MARKET REPORT
THIRD QUARTER 2023

Key Points

- Headwinds prevailed.
- S&P 500 cap-weighted vs. equal-weighted performance disparity.
- Yield curve flattened, making it less inverted.
- We provide historical context for negative calendar year stock and bond returns.
- Minerals may create new boom towns in America.
- We introduce a new series: Risk vs. Uncertainty and the Investment Decision-Making process.

Total Return as of September 30, 2023						
			Annualized			
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	-3.3%	13.1%	21.6%	10.2%	9.9%	11.9%
NASDAQ	-3.9%	27.1%	26.1%	6.6%	11.4%	14.6%
Russell 3000						
Index	-3.3%	12.4%	20.5%	9.4%	9.1%	11.3%
Value	-3.2%	1.7%	14.1%	11.2%	6.0%	8.3%
Growth	-3.3%	23.8%	26.6%	7.5%	11.7%	13.9%
Russell Mid Cap						
Index	-4.7%	3.9%	13.5%	8.1%	6.4%	9.0%
Value	-4.5%	0.5%	11.1%	11.0%	5.2%	7.9%
Growth	-5.2%	9.9%	17.5%	2.6%	7.0%	10.0%
Russell 2000 (Small Cap)						
Index	-5.1%	2.5%	8.9%	7.2%	2.4%	6.7%
Value	-3.0%	-0.5%	7.8%	13.3%	2.6%	6.2%
Growth	-7.3%	5.2%	9.6%	1.1%	1.6%	6.7%

A Review of the Quarter

With the cost of capital rising, worker strikes commencing, the U.S. and China continuing their tit-for-tat relationship, another rating agency stripping the U.S. of its AAA rating and the threat of a government shutdown at quarter-end, **equity and fixed-income markets faced significant headwinds during the quarter**.

While we acknowledge negative headlines may be concerning, the view through our lens is less so. Why? Our fundamental, bottom-up approach to investing and constructing equity and fixed-income portfolios requires us to focus on individual companies and compounding rather than on macro events and relative returns. If we are correct in our analysis at the security level and have an adequate margin of safety, on average, headline noise only creates temporary price impairments. Knowing what you own, why you own it and having a reasonable idea of what it is worth is especially advantageous during uncertain times.

Amidst the headwinds, there was a small dose of comic relief during the period. Zoom, the video conferencing darling of the pandemic, called team members **back to the office**. While technology provides flexibility in where and when team members work, in our view, it is **no substitute** for having team members together, in-person, to collaborate and solve problems. Corporate America continues its nudging of employees back to the office; unfortunately, the pace will not likely be swift enough to save numerous office landlords from financial calamity.

U.S. Equities

Only **two** of the **11** economic sectors in the S&P 500 logged gains during the quarter with energy (+12.2) leading the charge followed by communication services (+3.1). Interest rate sensitive real estate (-9.5%) and utilities (-9.2%) led to the downside.

The market (S&P 500), on a price-to-earnings basis, is still priced slightly above its long-term average, but is not unreasonably expensive. Our strategies which call for individual stocks are trading at a reasonable **discount to intrinsic value**, which can bode well for long-term compounding in spite of near-term volatility.

The market cap weighted S&P 500 remains dominated by a handful of large companies with 10 accounting for 31.9% of the overall index at quarter-end, a new high. As mentioned in previous letters, a less concentrated market would be healthier, in our view.

As a point of comparison, the S&P 500 **cap-weighted** index was **down 3.3%** for 3Q and **up 13.1%** year-to-date on a total return basis; the S&P 500 **equal-weighted** index was **down 4.9%** during 3Q and only **up 1.8%** year-to-date on a total return basis.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, decreased 0.72% during the quarter but are up 1.70% year-to-date. U.S. Treasuries and Agencies, as measured by a similar index, declined 0.76% and gained 0.33%, respectively. Our fixed-income strategies **held up well** during the quarter and for the year-to-date period, in our view.

Treasury yields rose during the quarter with the 2-Year ("2s") increasing 18 basis points to 5.04% and the 10-Year ("10s") increasing 73 basis points to 4.57% at quarter-end. With a **negative 47 basis point** (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve remains inverted but is less so than at the end of 2Q.

Stocks versus bonds, some historical context. Most of the time when stocks (S&P 500) print a **negative** return for a calendar year, bonds log a **positive** return and the benefit of having bond exposure is apparent. However, occasionally, like in 2022, stocks and bonds both print **negative** returns for a calendar year and cause market participants to take pause. Historical context can be helpful: For the period beginning January 1, 1928, through December 31, 2022, the S&P 500 logged negative calendar year returns **26** times. During that 95-year stretch, the S&P 500 **and** corporate investment grade bonds only printed negative calendar year returns **nine** times while the S&P 500 **and** Treasuries (10-Year) only logged negative calendar year returns **five** times. (See table to the right for detail.)

	Negative Calendar Year Returns	
Year	**S&P 500 and Investment Grade Corps.**	**S&P 500 and 10-Yr. Treasury**
1931	X	X
1937	X	
1941		X
1957	X	
1966	X	
1969	X	X
1974	X	
2008	X	
2018	X	X
2022	X	X
Data Source: Stern College of Business Annual Data		

We believe last year was an **anomaly**, like a handful of other years since 1928 when stocks and bonds were highly correlated.

