1Q 2024
Quarterly Update

Key Points

- Equity markets marched higher.
- Staying the course during turbulent times typically pays off.
- FOMO can be expensive.
- We discuss areas that often get investors into trouble.
- We continue our series on Risk vs. Uncertainty and the Decision-Making Process.

Total Return as of March 31, 2024						
			Annualized			
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	10.6%	10.6%	29.9%	11.5%	15.0%	13.0%
NASDAQ	9.3%	9.3%	35.3%	8.2%	17.2%	15.8%
Russell 3000						
Index	10.0%	10.0%	29.3%	9.8%	14.3%	12.3%
Value	8.6%	8.6%	20.2%	7.7%	10.2%	8.9%
Growth	11.2%	11.2%	38.0%	11.5%	17.8%	15.4%
Russell Mid Cap						
Index	8.6%	8.6%	22.4%	6.1%	11.0%	10.0%
Value	8.2%	8.2%	20.4%	6.8%	9.9%	8.6%
Growth	9.5%	9.5%	26.3%	4.6%	11.8%	11.4%
Russell 2000 (Small Cap)						
Index	5.2%	5.2%	19.7%	-0.1%	8.1%	7.6%
Value	2.9%	2.9%	18.8%	2.2%	8.2%	6.9%
Growth	7.6%	7.6%	20.4%	-2.7%	7.4%	7.9%

A Review of the Quarter

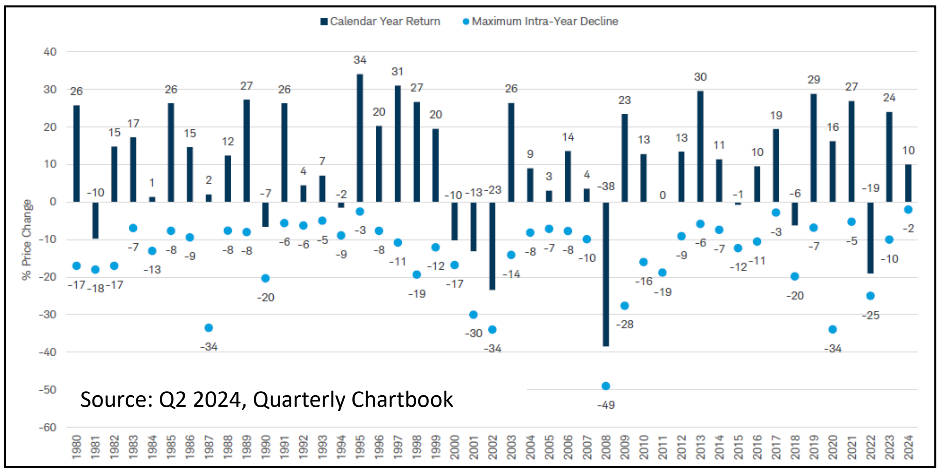
The U.S. equity market marched higher during the quarter with large-cap companies leading the way, followed by mid- and small-caps. Those companies trading at the highest multiples generally outpaced their more reasonably valued brethren.

Stocks of some large, fast-growing technology-related companies with AI and cloud computing exposure continued appreciating at a blistering pace. For many, valuations are stretched. A single company accounted for approximately 25% of the year-to-date gain of the broad-based Morningstar US Market Index. Unusual.

Early in the period, A New York-based community bank spooked markets when it announced write-downs and internal control weaknesses and was downgraded by two credit rating agencies. Its issues are largely related to a rent-controlled multi-family loan portfolio in New York City which is not representative of the typical community or regional bank across the U.S. Markets often paint with broad strokes initially, when bad news surfaces, sending ripples throughout an industry or sector. Details matter, especially in the banking sector where funding attributes and collateral can vary materially from bank to bank.

U.S. Equities

Rising investor sentiment in recent quarters has coincided with rising equity values and expanding multiples. On a price-to-forward-earnings basis, the S&P 500 was more than one standard deviation above its 30-Year multiple at period-end. Our shopping list of companies routinely increases and decreases in length over time and is currently shorter than we would prefer. Bargains are scarce and discipline is important, in our view.



Staying the course during turbulent times typically pays off.

