MARKET REPORT
SECOND QUARTER 2023

Key Points

- Headline S&P 500 performance does not tell the whole story.
- The yield curve remains inverted.
- Excess savings are being depleted.
- We discuss the expectations treadmill.
- It is important to stay the course.

Total Return as of June 30, 2023						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	8.7%	16.9%	19.6%	14.6%	12.3%	12.8%
NASDAQ	13.1%	32.3%	26.2%	12.0%	14.0%	16.3%
Russell 3000						
Index	8.4%	16.2%	19.0%	13.9%	11.4%	12.3%
Value	4.0%	5.0%	11.2%	14.4%	7.8%	9.1%
Growth	12.5%	28.1%	26.6%	13.2%	14.4%	15.3%
Russell Mid Cap						
Index	4.8%	9.0%	14.9%	12.5%	8.5%	10.3%
Value	3.9%	5.2%	10.5%	15.0%	6.8%	9.0%
Growth	6.2%	15.9%	23.1%	7.6%	9.7%	11.5%
Russell 2000 (Small Cap)						
Index	5.2%	8.1%	12.3%	10.8%	4.2%	8.3%
Value	3.2%	2.5%	6.0%	15.4%	3.5%	7.3%
Growth	7.1%	13.6%	18.5%	6.1%	4.2%	8.8%

A Review of the Quarter

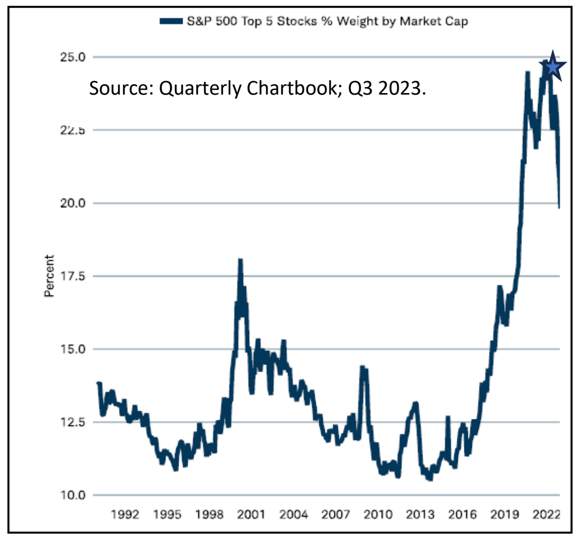
The devil is in the details. Headline numbers for U.S. large-cap market averages, like the S&P 500, do not tell the whole story. After easing some last quarter, the market has once again become quite concentrated with only a few companies representing a significant portion of the index and its year-to-date performance. We explore this further in the following pages.

Here we go again! While SPACs, as well as electric vehicle related companies were all the rage in recent years, now it is all about Artificial Intelligence (“AI”). Seemingly, many companies who mentioned AI during its quarterly earnings call got a boost in stock price. Reflecting on Amara’s law seems appropriate: “**People tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run**.” While AI holds promise for increasing productivity and reducing inflation, the impact on businesses is unlikely to come as fast as recent stock price action suggests. Be wary of shiny objects. Furthermore, an array of unintended consequences is inevitable. Corporate policies and laws will have to evolve as will societies’ expectations for interacting with service providers.

U.S. Equities

Nine of the 11 economic sectors in the S&P 500 logged gains with Technology (+17.2%), Consumer Discretionary (+14.6%) and Communication Services (+13.1%) posting the strongest returns for the quarter. Utilities (-2.5%) and Energy (-0.9%) contracted slightly. Based on quarter-end data, this market average became slightly more expensive as multiples expanded.

After retreating last quarter, the weight of the **top five** stocks in the S&P 500 (chart to the right) rebounded to **roughly 25%** of the index's market cap. A lower level of concentration would be indicative of a healthier market, in our view. With such high levels of concentration, passive market cap weighted index investors may be unknowingly taking on a higher degree of risk than anticipated.



Market concentration coupled with lofty expectations, restrictive monetary policy and softening labor markets can lead to increased levels of volatility which may create additional investment opportunities for our strategies. Although our strategies still generally trade at a **discount to intrinsic value**, our list of potential investment candidates was shortened a skosh during the quarter as markets lifted.

