Hutchinson
CAPITAL MANAGEMENT

January 2022

INVESTMENT PERSPECTIVES

Herd Mentality

The pandemic and the flood of new investors who entered the market over the past two years have brought seismic shifts to the investing landscape. We have seen increased accessibility and gamification of trading, the maturation of new asset classes, and the impact social media can have on markets, all within a relatively short period of time. Stories of astonishing and swift wealth creation have been pervasive throughout the media landscape, promulgating the notion that select assets hold the key to making money. Surely, one of the most fascinating phenomena to witness during this period has been the behavioral influence on investing – and how the market reacts to swings in the court of public opinion. Our belief is that the current trends in the market depict a strong herd mentality. Crowd psychology in markets is not new and has been a well-documented phenomena that has existed throughout history. The motivating force behind herd investing is the tendency for individual investors to look for leadership in the form of a majority – the idea that trends will continue if there is a critical mass of momentum behind them. Markets can be gripped by a common mindset among investors and this groupthink can lead to strong returns for a sustained period. These returns can lead to complacency, causing investors to extrapolate current trends well into the future. In this *Investment Perspectives*, we discuss different groupthink that has taken a foothold in markets during the pandemic, the implications for return expectations going forward, and what this herd mentality means in the context of our investment process.

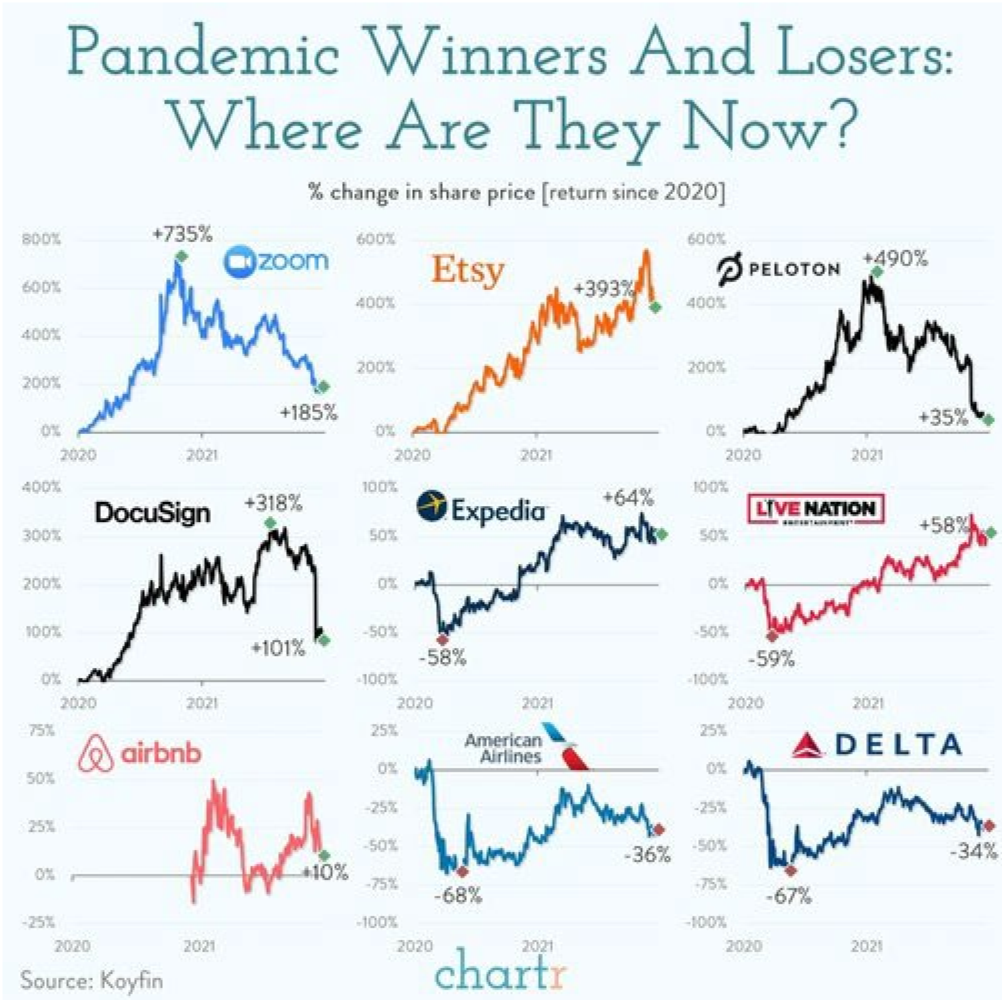
Where is the Herd Today?