The chart to the right illustrates price change only Calendar Year Returns for the S&P 500 and Maximum Intra-Year Declines from 1980 through March 31, 2024. The Calendar Year Return was always better than the Maximum Intra-Year Decline and two of the four worst years ended in positive territory.

On another note, we are always reading and thinking. Reflecting on certain historical events can provide insight into human behavior and crowd psychology. Along those lines, the South Sea Company was founded in 1711 in large part to privatize British government debt. The scheme resulted in an infamous bubble known as the South Sea Bubble whereby investors who got caught up in the mania lost large sums of money.

Sir Issac Newton reportedly lost money in the scheme and allegedly went on to say, “I can calculate the motion of the heavenly bodies, but not the madness of people.” In the 312 years since then, not a lot has changed with respect to how humans behave in large crowds, except perhaps the accelerated pace of events due to the internet and social media. The sporadic irrationality of the masses can create compelling investment opportunities.

The fear of missing out ("FOMO") can be contagious and overwhelming. Investors sometimes only see what they want to see, focusing on the upside and ignoring risks. Sensational stories surrounding "break-through" technologies that are told by mediagenic promoters and coupled with extraordinary short-term gains often fuel FOMO. Forming an opinion as to an investment's worth or intrinsic value is a great defense. If you cannot estimate an investment's value, passing is generally the prudent choice. Because without an estimate of value, it is impossible to have a perspective on whether something is undervalued, overvalued or at fair value.

Over the course of our careers, we have observed that when investors get themselves into trouble, the source of the trouble often falls into one or more of the following areas:

- **Emotions** - Allowing feelings rather than a process or sound reasoning to guide their investment decisions.

- **Overpaying** – Paying too much for an investment (price) relative to what is ultimately received (value). This often occurs when there is no framework for estimating value and/or a riveting story is involved.

- **Lack of Humility** – Unwilling to admit what they do not know and forge ahead anyway. Analogous to driving blindfolded.

- **Too Much Debt** – Excessive leverage, relative to a given business model, limits flexibility and can end in disaster for equity holders.

- **Too Trusting** – Entrusting capital to the wrong people.

- **Fragile Business Models** – Business lacks a competitive advantage and/or is prone to obsolescence.

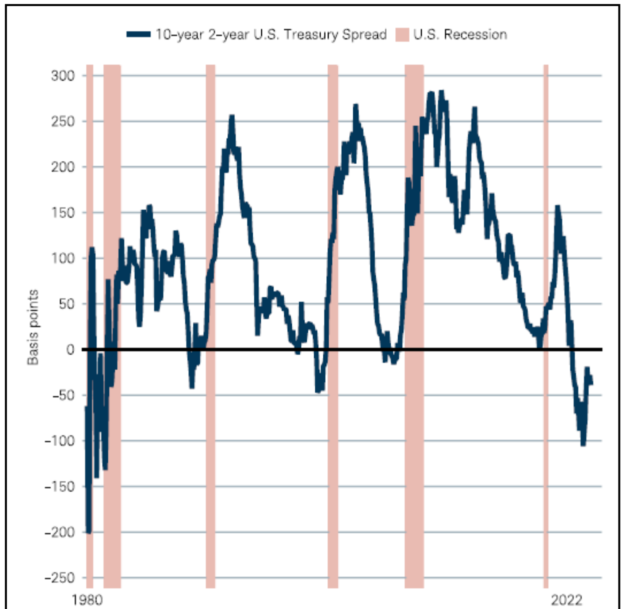
Have you ever found yourself in one or more of these areas of trouble? Our value-oriented investment process (which we have been honing for more than 30 years as of this writing) helps us navigate the aforementioned issues, and we believe, gains in value with each passing year.

The inherent risks embedded in stocks are at the forefront after a market crash, yet late in a strong market cycle the eye-popping returns of glamour stocks are of greater interest. Staying vigilant and warding off complacency is critical to long-term investment success, in our view.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, increased 0.4% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, declined 0.3%.

Treasury yields rose during the quarter with the **2-Year** ("2s") increasing 37 basis points to 4.62% and the **10-Year** ("10s") increasing 34 basis points to 4.22% at quarter-end. With a **negative 40 basis point** (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve **remains inverted** (see chart to the right) and has been so for the longest period on record as of late-March.