In addition, note the performance of the **top five** (dark blue) relative to the S&P 500 (lightest blue) and the S&P 500 *less* the top five (mid blue). The five have had an outsized impact on index performance in recent years – up and down. From a performance contribution perspective, around **three-quarters** of the index's year-to-date results came from **just seven** companies.

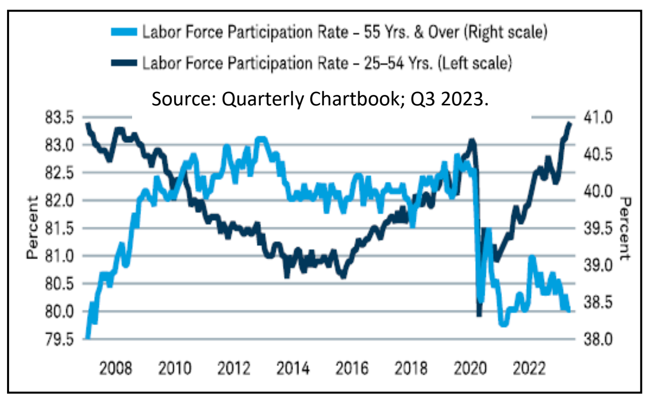
Excepting recent times, the S&P 500 was last this concentrated during the dot-com boom of the late '90s and early 2000s when expectations for new technology companies were unrealistically high.

Many then new technologies were hugely beneficial to industry and society, yet in some cases it took years for the stock prices of certain companies to grow into the valuations ascribed to them during the frenzy.

Our **value-oriented** investment process **helps us** avoid investments where lofty embedded expectations are seemingly disjointed from probable reality (think high price-to – earnings, sales, etc.). Managing risks and diligently working to avoid a zero in a long series of compounded results is a priority for us, because a zero in any string of numbers is, well, zero.

Charlie Munger has a unique way of cutting to the chase. We hope you enjoy a few of what we regard as his insightful and thought-provoking quotes:

- "The world is full of **foolish gamblers**, and they will not do as well as the **patient investor**."
- "Don't bail away in a sinking boat if you can swim to one that is seaworthy."
- "Ben Graham said, 'Day to day, the stock market is a voting machine; in the long term it's a weighing machine.' If you keep making something more valuable, then some wise person is going to notice it and start buying."



Many individuals ages 55+ (light blue) left the labor force during COVID and simply have not returned to date. This reduction in the workforce created a gap and has contributed to wage pressures in recent years. The participation of those in the 25-54 range has recently exceeded pre-pandemic levels. The Federal Reserve's (the "Fed") restrictive monetary actions, in part, can lead to looser employment conditions thereby slowing the pace of wage increases in the coming year.

However, the Fed's actions are going head-to-head with Congress' three stimulative bills: the Infrastructure Investment and Jobs Act, the Creating Helpful Incentives to Produce Semiconductors and Science Act and the Inflation Reduction Act. Estimated spending from these three bills totals around $2T. Essentially, the Fed's foot is on the brake pedal and congress' on the gas.

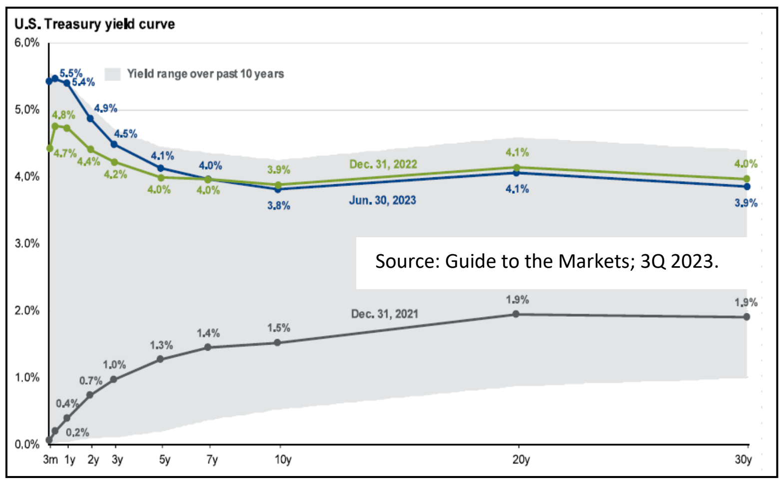
Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, decreased 0.1% during the quarter, yet is up 2.4% year-to-date. U.S. Treasuries and Agencies, as measured by a similar index, declined 1.1% and gained 1.1%, respectively.

