

(This is not financial advice, the sole opinion of the writer. Written on December 31st 2022)

The theme of this paper is the number '2'. The financial world, has 2 important figures that come out with letters\memos annually. One is the annual letter to the shareholders of Berkshire Hathaway¹, the others, are written by Howard Marks². We will have to wait for March, to read Warren's annual address to the public, whereas Marks published a new memo over the last few weeks. Marks' named it "A Sea Of Change", representing a changing of the times. Economics, tends to get split up into 2 kinds, Micro and Macro. Business managers have to be able to look at the macro environment in order to understand 2 things,

I very frequently get the question: "What's going to change in the next 10 years?" And that is a very interesting question; it's a very common one. I almost never get the question: "What's not going to change in the next 10 years?" And I submit to you that that second question is actually the more important of the two -- because you can build a business strategy around the things that are stable in time. ... [I]n our retail business, we know that customers want low prices, and I know that's going to be true 10 years from now. They want fast delivery; they want vast selection.

It's impossible to imagine a future 10 years from now where a customer comes up and says, "Jeff, I love Amazon; I just wish the prices were a little higher." "I love Amazon; I just wish you'd deliver a little more slowly." Impossible.

And so the effort we put into those things, spinning those things up, we know the energy we put into it today will still be paying off dividends for our customers 10 years from now. When you have something that you know is true, even over the long term, you can afford to put a lot of energy into it. (Jeff Bezos)

Sometimes, things that you believe will never change do. That happens normally in the macro field. In investing, alongside business management, you make macro forecasts on a daily basis. However, the Macro is supposed to affect you only in 2 extreme cases. The first, when everything seems to be going great for everyone. Everyone is making money, everyone is investing, everyone is buying. That is when you should most likely depart from assets you do not intend to hold on forever. When the opposite occurs, then you can allow yourself to be more aggressive, because the likelihood of a margin of safety³ increases. Warren Buffet, Howard Marks⁴ and the likes claim to rarely make economic forecasts, but a bit of a closer observation shows that is not entirely true. Their actions show their conviction in economic forecasts only when "the pendulum swings" entirely into a single direction and they get considerably more aggressive. However, risk will always be there, and has to always be looked at separately. The micro economics are always there, and that is what matters most to each individual business. The macro, is the environment in which the Micro operates.

¹ <https://www.berkshirehathaway.com/letters/letters.html>

² <https://www.oaktreecapital.com/insights/memos>

³ Chapter 20, The Intelligent Investor, Benjamin Graham. <https://www.bookdepository.com/Intelligent-Investor-Benjamin-Graham/9780060555665>

⁴Read, listen and watch anything to do with Howard Marks Co-Founder of Oaktree Capital Management.

Earlier this year, Jamie Dimon, the CEO of JPMORGAN CHASE let it slip on stage claiming, an economic hurricane is heading our way. This leads me to one, of 2 quotes, that I will be discussing here. The first one, was said to me by my father 2 years ago, "I don't know what it is, but we are in the middle of a revolution".

Revolution (definition, thanks to google) - a forcible overthrow of a government or social order, in favor of a new system. Let's redefine as just a forcible change of an old system, in favor of a new one. Revolutions happen sometimes by design, and sometimes they just happen. The technological ones (e.g., the Industrial Revolution) cause major shifts in business, alongside changes to how people conduct their lives. The technological one, was the kind that my father meant, and he was right.

The change in our day-to-day life, was miscalculated by many major businesses, and by the public as well. Businesses changed their business models based on an assumed change in the habits of people. The public assumed that they were right, by inflating their prices in the stock market. And the miscalculations, of everyone, were loud and clear. But that is the case always with decision making under deep uncertainty⁵. Warren Buffett, just like many more of his school of thought (misleadingly defined as Value Investors. There is only one form of investing, the rest is gambling). Constantly repeat, that they do not believe in Macro economic forecasts, not because they are unimportant, but for the reason that they are impossible to predict. He repeated time and time again in every annual meeting since 2012 that he would never be able to predict low interest rates for as long as they did without it having serious repercussions⁶. However, we did probably see asset inflation, that was unrepresented in CPI. We just didn't realize it until 2021.