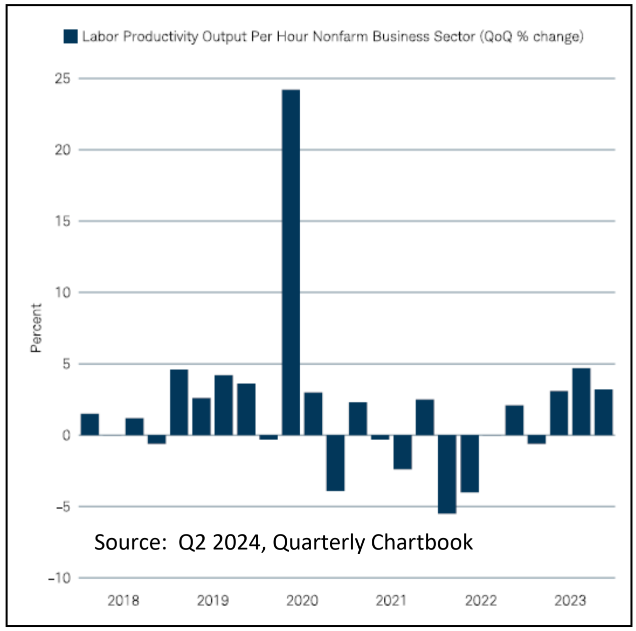
Source: Q2 2024, Quarterly Chartbook

After suffering through the fixed-income-yield drought of late-2008 through early-2022, many investors view current money market yields as an oasis. However, when the yield curve normalizes and short-term rates yield less than longer-term rates, remaining in cash long term can be the equivalent of a frog being boiled alive as inflation erodes purchasing power. In our fixed-income strategies, we generally keep the average maturity in the two to five-year range, but there can be market driven exceptions.

Regarding convertible securities, strong equity markets in recent quarters have reduced our opportunity set. By way of example, a company benefiting from the AI boom issued a $1.5B private convertible note during the quarter with a 0% interest rate and a 37.5% premium over the common stock price at the time of issuance. And the price of the common stock had lifted significantly in the months leading up to the issuance. Management was opportunistic. This could end up being nearly free capital for the company, which is good for it, but investors may not have an equally joyful outcome. Chalk the accepted pricing up to FOMO, because there seemingly is no other logical answer.

Commodities, as measured by the Bloomberg Commodity Index, increased 2.2% for the quarter and were down 56 basis points over the last year. After contracting in 2021 and

2022, worker productivity growth has once again been on the rise which helps reduce inflation (see chart). Oil (WTI) increased 16.8% for the quarter as OPEC production cuts were balanced by non-OPEC production, including record U.S. production, and relatively stable consumption and global turmoil.



In 2023, the U.S. exported roughly 7.6 trillion cubic feet of natural gas (# 1 in the world), up from 1.5 trillion cubic feet a decade ago. An estimated 60% went to Europe as the U.S. energy complex rose to the occasion, filling the void left by Russia.

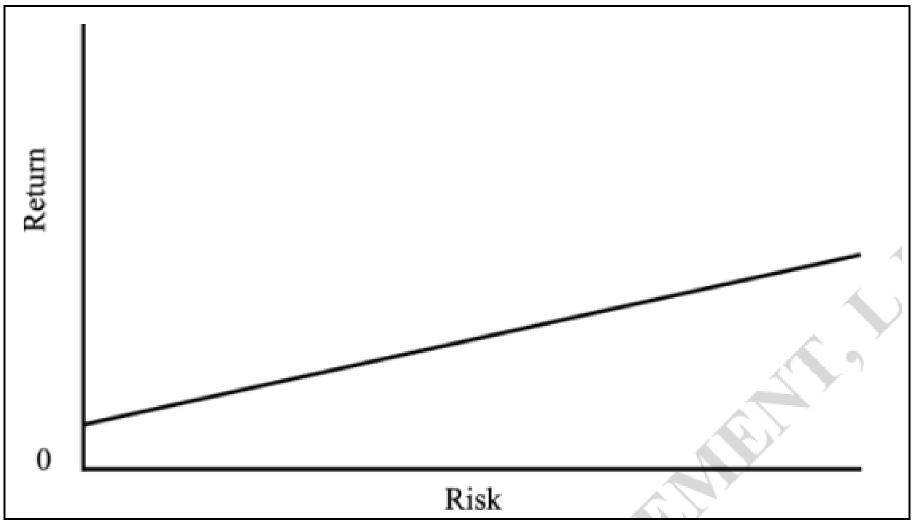
Growing computing power requires lots of electricity. According to a recent Barron's article, "data centers could constitute up to 7.5% of total U.S. electricity consumption by 2030, citing data from Boston Consulting Group." The same report indicated that "data-center share of U.S. electricity consumption is expected to triple from 126 terawatt hours in 2022 to 390 terawatt hours by 2030. That's the equivalent usage of 40 million U.S. homes" and an annualized growth rate of 15% per annum. Power generators and grid operators have a significant amount of work ahead of them.

