can dominate through scale and efficiency. Its march from bookseller to retailer-to-the-world and cloud service provider illustrates the results of this dedication. To achieve the end results, the company focuses on customer satisfaction and efficiency to the exclusion of almost everything else.

Amazon’s Bezos believes that humans are intrinsically lazy and will do the least amount of work for the most reward. He also believes that most organizations quickly evolve from a “Day 1” growth mindset to a “Day 2” paradigm, where mediocrity is tolerated, causing internal bureaucracy and decline. To combat these tendencies, Amazon’s management stresses productivity and honest confrontation between employees to get better results. Bezos wrote in his 1997 letter to shareholders that, “[Y]ou can work long, hard or smart, but at Amazon, you can’t choose two out of three.”

The New York Times recently published an in-depth piece on Amazon’s treatment of its warehouse workers on June 15th. The story detailed the experiences of employees who worked at Amazon’s JFK8 facility, a warehouse with an area of 15 football fields, located in Staten Island, serving New York City. Amazon measures employees’ productivity on task and time away from task and displays these metrics constantly. For example, a picker would be shown how many items he or she picked per hour and how much time away from the job was recorded. Amazon also institutes policies that prevent raises for hourly workers after three years and discourages internal promotion. Interestingly, Walmart promotes twice as many managers from its lower ranks as Amazon.

Employees were also fired immediately for missed shifts or miscues, even if they had long histories of positive workplace reviews. Intense pressures in the company’s white-collar workforce also caused managers to quit while sick with cancer or handling family emergencies, according to an earlier NY Times article by the same reporter five years ago.

Employees are the most valuable resource that any company has, and firms must compete to retain skilled employees.

The intense focus on results and productivity have led to incredibly high levels of employee turnover. Amazon loses about 3% of its hourly employees every week or an amazing 150% yearly, which is twice the turnover of the average company in the retail and logistics business. Amazon employs 1.3 million people worldwide, of which about 1 million work in the US. Exact numbers are hard to find, but most of Amazon’s workers are hourly. Assuming Amazon has 750,000 hourly employees, the company would then burn through more than 1 million employees each year. A former Human Resources manager for Amazon assumed that it takes 6-7 applications to hire 1 worker. Therefore, Amazon is sifting through over 4% of the total workforce of 160 million people every year. This rate is not sustainable on a long-term basis, since the company will run out of workers if it continues to grow and churn at past rates.

Eagle Ridge Investment Management is the antithesis of Amazon from a human relations standpoint. We try to create an atmosphere that encourages employees and partners to remain with us. Aside from ethical concerns, our business rationale is that we serve a small pool of 250-300 families on an ongoing basis. We want everyone at our company to develop deep relationships with our clients, since people that work together closely tend to care more and do a better job meeting client needs.

As part of our investment process, we determine if a company’s human resources practices limit the ability of that company to thrive. Employees are the most valuable resource that any company has, and firms must compete to retain skilled employees. Mistreating human resources is a risk to a company’s ability to flourish, since talented contributors will leave or avoid working in a toxic environment where they are treated as fuel rather than the lifeblood of an organization.

Triple D Disconnect:

The Interrelationship Between Donations, Donor-Advised Funds & Deductions

Introduction

Generous taxpayers have long been accustomed to claiming an itemized deduction for contributions to charitable organizations in the calendar year in which the contribution is made. Regardless of whether a donation is made in cash, or in kind (stock, real estate), the fair market value of property at the time of the donation is eligible for an itemized charitable deduction, subject to Adjusted Gross Income (AGI) limitations. Under the 2017 Tax Cuts and Jobs Act, the AGI limitation threshold for itemized charitable deductions was increased to 60% from 50%, through December 31, 2025. The value of charitable contributions exceeding this threshold in a calendar year may be carried forward to future calendar years. Charitable organizations recognized by the IRS under IRC 170(c) constitute eligible recipients. This eligible recipient list also includes Donor-Advised Funds ("DAFs"), which have become popular vehicles for establishing a pool of funds for charitable distribution at a later date.

What is a Donor-Advised Fund?