Buffet said many times over the years, if he could know one thing about the future, it would be future interest rates. As he said in annual meeting for Berkshire Hathaway shareholders as recent as 2018⁷ something like "I know that interest rates will eventually have to go up, I don't know when and I don't know by how much". The sea of change, or hurricane, are observed in 3 Macro economic forces. The first one to arrive was inflation. Inflation, was an outcome anticipated by a handful of people, in the dawn of 2020, in 2022 suddenly everyone else, claimed to see it happening. 3 notable figures spoke at the time, Larry Summers and Muhammad El-Erian on TV (primarily Bloomberg) and Michael Burry through action and Twitter. The public preferred to listen to the likes of Paul Krugman (whose academical and theoretical reputation gave a voice permitting extreme dangerous behavior), Afsaneh Mashayekhi Beschloss (whose investment philosophy is driven more by ideology than practical business thinking. Don't be fooled by her nicely seeming appearance either. I am sure she can be cut throat and ruthless too), Jim Cramer⁸ (who needs to be looked at as no more than an

⁵ https://www.bookdepository.com/Theory-of-Decision-under-Uncertainty-Itzhak-Gilboa/9780521741231?redirected=true&utm_medium=Google&utm_campaign=Base3&utm_source=IL&utm_content=Theory-of-Decision-under-Uncertainty&selectCurrency=ILS&w=AFF9AU9SG71NPF8VT0B&gclid=CjwKCAiAhqCdBhB0EiwAH8M_Gizv_E09t8UvNViSliRIJvtFrXQhzex8AbFhoWMM7RkFehEFQGlMBoCaQAQAvD_BwE

⁶ To this we will have to credit technological advancement. We will return to technology and its deflationary effects later.

⁷ https://www.youtube.com/watch?v=sYiv4AMq9Tk&t=8983s&ab_channel=InvestorArchive

⁸ <https://www.imdb.com/title/tt2241351/> The similarity between George Clooney's character (On Money Monster) and Jim Cramer, made me realize back then how much of a joke he is. Shows you something about CNBC. I am a fan of Bloomberg.

entertainer) and Cathy Wood (Who made one lucky call)⁹. I ask people what their thoughts are on Jim Cramer, and what finance channels do they watch as a means of evaluating their views on the subject. Yes, I think that if you watch Jim Cramer, or you want nothing to do with him, says a lot about you.

The second major financial force at the moment, is Quantitative Tightening¹⁰ (QT), the opposite of Quantitative Easing (QE)¹¹. This is the first time this is happening (check how non-existing the page is on Wikipedia). Nobody knows how much of an effect it will have.¹² What is clear, is that it forces money to be taken out of the market. This will probably have the greatest effect on asset pricing. In the last decade, we had an excess of money due to low interest rates. The human race is smarter than it was in the past, greatly enhanced by the power of the world wide web. "Money makes money" has become common knowledge. The great success of several technologically driven companies, driven by their new business models (Their business models are just as innovative as the technology itself)¹³ became the basis for new fantasies. This created an environment most evident in the VC and Private Equity world. The FTX story should not be a surprise. It is one of many out there. This first dawned on me several years ago, when I spoke to two relatives (one a CPA, the other took many courses in accounting and has considerable experience in observing businesses) who had the skills of reading financial reports, but most of the time did not read them, definitely not extensively. If people have the skills and choose not to use them, even if they are investing over 5% of their own capital, why should a fund employee do this, when he is investing a smaller percentage of someone else's money? No due diligence done, no real investigative work before money exchanges hands.

(Personal Story, summer 2019 nobody wanting to peek at my BOOKS).

If you ask many Business students, the accounting classes are the most hated, or often the hardest, in their studies. Many people choose to avoid doing it, in their own personal life. In the summer of 2019, I conducted a social experiment. I travelled in the U.S with a binder, that was, well, my "Books". I did my own bookkeeping. When I was asked what am I doing for work? I detailed the different endeavors I was undertaking. I spoke about profit margins, and why each business made sense, or what was the strategy and long-term plan. I always offered people to look at the books. No one cared, nobody wanted to. I find that fascinating. Because I take everything, anyone takes regarding money, and business with a grain of salt, until I see the books. That's the story. People avoid looking at the numbers. I am still today, operating in all the fields I did 4 years ago. I evolved, based on what I found in the numbers.