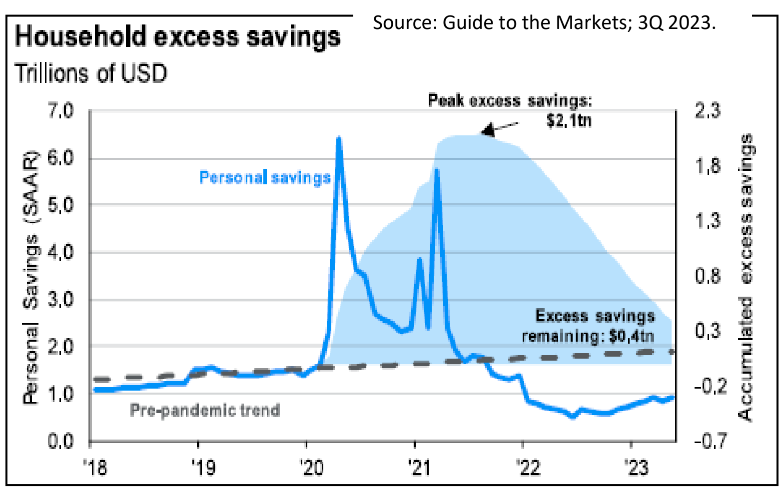
Treasury yields rose during the quarter with the 2-Year ("2s") increasing 71 basis points to 4.87% and the 10-Year ("10s") increasing 29 basis points to 3.84% at quarter-end. With a **negative 103 basis point** (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve is **more deeply inverted than at year-end**. An inverted yield curve often portends economic weakness. The yield curve should normalize by either short-term rates declining once inflation cools or long-term rates increasing.

Note the **normal sloping** yield curve (**bottom of chart**) whereby longer maturities yield more than short-term securities.

Compare that to the December 31, 2022 yield curve (green) and June 30, 2023 yield curve (blue) at the **top of the chart** whereby longer maturities yield less than short-term maturities. This is unnatural and unsustainable.



The chart to the right illustrates estimated **excess** household savings accumulated during COVID from the various stimulus programs and fewer spending opportunities. It is possible that excess savings have given many consumers the confidence to keep up their spending in the face of higher inflation.



However, estimated excess savings **declined markedly** during 2022 and year-to-date. Behaviorally, it would be logical for the average consumer to more closely monitor spending as their savings decline and they begin using more credit.

Commodities*,* as measured by the Bloomberg Commodity Index, decreased 2.6% for the quarter and 7.8% year-to-date. Oil (WTI) declined 6.6% for the quarter and 12.0% year-to-date. Natural gas (Henry Hub) gained 18.1% during the quarter and contracted 29.5% year-to-date. The prices of many commodities have declined year-to-date on concerns of slowing domestic and global growth, in part due to restrictive monetary policies and China's seemingly anemic economic recovery.

The Expectations Treadmill

Expectations built into a company's stock price are analogous to the speed of a treadmill. If the company beats expectations and the market believes the fundamentals which led to the "beat" are sustainable, the stock price will often rise as investors extrapolate the incremental improvement into future periods. The effect, however, is that the speed of the treadmill has been increased as fundamentals improve and the company has to run faster and faster to keep up with expectations and maintain its stock price. On the other hand, a company with low expectations (e.g., low price-to-value) at the beginning of a period may have an easier time posting above average returns because its hurdles are lower. Typically, at some point it becomes difficult for a company with **lofty expectations** embedded in its stock price (e.g., high price-to-value) to meet the challenge and the stock price corrects. If embedded expectations are **too high**, the correction can result in a **permanent loss of capital**.

Consider the case of Turnaround Timmy, a fictional character based on our many years of observation. Timmy recently took the helm at Gadgets, Inc. ("Gadgets"), a company with below average *return on capital* and *revenue growth* relative to peers. In light of these challenging fundamentals, the market does not expect much (low hurdle) and Gadgets trades at a low price-to-value.

