Compounder Fund Investors' Letter: War and Investing

COMPOUNDER FUND
GROWING YOUR WEALTH AND ENRICHING SOCIETY

Dear investors,

To say that the first two months of 2022 have been eventful is an understatement. January saw a big decline in the stock prices of many high-growth companies in the US market and elsewhere. Compounder Fund's holdings were not spared. This prompted Jeremy and me to send a letter titled "**Solidarity**" on 27 January, outside of our regular quarterly letter-cadence, to explain the situation to all of you.

The January declines have largely continued throughout February thus far. Falling stock prices are painful to experience. But something far more horrifying has happened. Earlier this week, Russia **started military attacks** on Ukraine. The foreign minister of Ukraine said that Russia has launched a "full-scale invasion" of the country. Russia's aggression - unconscionable in my view - has shattered the relative peace that the world has enjoyed over the past few decades. Given the gravity of the situation, Jeremy and I think it is appropriate to write to all of you again outside our normal schedule.

The bottom-line is this: **We are *not* making any changes to our investment approach because of the armed conflict between Russia and Ukraine.** Before I expand on our bottom-line, I want to first acknowledge how fortunate Jeremy and I are to be able to discuss relatively mundane matters such as investing while the people of Ukraine are fighting for their lives and their independence. It is a good reminder for all of us to be thankful for what we have in life. If any of you have family or friends living in Ukraine right now, Jeremy and I sincerely wish that they will remain safe and sound throughout the entire ordeal.

Without downplaying the tragedy of war, I want to now expand on our bottom-line. There are four things I want to share. First, there's a useful framework for thinking about investing in stocks during war scares that can be found in the classic investing book, ***Common Stocks and Uncommon Profits**,* that was first published in the late 1950s in the USA. The book is written by Phillip Fisher, who's an excellent investor in his own right, but is perhaps most famous for being an influential figure in Warren Buffett's own evolution as an investor. Buffett has said that his investing style is 85% Graham and 15% Fisher. Here's what Fisher wrote (emphases are mine):

> Common stocks are usually of greatest interest to people with imagination. Our imagination is staggered by the utter horror of modern war. The result is that every time the international stresses of our world produce either a war scare or an actual war, common stocks reflect it. **This is a psychological phenomenon which makes little sense financially**.
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> Any decent human being becomes appalled at the slaughter and suffering caused by the mass killings of war. In today's atomic age, there is added a deep personal fear for the safety of those closest to us and for ourselves. **This worry, fear, and distaste for what lies ahead can often distort any appraisal of purely economic factors**. The fears of mass destruction of property, almost confiscatory higher taxes, and government interference with business dominate what thinking we try to do on financial matters. **People operating in such a mental climate are inclined to overlook some even more fundamental economic influences**.
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> The results are always the same. **Through the entire twentieth century, with a single exception, every time major war has broken out anywhere in the world or whenever American forces have become involved in any fighting whatever, the American stock market has always plunged sharply downward**. This one exception was the outbreak of World War II in September 1939. At that time, after an abortive rally on thoughts of fat war contracts to a neutral nation, the market soon was following the typical downward course, a course which some months later resembled panic as news of German victories began piling up. **Nevertheless, at the conclusion of all actual fighting - regardless of whether it was World War I, World War II, or Korea - most stocks were selling at levels vastly higher than prevailed before there was any thought of war at all. Furthermore, at least ten times in the last twenty-two years, news has come of other international crises which gave threat of major war. In every instance, stocks dipped sharply on the fear of war and rebounded sharply as the war scare subsided**.
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> What do investors overlook that causes them to dump stocks both on the fear of war and on the arrival of war itself, even though by the end of the war stocks have always gone much higher than lower? They forget that stock prices are quotations expressed in money. Modern war always causes governments to spend far more than they can possibly collect from their taxpayers while the war is being waged. This causes a vast increase in the amount of money, so that each individual unit of money, such as a dollar, becomes worth less than it was before. It takes lots more dollars to buy the same number of shares in stock. This, of course, is the classic form of inflation.
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> **In other words, war is always bearish on money. To sell stock at the threatened or actual outbreak of hostilities so as to get into cash is extreme financial lunacy**. Actually just the opposite should be done. If an investor has about decided to buy a particular common stock and the arrival of a full-blown war scare starts knocking down the price, he should ignore the scare psychology of the moment and

