DIAMOND LAKE
CAPITAL

January 31, 2023

The market in 2022 felt like a schoolyard brawl with lots of punches, bloody noses, and exciting moments but in the end everyone took a beating. The only silver lining might be summarized when your kid comes home and says, “you should see the other guy.”

The Diamond Lake Capital Model Portfolio dropped 15.36% in 2022, a slight improvement of 2.75% against the S&P 500 Total Return index, which fell 18.11%. We use the total return index as both an opportunity cost and our preferred stock market index benchmark since it’s a fair way to compare what an investor would get as they re-invest dividends. If we can’t beat it over time, we’re not doing a good job.

	Diamond Lake Capital	Relevant Comparison Returns	
1/1/2022 - 12/31/2022	Net Return	S&P 500 TR	Vanguard 2040 TDF
	-15.36%	-18.11%	-16.98%

The market hasn’t been this bad since 2008. In 2022 we saw incredible CPI inflation of 6.5%, only surpassed by the 7% increase in 2021. We witnessed uncertainty and speculation fueling volatility across the board and even negative yield bonds, later followed by a jump in the 10 year US Treasury yield. Interest rates are indeed the gravity of risk assets: the higher they go, the lower equity prices go, and the longer the duration of those expected cash flows (the more *growthy* they are), the more the market has discounted them.

Our portfolio had a few position changes, which are discussed more in the Portfolio Analysis section below. We aren’t fans of adding or selling positions based on short-term trends, diversification for the sake of “reducing risk”, or rebalancing because of a pre-determined asset allocation. As discussed in our Investment Philosophy, we want to find strong businesses with favorable economics that we can hold for 5-10 years or more. Our selling philosophy is about business deterioration or better opportunities, not missing-earnings-per-share-by-one-cent events. Though our investments aren’t all boring, our trading logs are. Academic research links high portfolio turnover with low performance. Our personalities support this.

TRENDS

Averages hide a lot. It doesn’t help too much to know the average depth of a river before attempting to wade across. To get the *average stock market return* requires a lot of bobbing. Only 8 years of the last 95, or 1 in 12 years, has the market returned between 6 to 12% in a given year[1]. The rest swing back and forth rather violently, more so than fundamentals suggest they should.

[1] S&P 500 Total Return data 1926 to 2022.

Themes that will likely move 2023 are hard to tell and short term prediction accuracy is largely luck. The directional change in general Inflation will matter, as will how *soft* of a landing the US economy has. If you look at real GDP, we are already in a recession[2]. China is opening up. The world looks to more normalcy. That said, stocks that dropped 80% can drop 50% further. But like with many years, what worked last year often doesn't this year. Mean reversion can be our friend if timing is right; that said, in investing, you have to be contrarian and right.

We've also seen increasing trends with retirement accounts flocking to target date funds. Roughly $1.8 trillion is invested in target date mutual funds (TDFs), according to Morningstar. Vanguard reported that most 401(k) plans — 98% — include this kind of fund in their lineup, and 80% of all 401(k) participants are invested in these funds[3]. Even so, the performance of popular options such as Fidelity Freedom or Vanguard have been terrible. Here's a table of these returns to prove that point.

Target Date Year (Cumulative 5 Yr Returns)	Vanguard	Fidelity Freedom
2025	-11.10%	-19.90%
2035	-8.20%	-19.40%
2045	-1.00%	-17.90%
2055	-4.90%	-15.00%

We think this is an incredible opportunity for our clients to switch from overly diversified, underperforming Target Date Funds to a concentrated portfolio that has a more appropriate asset allocation[4].

PORTFOLIO ANALYSIS AND SELECT STOCK PERFORMANCE

As 2022 progressed, we recognized a need to sell off our position in Amazon. Unions and a high exposure to labor costs can create debilitating profits for companies and industries. We also sold our position in Covetrus in late May at a 1.3% discount to the private equity offer of $21.00 per share. The deal closed in October[5] at the $21 price. We also sold Bread Financial Holdings. Management is judged by errors of omission and of commission. To switch the company name to a recently acquired merchant lending firm, while losing traction, and focusing on flavor of the day corporate speak announcements didn't fit our investment philosophy. We

[2] Negative *real* GDP growth for 2+ quarters.
[3]https://institutional.vanguard.com/content/dam/inst/vanguard-has/insights-pdfs/21_CIR_HAS21_HAS_FSreport.pdf
[4] Too much of a slant to fixed income and overdiversification are two of the many problems.
[5] https://covetrus.com/clayton-dubilier-rice-and-tpg-complete-acquisition-of-covetrus/

added a small position of Alphabet to our model portfolio; search and YouTube are such delicious businesses, and the multiple was right.

Two higher conviction ideas moved down more than the market, JD and VIRT. One due to the persistence of Covid restrictions gone too far, the other on potential regulations on best price and how deals are routed and margins under VIRT. Costco also continues to be one of the larger portfolio holdings. It’s a fantastic business that does well when the economy is growing and resilient when the economy is in a recession.

As with all of our holdings, we’ll continue to re-evaluate each one against our watchlist and make adjustments according to what the market offers. Sometimes, that might mean selling a current holding to increase our position in a more favorable existing holding. Other times, it might mean an opportunity to add a new business to our existing portfolio. It might mean doing nothing at all. In the investment arena, we often find that being patient and waiting can be the most challenging but rewarding situation.

LOOKING FORWARD

While we’re not macro nerds and don’t have much to offer on predictions, inflation and the impact on cost of capital is a big story for risk assets like stocks. Super high growth stocks with 10 years of negative free cash flow per share are likely to continue to suffer, and many will die. To not thrive on the tailwinds of cheap money and scalable digital business models is not a good sign. The best we can do is avoid the big traps, and to buy a select set of businesses, where we see an edge in relative valuations, business models, and managers who are rational stewards of capital.

We’re always around to talk and answer any questions you may have.

Your partners,

Greg Greer

Joe Andelin

DISCLOSURES

Diamond Lake Capital, LLC is a registered investment advisory (RIA) firm. This letter is not investment advice and should not be deemed as investment advice or a recommendation to purchase or sell any specific security. Information referenced in this letter comes from sources we believe to be reliable and accurate. Opinions written are subject to change and past performance is not a guarantee of future results. Additional information on DLC (CRD #314605), including form ADV, can be found on the SEC's website.