Risk vs. Uncertainty and the Decision-Making Process

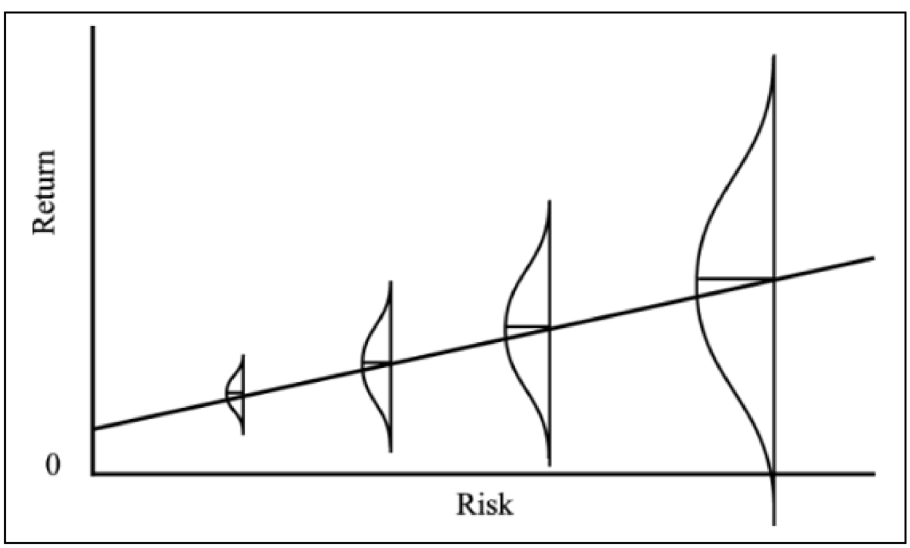
Last quarter we covered the differences between **Risk** and **Uncertainty**. In this update, we discuss how risk is portrayed in investing, the different types of risk we face and how we incorporate risk into our investment decision-making process.

Recall from last quarter, **Risk** involves unknown outcomes with known probabilities of potential outcomes. An easy illustration of risk - a standard coin has a 50/50 chance of landing on heads. We do not know if it will land on heads, but we at least know it can only be heads or tails, and we know the probability of each.

Risk assessment is an integral part of our investment decision-making process. Often the thought is that taking more risk is the way to achieve higher returns. Howard Marks is an author and investor whose work and thought process we respect. He is the co-founder of Oaktree Capital, famed credit investor and author of *The Most Important Thing*. Investors can learn a lot from his quarterly “Memos” which are published by Oaktree (they are also available via podcast). Marks has discussed risk several times in his memos over the years. His illustration **below** highlights the **academic** view of risk and return:



The graph **above** makes you believe more risk = more return. Simple! Why wouldn’t anyone take more risk? More risk does not guarantee higher returns, but rather the possibility of higher returns. In light of the possibility and not the guarantee, we must recognize that the range of outcomes widen, including the potential for losses. Marks better captures the true relationship of risk and return below, in our view.



Types of Risk

The risks described below are not all inclusive, often overlap and can apply to investors, businesses and individuals alike:

- **Permanent Loss of Capital** – the most important risk to consider in investing. Many other risks are contributors, but we believe this is the main risk to all investors. We are not talking about short-term volatility and price fluctuations, but rather permanent impairment of capital.