definitely begin buying. This is the time when having surplus cash for investment becomes least, not most, desirable. However, here a problem presents itself. How fast should he buy? How far down will the stock go? As long as the downward influence is a war scare and not war, there is no way of knowing. If actual hostilities break out, the price would undoubtedly go still lower, perhaps a lot lower. Therefore, the thing to do is to buy but buy slowly and at a scale-down on just a threat of war. If war occurs, then increase the tempo of buying significantly. **Just be sure to buy into companies either with products or services the demand for which will continue in wartime, or which can convert their facilities to wartime operations**. The great majority of companies can so qualify under today's conditions of total war and manufacturing flexibility.

Do stocks actually become more valuable in war time, or is it just money which declines in value? That depends on circumstances. By the grace of God, our country has never been defeated in any war in which it has engaged. **In war, particularly modern war, the money of the defeated side is likely to become completely or almost worthless, any common stocks would lose most of their value**. Certainly, if the United States were to be defeated by Communist Russia, both our money and our stocks would become valueless. It would then make little difference what investors might have done.

On the other hand, if a war is won or stalemated, what happens to the real value of stocks will vary with the individual war and the individual stock. In World War I, when the enormous prewar savings of England and France were pouring into this country, most stocks probably increased their real worth even more than might have been the case if the same years had been a period of peace. This, however, was a one-time condition that will not be repeated. Expressed in constant dollars - that is, in real value - American stocks in both World War II and the Korean period undoubtedly did fare less well than if the same period had been one of peace. Aside from the crushing taxes, there was too great a diversion of effort from the more profitable peace-time lines to abnormally narrow-margin defense work. If the magnificent research effort spent on these narrow-margin defense projects could have been channelled to normal peace-time lines, stockholders' profits would have been far greater - assuming, of course, that there would still have been a free america in which any profits could have been enjoyed at all. **The reason for buying stocks on war or fear of war is not that war, in itself, is ever again likely to be profitable to American stockholders. It is just that money becomes even less desirable**, so that stock prices, which are expressed in units of money, always go up.

Second, since the publication of Fisher's book, more data has emerged to show that US stocks are indeed resilient even in the face of war. Table 1 below, **from** LPL Research, shows this dynamic.

Table 1

How Do Stocks Do After Major Events?
S&P 500 Index Performance After Geopolitical And Major Historical Events