⁹ Cathy by the way, is someone I personally like. I would never give her the power to make any decision, but she is someone I would constantly want to listen to, because she has an extremely positive attitude and her nature allows her to see the technological tsunamis that are destined to come. But she has not shown any capability in predicting their outcome and influence. Anyone who says to you they are a long-term investor and talks to you about 5 years ahead never picked up a history book and understood how long it takes from when the technology is invented until it actually influences on a grand scale

¹⁰ https://en.wikipedia.org/wiki/Quantitative_tightening

¹¹ If there is a monetary base of \$500m (m = million) in circulation and the money multiplier is 10%, the maximum change would be \$5b (b = billion). (study.com)

¹² https://ycharts.com/indicators/us_monetary_base_h6msm#:~:text=Basic%20Info,6.331T%20one%20year%20ago.

¹³ I recommend listening to Berkshire Hathaway's annual meeting 2018 at exactly 4 hours and 0 minutes and listen to what Warren Buffet describes.

https://www.youtube.com/watch?v=sYiv4AMq9Tk&t=18174s&ab_channel=InvestorArchive

So, people avoid looking at the numbers, and investigating them. Instead, they like shiny toys, or the concept of having lots of users but we don't know how to make money with them yet, this is the fallacy of Metcalfe's Law¹⁴. The one company that comes to my mind the most, who's till this date is probably the greatest acquisition without any understanding of its monetization is WhatsApp (16 billion)¹⁵. Technological innovation is deflationary. Whatsapp, Skype and the likes have created such competition for telecommunication companies that it reduced considerably the pricing of international calls. Now what happens when that money does not go towards actual technological innovation? Or even practical use cases. This was extremely clear within the Crypto, NFT world. Binance's coin does not have any value besides what value Binance chooses to give it. This is a similar use case to Warren Buffett thinking of borrowing money from Kuwait in the 1960s¹⁶ (Berkshire Hathaway annual meeting 2011¹⁷). The NFT art world, is most similar to gold. The concept of holding an asset just for the idea that someone else will want to pay more for it later on. Similar assets with track records are, Wine, Jewelry, collectibles and more. What these hold is a track record. When anything new comes around, I believe in treating it with the precaution I would give a tulip bulb¹⁸. In conclusion, we are most likely to see the effect of QT on asset pricing, primarily those of assets that do not produce more assets. Following with companies that do not actually provide a real source of revenue or show any ability to produce profits. We have seen major signs of that in 2022, and it will get much deeper I believe in 2023(I would never act on any belief in Macro Economic trends).

The third one is rising interest rates. This has been seen and seen before, out of the three, this is the one we've seen most recently. In a nutshell "When interest rates rise, the cost of borrowing money becomes more expensive. This makes purchasing goods and services more expensive for consumers and businesses. For example, purchasing a home becomes more expensive as mortgage rates rise and financing growth for a business also becomes more expensive as rates on loans increase"¹⁹. What we did not see for a very long time is the pace. The dangers here, are 2. The fed falling too short, and the fed will lose control of inflation again. The other danger is, that they will go too far. Jeff Gundlach loosely said, they failed so much in the recent past (longer than the last 3 years) who is saying they can get inflation back down to only 2% and not completely crashing it, deflating the US dollar? Another thing that we need to discuss, is all the talk fixed yield fund managers talking for the last few months that now is the time to get into bonds. Think of a car salesman. Is he ever going to tell you that now is not a good time to buy a car? That you should wait a year? Professionals, whose income and financial wellbeing is dependent on you needing their service, will always think of a reason why. The time to get into bonds, as far as I understand, is not when rates go up, but rather when they go down. The reason is, if you hold a government bond, with a yield of 7%, and anyone else can get from the same government a bond for 6% isn't yours worth more? So if I know that the

¹⁴ Metcalfe's law states that the value of a telecommunications network is proportional to the square of the number of connected users of the system (n²). [Wikipedia](#)

¹⁵ We will get back to this, Mark Zuckerberg and Meta later.