- **Leverage** – borrowing capital can enhance returns. The issue is that leverage magnifies results. Positive results magnify gains, however negative results magnify losses with the potential of losing more than just the original investment.

- **Funding** – born out of leverage, occurs when the duration of assets and liabilities are mismatched. The downfall of Silicon Valley Bank ("SVB") in the spring of 2023 is a prime example. SVB had a high percentage of uninsured deposits (short-term liabilities) which they invested in long-term Treasuries (long-term assets). A combination of interest rate increases (Treasury values falling) and a swift outflow of deposits caused a liquidity crisis. SVB failed and was acquired by another bank.

- **Interest Rate** – higher interest rates mean lower bond values. Fixed-income investors are directly exposed to this type of risk. Businesses and individuals with exposure to variable rate debt and debt rollovers are too.

- **Reinvestment** – tied to interest rates. Investors are subject to reinvestment risk when coupon payments and maturing bonds must be reinvested at market rates (which are likely to differ from their original investment). A similar risk can occur in equities when a security has appreciated above its intrinsic value and the price is no longer justified. Then we decide to sell it, but where do the proceeds go? Ideally, we purchase a security trading at a favorable discount to intrinsic value. If few opportunities exist in an overexuberant market, we may find it difficult to reinvest the sale proceeds.

- **Credit** – simply the risk that a borrower will default and not be able to pay the interest and principal as expected.

- **Concentration** – a limited number of holdings and/or significant exposure to a given industry, sector and/or asset class. When a portfolio is concentrated in only a few holdings and/or industry, sector and/or asset classes, negative developments will have an outsized impact on returns compared to a diversified portfolio.

- **Over-diversification** – is the flip side of concentration risk. Having a large number of holdings eliminates the ability for any one position to have a material impact (positive or negative) on the portfolio. At which point, index funds present the same opportunity, delivering low-cost market returns (but without risk controls).

- **Career** – portfolio managers can come under scrutiny for investments that look like losers (whether due to short-term price fluctuations or an actual permanent loss of capital). This is why you often see managers and analysts chasing the same stocks. There is safety in numbers when many analysts recommend the same stock. If the stock performs well, that is great. If there is a permanent loss of capital, they can blend in with the crowd knowing many others provided the same recommendation. This behavior points to group think, something we work diligently to avoid. We strive to not let the herd influence our decisions and maintain objectivity by sticking to our investment decision-making process. Stocks that are out of favor can often look like losers in the short-term, but represent a significant value in the long-term. It is important to stay diligent in our measurement of a company's intrinsic value. The difference between price and intrinsic value can persist for some time (although when the gap closes quickly, it is surely a good thing). Being objective in our decision-making is vital to our process, as is not allowing the risk of looking wrong in the short-term affect the portfolio.

Other risks include, but are not limited to: underperformance, illiquidity, not taking enough risk, FOMO (as previously discussed), model, black swan, fundamental, valuation, correlation, loss of purchasing power and upside. There are lots of risks to consider!

Many of the risks discussed apply to our investment decision-making process. We attempt to quantify these risks where possible and weigh them appropriately when determining the intrinsic value of a given investment. Accepting risk is a part of investing; however, it is important for the returns produced to be commensurate with the risk taken.

To summarize, the relationship between risk and return is **not** a straight upward sloping line, but rather a **range** of possible outcomes that increase as more risk is taken. Investors, businesses and individuals are exposed to a variety of risks. It is important to quantify and monitor them. The potential for higher returns is needed to incentivize risk taking. Next quarter we will dive into **uncertainty** and the part it plays in investing and life.

Looking Ahead

Market participants may become hyper-focused on the 2024 U.S. Presidential election as the weeks pass, rhetoric becomes more elevated and November 5 draws near. Fortunately, markets have historically rewarded long-term investors regardless of which party was in office. Sound investment principles along with competent management at the helm of companies held in our strategies should provide the necessary tools to successfully navigate whatever lies ahead.

If you would like some peace between now and November, consider dropping your smartphone in a bucket of water and blocking the news channels from your television.

Our search for value in a field of pricier equities and fixed-income instruments continues.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.