WEALTH MANAGEMENT

MAINTAINING DISCIPLINE IN A PERIOD OF MARKET CALM


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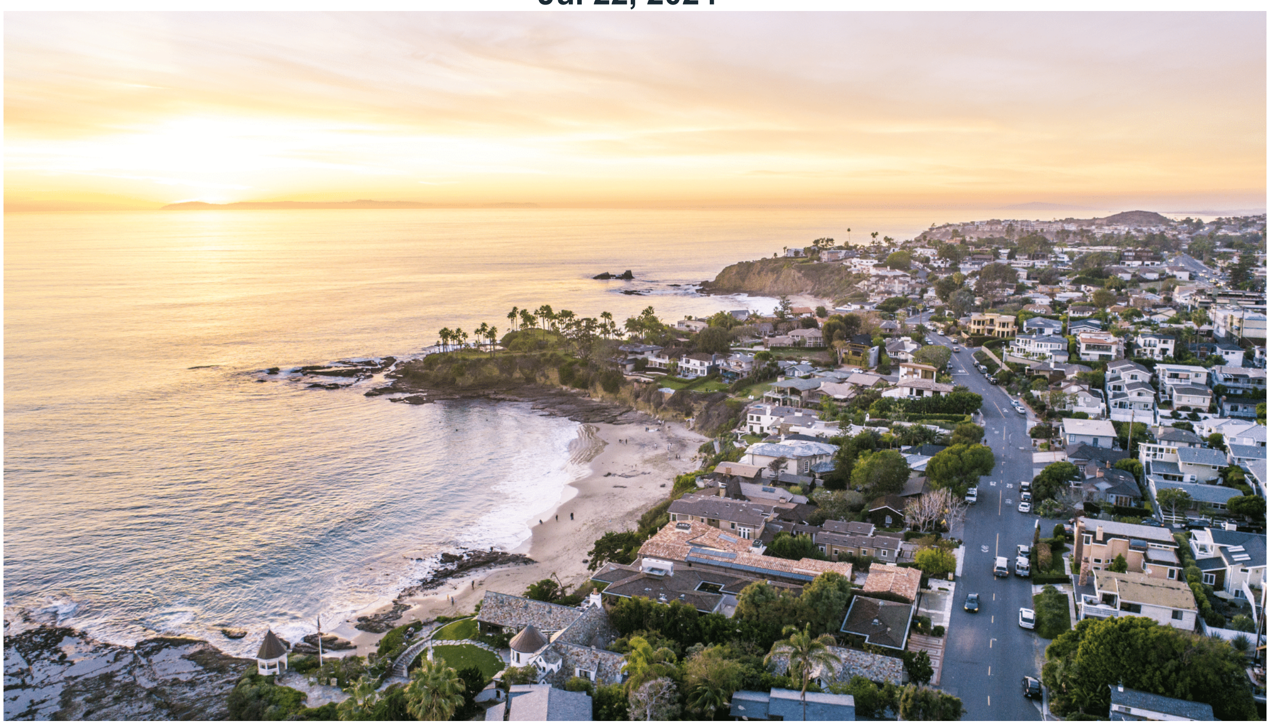

Quarterly Commentary – July 1, 2024

We'd describe the first six months of 2024 as a period of relative stability in the markets, but also one that continues to demonstrate a significant imbalance in terms of the performance of stocks across the various sectors of the U.S. and global economies. U.S. equities, as measured by the S&P 500, gained +4.3% in the second quarter, and +15.3% for the six months ended June 30, 2024. While that index is composed of 500 individual stocks, the driving force behind its growth has been the performance of a relative few, large, and mostly technology-oriented companies. To underscore the point that large-cap technology is winning in the equity markets, the Nasdaq Composite index rose +8.5% during the second quarter, and +18.6% for the first six months of the year. Stocks more broadly have fared less well. The average stock in the S&P 500, as measured by the S&P 500 Equal-Weighted index, was down by -2.6% in the second quarter, and up by "only" +5.1% for the year-to-date, trailing the capitalization-weighted index by over ten percentage points. The Dow Jones Industrials was down -1.3% in the most recent quarter (+4.8% year-to-date), the Russell 2000 small cap index was down -3.3% in the second quarter (+1.7% year-to-date), and the ACWI Ex-US international equity benchmark returned +1.3% in Q2 (+6.0% year-to-date).

