The Standfast Report

COMMENTARY FOR INTELLIGENT INVESTORS
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Interest Rates. On Wednesday this week the Board of Governors of the Federal Reserve System approved action by the Board of Directors of the Federal Reserve Bank of Kansas City to increase the primary credit rate from 1.75% to 2.50% effective 07/28/2022. This is the language used in the press release. In the vernacular of most of our news media, the Fed raised interest rates by 0.75%. "Interest rates" in this context refers to several related interest rates and benchmark rates. There is an educational article on Investopedia.com titled "The Federal Funds, Prime, and LIBOR Rates" that may be helpful to readers who desire a more complete understanding of interest rates.

What does this mean for investors? In part this means that any businesses that has debt could (all other things being equal, which they rarely are) have an increase in the interest expense on their debt and therefore could have reduced earnings. This could also mean that businesses will try to protect their profits by raising prices. But if one is going to take on long-term debt (such as a home mortgage) within the next few years, then now may still be a relatively good time to get a fixed-rate loan. Historically speaking interest rates still seem to have more room to go up than down, especially considering their utility for the Fed as an inflation-fighting tool...but that is a discussion for another day.

Stock Market. Several broad U.S. stock market indices and ETFs were up between about 4% and 5% this week. If the recent rise in interest rates implies an imminent increase in the cost of doing business, then the general rise in the stock market this week would seem inexplicable. However, it may be that the unprovable belief that *this* rate increase intrinsically means that this rate increase will be the *only* rate increase in the near future outweighed the more mathematically obvious implication in the minds of investors. For the Fed, what they say about interest rates and the rates they set are not merely about the interest rates themselves...it is also a psychological mission to influencing investor sentiment and help stabilize the markets while subtly fighting inflation with incrementally higher interest rates. This was a successful week for the Fed. But investors should remember how the economy (and math) works in the long run. As intelligent investors have said, interest rates are to asset prices what gravity is to matter.

Hennessy Advisors, Inc.* / QE 03/31/2022 / Reviewed 06/12/2022. There has been an underlying and hidden issue of redemptions exceeding organic inflows (hidden by market appreciation) for the first 4 of the last 5 quarters which was blatantly revealed in QE 03/31/2022 and will likely become more painfully obvious in QE 06/30/2022. The $40m debt issuance (and 40% balance sheet expansion) in QE 12/31/2021 is somewhat concerning but may have actually been very wise (or lucky) given recent rising interest rates. If Monday 06/13/2022 is not a "black Monday" then perhaps it would be a good time to evaluate any holdings of Hennessy stock and keep any proceeds from selling for an opportunity to buy at a lower price in the near future...or to buy something else...something more grounded in a specific key product or service. This company might be OK long-term, but I see no obvious reason to think it will be spared in the short-term or the in the long-term because it does not seem to have a moat. The earnings and stock price could dwindle over time or management will use cash and more debt to buy management contracts and then ultimately sell the firm to a larger financial institution.

Sturm, Ruger & Company, Inc.* / QE 04/02/2022 / Reviewed 06/28/2022. The short of it is that (1) the company is coming off a time of "unprecedented" consumer demand and could see profits go down further in dollar terms in 2022 but that profit as a percentage of sales may not come down as much and that (2) the balance sheet remains strong (even became somewhat stronger from 12/31/2021) and that (3) core demand probably will remain through future ups and downs. Perhaps not the best time/price to buy, but possibly a good business nonetheless. Also, as with any good business, I would likely expect to buy more gradually (perhaps at better prices) anyway. Also...the price ratios (P/E and P/S) are not bad right now (06/28/2022) so it could be a good price for the current situation.

Smith & Wesson Brands, Inc.* / YE / 04/30/2022 / Reviewed 07/28/2022. It seems that sales for fiscal 2022 of ~$864m leaves plenty of room to "revert to the mean" (average ~$619m since fiscal 2010) by as much as $245m/28% for fiscal 2023. But, fiscal 2022 was the first year without effect from American Outdoor Brands (sold) which apparently lost ~$89m in fiscal 2020, the company is now a "pure" firearms manufacturer, the balance sheet had very significant conservative improvements in fiscal 2022 (assets +11%, liabilities -24%, equity +35%), and the cash flow in last 3 years has been toward conservatism and strength (positive cash flow from operations while substantially paying down debt and buying back stock).

There are certain irritations with the company such as the significant stock buybacks prior to the capital expenditure-intensive move to Tennessee, lack of "in kind" or "unit count" inventory/backlog data (unlike Ruger), not manufacturing all parts "in house", and sales and marketing seems more broad and complex than it need be. The company seems less focused than Ruger, but they make popular products, they have strong core financials and they are moving to Tennessee. For recent months and currently, P/S and P/E ratios are ~100% better than Ruger's, presumably because investors think S&W sales for the trailing 12 months are much higher than they will be in the next few years.

* Disclaimer: The author has financial positions in these investment vehicles.

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