Created in the 1930s, Donor-Advised Funds were not formally embraced by the Internal Revenue Code until passage of the Pension Protection Act of 2006. Notwithstanding, DAFs began to grow in popularity in the 1990s and now represent one of the fastest growing segments of philanthropic activity. Briefly, DAFs consist of individual donor accounts managed by a sponsoring organization recognized as a qualifying charity under IRC 501(c)(3). Over time, an individual taxpayer may contribute cash or property to the DAF, allow the fund to appreciate in value and periodically or ultimately distribute some or all of the accumulated assets to [a] specified charitable organization(s) of choice. As noted above, contributions to a DAF are eligible for an itemized charitable deduction based upon the value of the property ***at the time of contribution***. As long as the DAF remains "active," i.e., periodic contributions and/or distributions are made, there is no limit on the size of the fund or deadline for distributions to charity.

The Disconnect

Today, Donor-Advised Funds hold more than $140 billion in assets, a fact which has not gone unnoticed by members of Congress. This is where the disconnect between donations, DAFs and deductions enters the picture.

On June 9th, the Accelerating Charitable Efforts ("ACE") Act was introduced in the Senate on a bipartisan basis, seeking to compress the time interval between funding a DAF and distributing assets to charity. Under this proposal, DAFs will be parsed into "qualified and non-qualified" arrangements. Prospectively, a ***Qualified DAF*** is one where contributions to the fund, plus investment returns, are distributed ***in entirety to charity within 15 years of the donation***. Qualified DAFs will entitle the donor to an upfront (at time of donation) charitable donation, as permitted under current law. ***Non-qualified DAF donations*** will constitute arrangements where donations are not completely distributed to charity within 15 years. Under this classification, cash contributions would not be eligible for an upfront charitable donation. Instead, the deduction would be taken when the cash is distributed to charity. Additionally, non-cash donations would not be eligible for a deduction by the donor until such time as the sponsoring organization sells the asset and distributes the cash proceeds to charity. Effectively, ***no charitable deduction will be allowed for contributions to Non-qualified DAFs*** until the contributed property is distributed to charity. The amount of the future deduction will represent the dollar value of the actual distribution to charity. Lastly, non-qualified DAFs would be required to completely distribute assets to charity at the end of a 50-year period.

Triple D Disconnect: continued

Contributions of non-publicly traded securities to DAFs would follow similar rules to contributions made in kind. Specifically, no charitable deduction will be permitted until such time as the charity liquidates the non-publicly traded asset and remits the proceeds to charity. At that point, the donor of the non-publicly traded security will receive a deduction equal to the value of the proceeds of sale.

The proposed legislation also creates a new ***Qualified Community Donor-Advised Fund (QCDAF)***, constituting a donor-advised fund that is established and controlled by a community foundation. Community foundations sponsoring pooled DAFs permit donors of more modest means to have a greater impact by pooling their contributions with other donors. A QCDAF cannot benefit a community of more than four states; further, a QCDAF must distribute a minimum of 5% of its asset base annually, and no individual may have advisory privileges regarding one or more DAFs it administers with assets of more than $1 million. Lastly, a community foundation sponsoring QCDAFs may not have QCDAF assets that equal or exceed 25% of its overall asset base.

There are various proposed administrative provisions, including a 50% excise tax upon the sponsoring organization, for failure to timely distribute. Additional provisions pertaining to Private Foundations are also included in the proposed bill but are outside the scope of this discussion. Anyone needing further information in this area may contact their Eagle Ridge Portfolio Manager.

Prospective Strategies

As you know, there has been much discussion surrounding the increase in individual income tax rates, with prospects for any increase taking effect in 2022. The typical strategy under these circumstances is to accelerate income into the current calendar year, and to defer deductions into the ensuing calendar year, where they will be worth more. However, with the current proposal on the ACE Act, and the likelihood that many DAFs may have to reform their agreements under enactment, taxpayers planning to donate marketable securities to a DAF in 2021 may wish to do so no later than December 31st.

As always, decisions should not be made in a vacuum without consulting legal and tax professionals. We stand ready to be of assistance on matters related to financial and investment planning.

About Eagle Ridge

Eagle Ridge Investment Management is an independently owned, SEC-registered investment advisory firm. Our goal is to provide superior investment performance and a high level of service to a select group of clients, unencumbered by the need to sell products or meet corporate goals. We strive to help our clients meet their needs and compound their wealth through a disciplined investment process.

For more information, please contact Alie Hamilton at **a.hamilton@eagleridgeinvestment.com** or **203-227-4515**.