We don't think this imbalance in performance is necessarily irrational. A disproportionate percentage of the growth in earnings among S&P 500 stocks (as well as prospects for near and long-term future growth) has come from the stocks and sectors that are currently outperforming[1]. As we've discussed in our quarterly Investment Webinars with clients, Artificial Intelligence technology has sparked a massive investment wave and is raising expectations that its deployment will help drive business productivity across the economy. While these benefits are expected to be widespread over time, the market has identified a few near-term beneficiaries—the suppliers of AI infrastructure like chip designers and manufacturers, datacenters, as well as cloud computing and certain software businesses Among these selected stocks, the prices of a few have been bid to levels that we believe are not reflective of the real opportunity they face in terms of their long-term revenue and earnings power, so we have chosen to avoid a few entirely when building our portfolios

Bonds, as measured by the Bloomberg Aggregate Bond index, were essentially flat in the quarter (+0.1%) and are off by -0.7% for the first six months of 2024. In general, across the spectrum of bonds, shorter-maturity have outperformed longer-maturity securities. We have sought to concentrate our exposures to the shorter end of the yield curve. Yields are far higher across the spectrum than we had experienced over the past decade before the Federal Reserve began to tighten monetary conditions in reaction to inflation. It is a welcome change, but the persistence of inflation pressures into 2024 has so far kept rates high and prevented bond prices from rising.

Calm Before the Storm?

We feel the need to remind our clients (and ourselves) that periods of stability like the one we are currently experiencing should be expected, but so should periods of volatility. Many years ago, we described in this letter the nature of markets being akin to what we experience living here in earthquake country. Pressures build among the tectonic plates during periods of calm, and then pressures are released periodically in earthquakes that are typically too faint to feel but are occasionally violent. It’s impossible to predict the timing and intensity of earthquakes, but we know they’re coming. All we can do is prepare for them by enforcing strict building codes, knowing where the gas shutoff valve is in our homes, maintaining stocks of water and essential supplies, developing a plan with our families, and for those of us who are financially risk averse, paying a high premium to obtain earthquake insurance. Long-time residents have been through many earthquakes and understand that living in fear of the next one has little value. We do what’s necessary to prepare for them and get on with our lives, or we move.

During an earthquake, we feel panic but know there is nothing we can do but ride it out. Because we’ve taken the necessary precautions, we recover. In contrast, during episodes of market volatility, we can act in response to a similar sense of panic because the markets remain open. While time and experience have shown that the natural human reaction to adverse market events works significantly against their own long-term financial interests, the temptation to react in ways that we know will leave us less well off in the long run is insurmountable for most human beings. As your fiduciary, we approach market turbulence the way we approach earthquakes. We know we’ll experience periods of volatility, whose immediate effect is to diminish the value of our marketable securities holdings, but we take the necessary precautions to ensure that the effects are not irreversible, but only temporary.

We mention this here and now because when markets are benign and we feel comfortable, we can forget the true nature of markets. We do it now because valuations are elevated across parts of the market, reducing their margin of safety in the event of any weakness in their results or in the overall economy, or simply in the event of a change in investor sentiment. We note that this is not a prediction of market turbulence in the near term. Like predicting the timing of an earthquake, we believe that trying to anticipate market moves is a waste of time.

Rather, we think it is a reminder of why we tie our investment decisions to the fundamental long-term earnings power of each of our individual investments. If they become dangerously overvalued based on our assessment of their fundamentals, we sell them to make room for something else that has a wider margin of safety. If something seems cheap relative to our assessment of intrinsic value, we will own a disproportionately large piece in our portfolio. Like earthquake preparedness, this is our way to ride through adversity with confidence that we will recover intact.

2024 Election Views

The upcoming presidential election is a topic on everyone's mind, as it should be. Elections have consequences because they provide a mandate of sorts to the party in the majority to pursue its policy vision and seek changes in laws that affect the entire country. Nevertheless, from the standpoint of an investor in stocks, bonds and other investment assets, we do not believe that the outcome in November will have a meaningful impact on business and investment fundamentals in our capitalist system. In the period that the author of this letter has had the privilege to vote, the United States has had six presidents, three from each of the two major political parties. None of these presidents have enjoyed a situation where their party has held a 60-vote majority in the Senate, enough to invoke cloture to end debate and force a vote of Senators, while also controlling the House of Representatives. This is significant, because every law passed during this time required some measure of compromise with the other party.[2]

As an example, during the period since Reagan's second term, while tax platforms seem to have always been a major point of contention in the debates leading up to elections, the individual tax code hasn't changed much. It still is progressive. The top federal bracket was 38.5% in 1987, and it is 37% today. It hasn't been over 39.6% during the period in-between. Corporate tax policy has changed a bit, but it accounts for high-single digit percent of the federal revenue whereas individual taxes account for roughly 50% of revenues and Social Security and Medicare taxes account for about 35%. When President Reagan came into office, the sources of federal revenue were split almost the same as they are under President Biden.