¹⁶ https://www.youtube.com/watch?v=i9f8UFYVr7I&ab_channel=RalphKhattar

¹⁷ https://www.youtube.com/watch?v=fKTmuoU9IVE&t=18283s&ab_channel=InvestorArchive

¹⁸ I recommend A Short History of Financial Euphoria, Book by John Kenneth Galbraith, <https://www.amazon.com/History-Financial-Euphoria-Penguin-Business/dp/0140238565>

¹⁹ Investopedia

rates will rise over the next few months, shouldn't I wait until then? The time that makes the most sense, is at the peak of the rate hikes. The closer we are the better, however no one knows how high it will go, and for how long.

The flip side, to raising rates to high, is the political pressure that may come in case of a recession. Inflation may be more persistent, and the fed might be truly pressured to stop the process. Some are talking about inflation coming down to only 3-4%. In that case, current government bond buyers again will be getting again a near net zero return. Peter Lynch²⁰ said something once that gave me a new perspective on the concept of bonds, a company can have a wonderful year and decide to pay out some extra in dividends, but no company will turn around and say "you know what? I did so well I think I should pay a higher interest on my debt". To me²¹, investing in bonds only makes sense in bonds with yields at least above 10%, the investment must do things I discussed in previous letters, Higher return than the average rate of the s&p500, be enough to cover the premium on the risk and the time invested in finding the investment. And I remind you all, with something from our philosopher of risk, Howard Marks, risk²², is something impossible to quantify.

I will summarize with this. The stock market, like the economy as a whole, will go up, will go down. When, how, I don't know, I can only guess. Same as I can only guess with a roulette. I don't put my money on this, because I don't gamble in that sense. I try to deal with things I see as facts, not theory.

This may be Americas great reset opportunity (not the kind Dalio is talking about), I feel optimistic. We may get to restore interest rates to historic norms and the fed may land the plane softly and gently on the runway.

The new macro environment leads us into the micro. This leads us to the second quote, that symbolizes to me more than anything, the age we just lived in.

This is what is happening now:

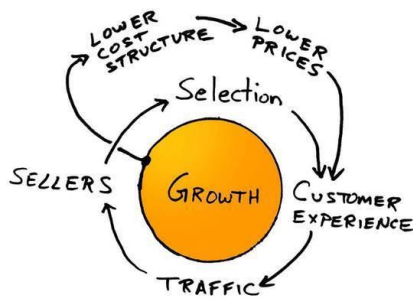
"Increase supply and demand follows"²³. No one has better understood this, than Jeff Bezos, in my eyes, the greatest entrepreneur of our time.

²⁰ https://www.youtube.com/watch?v=myu4Nv0pt0U&ab_channel=InvestorArchive Peter Lynch – How to be Successful In Investing

²¹ I personally look at returns in a distance of at least 20 years. 10 years to me is short.

²² https://www.youtube.com/watch?v=QGisSRUFZpE&t=2s&ab_channel=WhartonSchool Howard Marks, @oaktreecapital Co-Chairman, on Investing Risk – Wharton School Investor Series

²³ Michael Keaton, as Ray Kroc, the first minute of the film 'The Founder'



Jeff Bezos, is the creator of the new Eco System business model, a model that revolutionized the business world as it electrified²⁴ the imagination of humanity just as it completely destroyed the world in which the 3 business structures that Miles and Snow²⁵ wrote about decades ago. However, the business model drawn on a napkin, refers to the retail side of the business, not necessarily, the logistics side of it. Now, what I am asking you to do, is 2 things. Imagine the old mall you used to go to, and try to think, how a mall could truly grow its revenue. You will see, it is more or less the same business model. Amazon, uses technology in order to revolutionize and disrupt industries that have not changed in a long time. The second thing I am asking you to do, is let go of the way of thinking that segregates companies like intel and Meta and Apple as Tech, but look at them as intel- a commodities company (microprocessors) – Meta, telecommunications (with whatsapp), the old flea market (FB marketplace), Apple – residential real estate, telecommunications, media. When you understand this, you understand that the metaverse is already here, and it's here when you're walking around your house cleaning and you're on the phone with your airpods talking to a friend on the phone or listening to a podcast. These products that the companies provide, that were deflationary over the last decade, are becoming more expensive now for companies to provide, as they become more expensive due to inflation, and more difficult to develop let alone acquire (Regulators less likely to play along, and investors are less likely to provide capital to start ups, so there will be a smaller selection to acquire). The development of new technology, is not always possible, as we've learned over the last decade with Moore's Law²⁶, progress does not always happen in the same pace that it did before²⁷.