In the past year, we have seen certain areas of the market gain significant traction among market participants and speculators. These include disruptive but unprofitable companies and a narrow focus on the "winners" and "losers" of the pandemic. People who have made money in these areas are quick to tell their friends, and those friends, in turn, are quick to chase what is working. In many cases, we believe this is a recipe for bad financial outcomes.

1. Unprofitable companies: In 2021, we also saw the continued rise of investors pouring money into companies that are currently unprofitable in the hope of "buying the future." In this segment of companies, the cast changes but the central characters share traits: they are disruptive and innovative, have unjustifiably high valuations, and, most importantly, possess a captivating story. When companies embody these characteristics, investors are willing to dismiss or ignore the present flaws in the profitability of the business on the promise of future growth. Undoubtedly, some of these companies will go on to be transformative players in their respective industries. However, there are many more that do not, and when the flashy story loses its appeal and the wave of momentum turns, the financial repercussions for investors can be devastating.

   The steady decline of interest rates over the past several decades also contributes to the proliferation of investment in unprofitable companies. When early-stage companies can borrow for next to nothing, it's much easier for investors to discount the company's cost of carrying debt. History has shown that investors are willing to pay a premium price when money is cheap; the current profitability of the company comes is a secondary consideration. To illustrate this point, the chart below shows the percentage of IPOs where the listing company is profitable and its steady declined over time.

2. "The Winners and Losers of the Pandemic": Investing with the herd is as easy, or at least as publicized, as it's ever been. For the past two years, many winning investments have predicated around the common force of an accessible and tantalizing story. As investors, we are not lacking for information or opinions on the investments we own, and this is especially true as it pertains to the impact of Covid-19. Many investors have been successful by placing winning bets on companies that stand to benefit (or suffer) amid the unsettled economic climate brought on by the pandemic. Investors have flocked to these perceived winners with very little consideration for other aspects of their business fundamentals. For new investors, this stay-at-home vis-à-vis reopening trade may be the only basis for their investment. Every CEO has addressed Covid in some form on their earnings calls, which influences public opinion and market participants about how the virus will impact each company. Our investment process aims to decipher profitable, well-managed companies with sustainable positive business trends from companies who have reached lofty valuations on the back of unsustainable growth.



Profitability aside, the moment that Covid emerged the market formed opinions around which companies stand to benefit and which stand to suffer. The chart above shows nine highly publicized example and depicts what can happen when the herd suddenly migrates.

Setting the table for return expectations

As we have noted, the sort of investing groupthink we have witnessed over the past 18 months is not a new phenomenon, but it's important to identify what makes this situation unique, and how it impacts future return expectations. In March of 2020, we experienced the quickest decline into a bear market in history. Many individuals who came of age as investors after the Great Recession found themselves in a period of muted inflation, low interest rates and a decade-plus bull market followed. Now, nearly two years removed from that event, it's easy to forget the anxiety that a 34% market decline can bring to market participants. With the S&P 500 having posted a robust rally from the pandemic lows, the brief period of extreme market stress has been largely forgotten. As a byproduct, expected future returns for this large contingent of inexperienced investors has been distorted by the rapid rise of equity prices that has ensued.

