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What a Mess

Hurricane Ian inflicted terrible damage in Southwest Florida where we have many clients and friends. The massive cleanup effort has only just begun. Clearly it will be a long hard road to rebuild but I believe their homes, communities and beaches will ultimately be even better than before. The resourcefulness of people, especially in dire circumstances, is amazing. In the financial world, higher interest rates have created a different kind of dangerous storm. Higher rates may pose a serious threat to those who borrowed heavily and bought too much when rates were low, and the economic skies seemed clear. The growing financial stress could force many to sell assets resulting in even more pressure on prices. We would not be surprised if things get worse before they get better.

As with hurricanes, financial crises are frightening and cause great damage. They also do not last forever. We know the best time to prepare for hurricanes is before they hit, when the sun is still shining. In good times it's a good idea to prepare for bad times. The reverse is also true, at least in the financial markets. Corrections and recessions may often present the best opportunities. Individuals and companies with strong balance sheets are in a good position to prepare for better days.

In 2017 the Island of St John was hit by two devastating hurricanes. My wife and I first visited St John in 1998 and have returned almost every year since. We love the island and its people. When I called a friend in St John to ask how we could help he said, "Come down and spend some money, the few businesses that are open are barely hanging on. They need customers". So that's what we did.

During our visit I met with a friend who grew up on the island and owned a local business. I knew he had to be losing money and expected to find him worried and discouraged. We met in downtown Cruz Bay where debris was strewn all over and most businesses were closed. He was sweaty and dirty from a long day of cleanup work. Still, he seemed positive and energetic. He shared that his family was safe and that his home was damaged but livable.

He then pointed to a building that was almost completely destroyed. “I bought that this morning”. He could tell by my reaction that I was surprised, worried he might be getting in over his head. It seemed too early to be buying anything. He smiled and said, “Don’t you worry my friend, it’s a great location, yes!?” I agreed, but worried to myself that it would cost a fortune to rebuild. He went on, smiling even bigger, “Perfect for a parking lot don’t you think? The hurricane gave me this opportunity. No hurricane, no way I could buy it for what I paid. You know there’s a shortage of parking in Cruz Bay. This is not my first hurricane my friend and this time I have some money.”

It dawned on me that my island friend was doing exactly what we work to do at the Madison Group at Morgan Stanley. He bought an asset in limited supply with the potential to produce steady and growing cash flow. Daunting problems and uncertainty created an opportunity to invest at a lower price. He did not know when the tourists would return but he could afford to be patient. St John had recovered from past hurricanes and was likely to recover again. At first glance his investment appeared to be risky and out of touch with the grim reality. A closer look revealed he could afford the risk and the long-term return potential was significant.

While rates were low and borrowing fueled a boom, we held significant cash in our portfolios and focused investments in companies with strong balance sheets. This should put us in a good position to upgrade and add to our investments going forward. We are not looking for the next great thing or to call the bottom, we’ll let others try to do that. We will be working to build up ownership in today’s great businesses that we think are well-positioned to grow in the years ahead. We believe the key to longer term success will be to come out of this mess owning more high-quality assets. We are not in a hurry; we also are not going to wait until everything looks great, the crowds are back, and prices are higher.

Phil McCauley III
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