This led companies to start developing microprocessors designed for their specific needs as a tool for enhancing computational processing with the help of computer science as opposed to a more general design of hardware. Lean, mean, provide and develop for yourself. Companies will need to internally develop as opposed to acquiring outside, this includes also their own personal supply chain, something that Amazon too, reigned superior with over the last few years. The best company, by far, at inhouse development, is Apple. It doesn't matter if a car, AR or VR sets will be the next product. Apple will be able to price its products, at a rate higher than anyone else, with better margins, only, because it has its name on the product. Apple is better off delaying time and time

²⁴ I am begging you to watch - Jeff Bezos the Electricity Metaphor -

https://www.youtube.com/watch?v=vMKNUyImanQ&t=1022s&ab_channel=TED

²⁵ Organizational Strategy, Structure, and Process <https://www.bookdepository.com/Organizational-Strategy-Structure-Process-Raymond-E-Miles/9780804748407>

²⁶ **Moore's law** is the observation that the [number of transistors](#) in a dense [integrated circuit](#) (IC) doubles about every two years. Moore's law is an [observation](#) and [projection](#) of a historical trend. Rather than a [law of physics](#), it is an [empirical relationship](#) linked to [gains from experience](#) in production. (Wikipedia)

²⁷ Worthwhile listening to Peter Thiel as Oxford University on this matter -

https://www.youtube.com/watch?v=fQ4rc7npiXQ&t=818s&ab_channel=OxfordUnion

again coming out with new products, if there is a shred of a chance that it may damage the company's reputation. Apple's business strategy is the exact opposite of the gaming industry²⁸.

It truly deserves the place it holds as a business, not necessarily as a supreme product developer, in the minds of the public. Management developed internally, products developed internally, ignoring the trends, focusing on the meaning of the brand. Apple, like Amazon, like Costco, has a brand that can move. The company means more than a product. There are 3 natural situations a company is in.

1 - the CEO, or largest shareholder, is larger than the business. This is Fortescue Metals Group (Andrew Forrest), this was GE (Jack Welch). This wasn't the case for Apple (Jobs), or Microsoft (Gates), or Alphabet. These are the companies that people believe that anything the CEO touches turns to gold (recently Elon Musk).

2- The products are greater than the business. This is Google and Meta, Coke, Heinz Ketchup, 3M, think of products you know, but can't think of the name of the business. Or you hate the CEO and company (like many hate Mark) but you can't live without their products.

3- the business is greater than the product. This is Apple. This is LG, Toyota, Amazon. You buy the product, because of the brand. The brand of the business means something to you. This is the definition of a brand that can move.

Tim Cook, is doing something with Apple that is Warren Buffet's and Charlie Munger's wettest dream for Berkshire. In the words of Daniel Zhang²⁹, "Nobody cares more about the company than the founder." Apple's brand and status has never been better. It is not associated anymore with an individual, with a product. The consumers love the company, and the company, is why they buy the products. Apple doesn't sell devices, it sells the synergy of the products, it sells its own **Metaverse**. On the contrary, Meta is Mark Zuckerberg, and Mark Zuckerberg is Meta. But Mark doesn't represent the products. The products are incredible, they are so good that even though people hate the company, and hate the CEO and founder, they love the products.

Apple and Amazon³⁰ seem to be what Built to Last is written about. They are, the company, who each of their competitor or an adversary would use their silver bullet³¹ for.

I have been all over the place so let me reign you back in. What separates a great business from a good business:

1. Financial management – Warren Buffet says the single most important class he ever took was accounting in the University of Nebraska. Eric Schmidt, former CEO of Google, understood more than anything the concept of cashflow, and that you can have the best

²⁸ The gaming industry, in a nutshell, has been publishing unfinished games with bugs and fixes them as they go along.