Mortgage rates for a 30-year fixed rate mortgage hit **7.31%** at quarter-end, the highest level since December 2000. Existing homeowners with low fixed mortgage rates have been reluctant to sell and give up their low cost of capital. This has contributed to a limited number of **existing** homes for sale and supported **new** home sales. The supply-demand imbalance compounds the effect of underbuilding since 2008. New household formations continue, and housing is needed in spite of higher costs of capital. Sales incentives, base price reductions and smaller floorplans are tools homebuilders are using to combat higher costs.

Commodities, as measured by the Bloomberg Commodity Index, increased 4.7% for the quarter and contracted 3.4% year-to-date. Oil (WTI) increased 28.5% for the quarter and 13.1% year-to-date as Saudi-led production cuts, lower capital spending by Western producers and strong demand buoyed prices.

With China dominating raw materials and processing for key elements, like Cobalt and Lithium for electric vehicle batteries, the U.S. is increasing its activity in those areas. Rural towns like Magnolia, AR, may become the next boom towns if commercially viable Lithium extraction methods pan out.

Risk vs. Uncertainty and the Decision-Making Process
This **new series** will cover a broad range of topics with the goal of helping readers better understand our investment process. **This quarter** we discuss the concept of **"resulting"** and how it relates to decision and outcome quality.

Resulting (also referred to as "outcome bias") is determining whether a decision was good or bad based **solely** on the outcome (i.e., without context). This is a common practice, "I got the desired **result**, my **process** must have been correct!" The trouble is, thinking this way ignores luck's influence on everyday outcomes. In Annie Duke's book, *How to Decide*, decisions and outcomes are categorized into four buckets as illustrated in the accompanying chart to the right.

		Outcome Quality	
		Good	Bad
Decision Quality	Good	EARNED REWARD	BAD LUCK
	Bad	DUMB LUCK	JUST DESERTS

Annie **illustrates** each of the categories with a simple example – **driving through a stop light**:

- **Earned Reward** – the light is green; you go through the light safely. Good decision – Good outcome.
- **Dumb Luck** – you run a red light, still get through safely. Bad decision – Good outcome.
- **Bad Luck** – the light is green, but someone else runs their red light and you get in an accident. Good decision – Bad outcome.
- **Just Deserts** – you run a red light and get in an accident. Bad decision – Bad outcome.

Ideally, all our investment outcomes would land in the **Earned Reward** category. However, we are not so naïve to think Bad Luck will not be a factor. All our investment decisions are made in a world of uncertainty. There are so many known and unknown variables impacting each outcome that we will never be able to totally eliminate luck from the equation. We cannot control outcomes, but we can control process. Focusing on a thoughtful investment process

and high-quality decision making will not eliminate Bad Luck, but we believe it will ultimately lead us to Earned Rewards (and favorable investment results) more often than not.

Let's take the four buckets and apply them to the investment decision making process:

- **Earned Reward –** Purchasing a security at a discount to intrinsic value (i.e., with a margin of safety). A high-quality company with significant moats (competitive advantages), strong balance sheet, high percentage of insider ownership, high return on invested capital (ROIC) and sustainable earnings and free cash flow. The security eventually appreciates to its intrinsic value, leading to favorable returns. Good decision – Good outcome.

- **Dumb Luck** – Purchasing a security of a company that exhibits any number of poor characteristics – overpriced, highly leveraged, no discernable moats, unsustainable earnings and poor management incentives. Despite these traits, the company gets acquired at a premium, turning into a good investment. Bad decision – Good outcome.

- **Bad Luck** – Purchasing a security with the same "Earned Reward" characteristics, but perhaps there wasn't a wide enough margin of safety. The list of bad luck scenarios is not all knowable, whether it be a pandemic, earthquake, recession, war or regulatory changes. Any number of unforeseen circumstances can pop up, bringing bad luck into the equation of a decision with a favorable risk/reward. Good decision – Bad outcome.

- **Just Deserts** – Exhibits the same characteristics as "Dumb luck" – instead of being bailed out by luck, the company fails to grow into its lofty valuations, a downturn causes financial distress to an overleveraged company and/or lack of competitive advantages allows competitors to chip away at market share. The result is a permanent loss of capital. Bad decision – Bad outcome.

How do we minimize Bad Luck outcomes? By having a margin of safety. The wider the margin, the lower the probability of Bad Luck dictating the results. Margin of safety is one of our core values and we seek it in every investment we make. Even when Bad Luck rears its head, a wide margin of safety can minimize the risk of permanent capital loss.

Next quarter we will discuss in more detail the difference between Risk and Uncertainty. Risk having known probabilities of something occurring vs. Uncertainty's unknown probabilities (the unknown, unknowns).

Looking Ahead

Higher interest rates will likely be felt with greater intensity in the coming quarters as consumers, businesses and investors adjust to the current environment. This should lead to more discipline in capital markets and create opportunities for seasoned investors and conservatively run companies. The Federal Reserve's tightening cycle may be nearing an end, and if so, should be followed by a period of steady rates then rate reductions at some point.

With the returns of only seven stocks accounting for roughly 69% of the total market return year-to-date through September 30, we would expect returns to become more broadly distributed in the coming quarters. The search for value continues with enthusiasm.

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.