Timmy assembles an experienced management team and begins implementing his capital efficiency and revenue improvement plan. Several years pass and Gadgets' revenue, margins and return on capital improve and catch up with industry peers. Gadgets' stock price rises much faster than competitors because there was such a low hurdle from the onset.

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Timmy and his management team continue their hard work. After several more years, Gadgets becomes the industry leader with the highest return on capital and revenue growth metrics. Again, because of the initial low hurdle, the stock price has outperformed peers by a wide margin. Given the “new normal,” Gadgets now has a higher hurdle to cross in order to please the market (i.e., higher expectations are embedded in the stock price).

As time passes, Timmy and his management team continue to produce a high return on capital and above average revenue growth, but Gadgets stock price only performs in line with peers. Timmy and his team are on the expectations treadmill, running ever faster just to meet the market’s lofty expectations, which are evidenced by the high price-to-value at which the company trades.

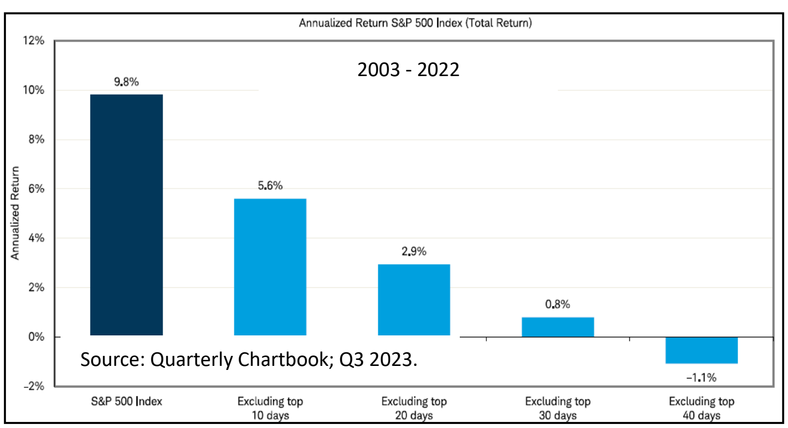
A couple concerns come to mind for companies with lofty expectations embedded in their stock price. **First**, in management’s pursuit of meeting or beating lofty expectations, there can be pressure to stretch accounting and moral boundaries or make poor acquisitions. All of which can be to the detriment of shareholders. **Second**, the correlation between the price-to-value of a company’s stock at the time of investment and its future compounded returns can be statistically significant over longer time horizons. A lower price-to-value is generally better for the prospect of above average future compounding.

Due to the expectations treadmill, a good company may not be a good investment at a certain point in time because high future expectations are already baked into the stock price.

In our parlance, businesses (stocks) trading at a discount to intrinsic value (our estimate of value) are said to have a margin of safety. When a margin of safety exists, the risk of a permanent loss of capital should be reduced and future returns can be above our discount rate or expected return.

Staying the Course

Rather than coming in even doses, investment returns typically come in **fits and starts**. The chart to the right, using the S&P 500 as a proxy, illustrates the importance of staying the course through turbulent times.



Source: Quarterly Chartbook; Q3 2023.

Missing the **top 10 days** during the 2003 to 2022 stretch resulted in a **420-basis point** difference in annualized returns.

Looking Ahead

In the ‘80s, the term “reindustrialization” rolled off politicians’ tongues with relative ease and was often compared to the rebuilding effort after WWII. Sound familiar? At the time, the culprit was the challenged steel and auto industries. Today, the effort is in large part focused on manufacturing capacity, specifically computer, electronic and electrical manufacturing, as well as infrastructure like roads, bridges, water and broadband. COVID highlighted weaknesses in global supply chains and served as a catalyst.

The “spend” associated with these efforts will exist for multiple years and is going head-to-head with the Fed’s actions to slow the economy. However, there is evidence that the Fed’s efforts are beginning to have an impact.

Equity markets, on average, are seemingly not priced for a general slowdown. We are keeping a keen eye on price-to-value relationships within our strategies and are eager to capitalize on new opportunities meeting our criteria.