²⁹ CEO of Alibaba Group.

³⁰ Jeff Bezos got the advice of Jim Collins Co-Author of Built To Last & Good to Great in 2001, after the Dot-Com Bubble burst

³¹ Andrew Grove, Andrew Grove, Andrew Grove. He get's mentioned all the time, by so many of the business greats.

products and employees, but if you run out of cash, you die. Growing too fast, can sometimes be the most dangerous thing a business can do. The major Microeconomic Sea Change, is that running a balance sheet with more debt than equity, an income statement that runs with a net negative return, is now too dangerous. These days are over. The business strategy pioneered by Phil Knight³², and taken into the 21st century by Jeff Bezos, is now over. The combination of a higher interest rate world, combined with higher inflation, will not allow refinancing at the same degree that it did. New products and services, new markets, the natural creators of growth, do not command the same pricing power as more established products and services in the markets they already control. The days of “Increase the supply, demand will come” are now over.

Meta owns Whatsapp, an amazing product. After nearly a decade of owning it, and still no understanding on how to monetize it, it will have to show as a product, an amount of return in the future that is ridiculous. Justifying the purchase price, and the return the money could have perhaps made elsewhere in the business, in a high interest rate environment, seems to me impossible.

So what are we looking for: high current ratios, and as little debt as possible. Large profit margins, high returns on equity to justify debt. Positive, stable cashflow. Forget about the concept of growth. My friend, spoke to me recently about Alphabet and the cloud business. He used a sentence “if they manage to keep growing the business like this for the next decade it will be wonderful”. Assumptions about growth, or wishful thinking are a fools game. There is a reason why Aswath Damodaran uses the word assume constantly in his text books for MBA students, but never on stage when he is speaking to professionals. Assumptions only work in a class room, when he is preparing students for jobs in which they need to provide the numbers their managers want them to provide. Whenever anyone is assuming or hoping, they are either lying to themselves, or trying to sell you something. The professionals know this, but they make too much money from selling to eager investors and getting extremely wealthy based on commissions.

Now more than ever, the question of “Do I understand the business?” is crucial. And the question, does not mean do I know how to use the product, etc. It means the economics of the business, or how will the business make money over time. The question of circle of competence is now more important than ever, and it comes to a simple idea, can you draw the company’s flywheel on a piece of paper. And if so, does it include making money? The higher interest rates go up, the faster you have to see a return.

Business Flywheel = Method for making money.

2. Management.
3. The brand of the company. It means something. This is beyond having an incredible product. This is the power of the Midas Touch. The consumers, will buy whatever you make, because the company’s brand means something. Toyota is the symbol of reliability for vehicles. Apple, Costco (with its home brand), Amazon.

³² Founder of Nike.

One last note: Inflation, may become “sticky” like Muhammad El-Erian suggests, around the 3-4%, combine that with higher interest rates, the profit margin is squeezed and on top of that is not worth as much as it did in the year before. The intrinsic value of a business, or project, is the total of all future earnings it will generate discounted at the appropriate discount rate. Higher interest, means smaller margins. Smaller earnings, unless your income does better in a higher interest rate environment, but that is only in the case that you gave out loans to the right people. The theory of cash is trash is utterly ridiculous, because, in an environment of higher interest rates, cash becomes more valuable, because more people will need it. This is the environment where cash, especially positive cashflow is king. Dividends, are a healthy source for companies to use for their own interest, by cutting the dividend returns. This may sound counterintuitive to many. The idea of “1 in the hand for 2 in the bush” lies on the premise, that I invest in a company because I believe that the business can do better with my cash today than I can myself, and therefore utilize it in a sense that will reward me later on. When a company returns the dividend, it makes a decision, that it does not know how to reinvest the cash in a fashion that will benefit the shareholders. Therefore, if, management does see opportunities rising over time, sometimes, cash that under normally gets distributed to shareholder as a dividend, can become an extremely healthy source for the business. Don’t read cuts in dividends as a default bad news, this is similar to the fallacy of searching for companies based on a high dividend return.

Yours,

From Nahariya