Even with inflation data at its highest level in 40 years, many households are in a better financial position now, than they were prior to the pandemic. Fueled by an accommodative monetary policy, the appreciation of nearly *all* asset classes has had staggering wealth effects.

We are long-term thinkers and optimists at heart, but calibrating return expectations for our clients is a consideration we do not take lightly. When we do financial planning, a foundational piece of the process is understanding how reliant the financial plan is on investment returns. Modeling conservative future returns allows our clients to build a margin of safety that is crucial in constructing a sustainable financial plan. The strong returns in the past several years have put many people ahead of these projections but investors should always be wary of extrapolating the recent past into the future.

The dangers of herd investing, and how it informs our decision making

Herd investing is not driven by logic and analysis, but rather the human tendency to be swayed by societal influences that trigger the fear of missing out (FOMO). This lends itself to paying a price that can be hugely out of step with the fundamental value of a company. The investor has the psychological "benefit" of being a part of the in-crowd, but the perceived safety in numbers can come at great peril. Typically, there is no thought given to the fundamentals of a company such as its profit margin, cash flows, management, and valuation. Bertrand Russell states following on this type of behavior:

"Collective fear stimulates herd instinct and tends to produce ferocity toward those who are not regarded as members of the herd."

At HCM, we aim to avoid areas of the market where soaring valuations are detached from their fundamental value. We continue to focus on business fundamentals as the foundation for making long-term investments. We identify good businesses with strong balance sheets that are run by able management teams. We will buy those businesses when they are undervalued and have growth drivers that are identifiable and sustainable. This approach requires us to be patient and disciplined. We are confident that following our time-tested approach to investing will help us preserve your capital and grow it over the long run.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of December 31, 2021, Hutchinson Capital Management (HCM) held:
0 shares of Zoom Video Communications, Inc. (ZM)
0 shares of Etsy, Inc. (ETSY)
0 shares of Peloton Interactive, Inc. (PTON)
0 shares of DocuSign, Inc. (DOCU)
0 shares of Expedia Group, Inc. (EXPE)
0 shares of Live Nation Entertainment, Inc. (LYV)
0 shares of Airbnb, Inc. (ABNB)
0 shares of American Airlines Group Inc. (AAL)
0 shares of Delta Air Lines, Inc. (DAL)

As of December 31, 2021 (Prices in USD unless noted otherwise)
Zoom Video Communications, Inc. (ZM) closed at $183.91
Etsy, Inc. (ETSY) closed at $218.94
Peloton Interactive, Inc. (PTON) closed at $35.76
DocuSign, Inc. (DOCU) closed at $152.31
Expedia Group, Inc. (EXPE) closed at $180.72
Live Nation Entertainment, Inc. (LYV) closed at $119.69
Airbnb, Inc. (ABNB) closed at $166.49
American Airlines Group Inc. (AAL) closed at $17.96
Delta Air Lines, Inc. (DAL) closed at $39.08

As of December 31, 2021, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	12/31/2021 Closing Price
Bank of America Corp	6.86%	$44.49
Apple Inc	6.66%	$177.57
Berkshire Hathaway Inc Class B	6.12%	$299.00
Microsoft Corp	5.36%	$336.32
Robert Half Intl	4.87%	$111.52
Store Cap Corp Com	4.78%	$34.40
Progressive Corp	4.69%	$102.65
Markel Corp	4.51%	$1,234.00
Jacobs Engineering Group Inc	4.20%	$139.23
Capital One Financial Corp	4.19%	$145.09

For a complete list of holdings, please see our most recent 13F filing on the following SEC website:
http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

Nothing herein should be construed as a solicitation or offer, or recommendation to buy or sell any security, or as an offer to provide advisory services in any jurisdiction in which such solicitation or offer would be unlawful under the securities laws of such jurisdiction. The material provided herein is for informational purposes only. Before engaging HCM, prospective clients are strongly urged to perform additional due diligence, to ask additional questions of HCM as they deem appropriate, and to discuss any prospective investment with their legal and tax advisers.