We think it's highly unlikely that either party will gain a 60% majority in the Senate, so we see little chance that laws can be passed in the next term without similar compromise regardless of who holds the White House. Meanwhile, corporations adapt to whatever policy exists at the time. If corporate tax rates rise, for example, they do what they can to pass it through to their customers like all other increases in cost of doing business.

Q2 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.

During the quarter we initiated new positions in Old Dominion Freight Line and GXO Logistics. We also exited our position in Medtronic.

Old Dominion Freight Line

As a leading less-than-truckload ("LTL") carrier, Old Dominion sits in the middle of North America's supply chain. By moving small shipments for other businesses, Old Dominion plays an essential role in maintaining the flow of goods through our economy.

Clocking 90 years in operation, Old Dominion has built the second largest, and most impressive, LTL network in North America. The business commands 12% market share and benefits from economies of scale stemming from network density in regional markets. We think management is best in class with an exceptional track record of continuously improving returns on invested capital. In our view, the combination of all these characteristics has created a highly reliable and cost-effective service that keeps customers satisfied and competitors at bay. Nine decades of business history, in an industry littered with fleeting successes and many failures, is a testament to Old Dominion's durability.

Over the past decade, revenue compounded at 12% annually while earnings per share increased seven-fold. These exceptional results were driven by growth in e-commerce and omnichannel retail, which rely on LTL networks for fast and reliable delivery to consumers. This dynamic will drive revenue growth for years to come. And the possibility of manufacturing moving closer to home could further turbocharge growth.

We have long followed Old Dominion, patiently waiting for an attractive entry point. We got our opportunity this year after the company reported weaker results due to lower customer volumes. Our thesis is that the current slowdown is short-term in nature. The timing of the recovery is uncertain, and we cannot predict the next nine decades, but we are confident Old Dominion will remain an integral and growing part of our nation's supply chains for the foreseeable future.

GXO Logistics

Outsourcing providers often possess the characteristics we like to see in a business: scale advantages, sticky customer relationships, and a long runway for growth. As the largest pure-play contract logistics provider in the world, GXO shares these qualities.

GXO operates warehouses for blue chip companies in Europe and North America. Revenue is generated from complex long-term agreements that protect GXO from inflation and volume swings. Dominant market position and expertise in several verticals result in efficient scale and cost advantages that shield GXO from the competition. Switching costs for customers are high, which means customers stay with GXO for decades.

Profits are set to grow on the back of strong demand for outsourcing and investments in warehouse automation and supply chain resiliency. GXO is also well positioned to gain market share in this consolidating industry. We expect these factors to result in double-digit earnings growth over the next five years.

GXO was spun off from the transportation giant XPO, which was founded by the legendary entrepreneur Brad Jacobs. We have been keeping an eye on the company since it became independent in 2021, watching the volatility in the stock from the sidelines. Recently, the shares came under pressure due to customer inventory destocking and slower customer activity. We took a closer look and concluded that the slowdown is temporary and that the valuation offers a discount to the value we see from GXO's long-term growth potential and business quality

Medtronic

Medtronic is one of the largest medical device companies in the world, developing life-saving treatments for heart disease, diabetes, general surgery, and more. Our thesis was that Medtronic could leverage its market leadership to bundle products for healthcare providers. We expected bundling to drive market share gains and stronger pricing. We thought these advantages would protect the business from competition while an aging population and growing demand from emerging markets would lead to much higher sales and profits.

Our thesis hasn't played out as expected. Medtronic has struggled to benefit from its scale, succumbing to industry pricing pressures and competition from more nimble players. Management tried to buck the trend by launching new innovative products, but the impact was limited, and earnings growth continued to disappoint. We therefore concluded our thesis was broken and decided to direct the capital to other ideas.

We look forward to speaking with you, and if you would like to come in for a visit, please drop us a note or contact us today.

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[1] According to an analysis by J.P. Morgan, the largest 10 stocks in the S&P 500 accounted for 37.0% of the total capitalization of the index. The previous 12 months earnings from these same 10 stocks accounted for 26.8% of the aggregate earnings across all the companies included in the S&P 500 index. Mathematically, therefore, the top 10 stocks trade at a somewhat higher multiple than the average stock, but we believe that business quality, growth prospects, and other quantitative and qualitative factors justify a premium valuation.

[2] Lack of compromise on issues of great importance to the minority party will result in a filibuster. It was the intention of the founders of our country to protect political minorities from the tyranny of the majority. The filibuster tactic was first used in the first ever session of the Senate in 1789 by the Senator from Virginia.