		S&P 500 Index Returns			
Market Shock Events	Event Date	1 Month	3 Months	6 Months	12 Months
Germany Invades France	5/10/1940	(19.9%)	(12.7%)	(4.5%)	(18.7%)
Pearl Harbor Attack	12/7/1941	(1.0%)	(11.0%)	(6.5%)	4.3%
N. Korean Invades S. Korea	6/25/1950	(10.0%)	1.6%	4.1%	11.7%
Hungarian Uprising	10/23/1956	(2.1%)	(2.8%)	(1.3%)	(11.7%)
Suez Crisis	10/29/1956	(4.4%)	(3.6%)	(0.0%)	(11.6%)
Cuban Missile Crisis	10/16/1962	5.1%	14.1%	20.7%	27.8%
Kennedy Assassination	11/22/1963	6.8%	11.9%	15.5%	23.2%
Gulf of Tonkin Incident	8/2/1964	(1.6%)	1.9%	5.3%	2.7%
Six-Day War	6/5/1967	3.3%	5.9%	7.5%	13.5%
Tet Offensive	1/30/1968	(3.8%)	5.1%	5.2%	10.2%
Penn Central Bankruptcy	6/21/1970	(0.1%)	7.2%	16.8%	28.6%
Munich Olympics	9/5/1972	(1.0%)	5.7%	2.3%	(5.8%)
Yom Kippur War	10/6/1973	(3.9%)	(10.7%)	(15.3%)	(43.2%)
Oil Embargo	10/16/1973	(7.0%)	(13.2%)	(14.4%)	(35.2%)
Nixon Resigns	8/9/1974	(14.4%)	(7.0%)	(2.8%)	6.4%
Reagan Shooting	3/30/1981	(0.9%)	(1.8%)	(14.0%)	(16.4%)
Continental Illinois Bailout	5/9/1984	(3.1%)	1.0%	6.4%	12.8%
1987 Stock Market Crash	10/19/1987	8.1%	10.9%	14.7%	22.9%
Iraq's Invasion of Kuwait	8/2/1990	(8.2%)	(13.5%)	(2.1%)	10.1%
Soros Breaks Bank of England	9/16/1992	(2.5%)	3.0%	6.8%	9.9%
First World Trade Center Bombin	2/26/1993	1.7%	2.0%	4.0%	4.7%
Asian Financial Crisis	10/8/1997	(3.7%)	(1.8%)	14.1%	(1.5%)
U.S.S. Cole Yemen Bombing	10/12/2000	2.7%	(0.9%)	(11.3%)	(19.6%)
U.S. Terrorist Attacks	9/11/2001	(0.2%)	2.5%	6.7%	(18.4%)
Iraq war started	3/20/2003	1.9%	13.6%	18.7%	26.7%
Madrid Bombing	3/11/2004	3.5%	2.7%	1.5%	8.4%
London Subway Bombing	7/5/2005	3.3%	1.8%	5.3%	5.5%
Bear Stearns Collapses	3/14/2008	3.6%	5.6%	(2.8%)	(41.5%)
Lehman Brothers Collapses	9/15/2008	(16.3%)	(26.2%)	(34.8%)	(11.7%)
Boston Marathon Bombing	4/15/2013	6.3%	8.4%	9.7%	17.9%
Russia annexed Crimea	2/20/2014	1.5%	2.6%	8.0%	14.7%
BREXIT	6/24/2016	6.5%	6.2%	11.0%	19.7%
Bombing of Syria	4/7/2017	1.8%	3.1%	7.6%	12.8%
North Korea Missile Crisis	7/28/2017	(1.1%)	3.6%	14.8%	13.4%
Saudi Aramco Drone Strike	9/14/2019	(1.4%)	5.4%	(8.8%)	12.5%
Iranian General Killed In Airstrike	1/3/2020	1.9%	(23.1%)	(4.2%)	14.4%
U.S. Pulls Out of Afghanistan	8/30/2021	(3.7%)	2.8%	?	?

Source: LPL Research, S&P Dow Jones Indices, CFRA, Strategas 02/22/2022
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

The third thing I want to share involves the performance of stocks in countries that *have* lost wars. In Fisher's text, he mentioned that stocks in the defeated side would lose most of their value. But this is not always true *in the long run*. In the "*Optimsm (as always!)"* section in Compounder Fund's **2021 first-quarter letter**, I shared how German stocks crashed in the 1910s and 1940s after losing World War I and World War II, respectively. But from 1900 to 1960, *despite losing two wars*, German stocks still produced positive returns. This example from Germany highlights the incredible resilience that stocks can show even in the face of extreme adversity.

Fourth - and most importantly - Compounder Fund's portfolio companies have little to no geographic or economic exposure to Russia and Ukraine. This means that their businesses are largely going to operate as per normal in the days, weeks, months, and years ahead, no matter what happens in Ukraine. This also means that any stock price declines, if they occur, are mostly a result of sentiment changes rather than any material deterioration in actual business fundamentals. Although stock price declines are far from a pleasant experience, we're not concerned because our investing approach, as you are familiar with, is one that's based on a stock's long-term business fundamentals. Over the long run, stock prices and business growth tend to converge.

As I bring this letter to a close, I want to share some sage investing advice, applicable for the current context, that Buffett once gave. In his 1994 Berkshire Hathaway shareholders' **letter**, Buffett wrote:

> "We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%.
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> But, surprise - none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital."

War between countries is a painful tragedy, not just for the citizens involved, but for humanity as a whole. But war should not stop us from investing for the long run.

Excelsior,
Chong Ser Jing
Co-founder and Portfolio Manager, Compounder Fund
25 February 2022

P.S: You can expect to see Compounder Fund's 2022 first-quarter investors' letter in mid-April 2022.
P.P.S: You can find all of our **past investors' letters here**.

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