

4Q 2023 Quarterly Update

Key Points

- The year ended on a high note.
- Seth Klarman succinctly summed up resisting temptation.
- Returns and cash flow matter.
- Fixed-income made a strong showing after a rough 2022.
- Record U.S. oil production reduced the potential economic impact of unrest in the Middle East.
- We continue our series: Risk vs. Uncertainty and the Investment Decision-Making process.

Total Return as of December 31, 2023						
	Annualized					
	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	11.7%	26.3%	26.3%	10.0%	15.7%	12.0%
NASDAQ	13.8%	44.7%	44.7%	6.1%	18.8%	14.9%
Russell 3000						
Index	12.1%	26.0%	26.0%	8.5%	15.2%	11.5%
Value	9.8%	11.7%	11.7%	8.8%	10.8%	8.3%
Growth	14.1%	41.2%	41.2%	8.1%	18.9%	14.3%
Russell Mid Cap						
Index	12.8%	17.2%	17.2%	5.9%	12.7%	9.4%
Value	12.1%	12.7%	12.7%	8.4%	11.2%	8.3%
Growth	14.6%	25.9%	25.9%	1.3%	13.8%	10.6%
Russell 2000 (Small Cap)						
Index	14.0%	16.9%	16.9%	2.2%	10.0%	7.2%
Value	15.3%	14.7%	14.7%	7.9%	10.0%	6.8%
Growth	12.8%	18.7%	18.7%	-3.5%	9.2%	7.2%

A Review of 2023

The year started with a contentious election of Speaker of the House (which turned out to be the third shortest tenure in history), followed by a Chinese spy balloon and collapse of Silicon Valley Bank (“SVB”). The Federal Reserve (the “Fed”) slowed its pace of rate increases, only hiking by 0.25% four times during 2023 and held steady at 5.25% - 5.50% from July onward. The higher rate environment took its toll on banks that allowed their assets and liabilities to become mismatched, like SVB. Its collapse in March stoked fears of broader banking concerns. The Fed stepped in, provided support to the financial system and allayed those concerns.

Artificial Intelligence (“AI”) related investments became the latest **hyped** segment of the market. While the potential long-term benefits of enhancing productivity and reducing inflation are incredible, **there are** a host of legal, social and moral considerations that must

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be addressed. Safely integrating AI into societal norms will be a long, arduous and messy journey, in our view.

The 10-Year Treasury yield generally rose from late-spring through mid-October. Rising yields of these longer dated issues along with striking workers across automotive, film and healthcare industries contributed to negative short-term equity market psychology. Then, factors like lower expected inflation, Treasury's auction plans and the potential for Fed rate cuts in 2024 led to declining yields and improved equity market psychology beginning in late-October. Markets seemingly processed declining yields as a magical phenomenon and nearly all assets lifted, quickly.

On November 28, 2023, Charles T. Munger passed away at the age of 99. Mr. Munger was Vice Chairman of Berkshire Hathaway and often referred to as Warren Buffett's long-time business partner. The world lost a brilliant mind, deep thinker, teacher and incredibly efficient and unambiguous communicator. His wit and wisdom will be missed by legions of investors.

A **few** large-cap technology issues dominated cap-weighted index performance throughout the year, but slightly less so in the final quarter.

U.S. Equities

Stocks of companies corralled into the growth category generally rose the most during the quarter and the year, but in some cases have not recovered from their 2022 drubbing. When comparing calendar year 2023 to 2022 broad-based index data, large-cap growth indexes fully recovered and gained ground (thanks to a few securities) while mid- and small-cap issues are **still underwater**.

As a point of comparison, the S&P 500 **cap-weighted** index was **up 11.7%** for 4Q and **26.3%** year-to-date on a total return basis; the S&P 500 **equal-weighted** index was **up 11.9%** during 4Q and only **up 13.9%** year-to-date on a total return basis. The similar 4Q returns are reflective of broader market participation, finally.

Seth Klarman of The Baupost Group, in an interview with David M. Rubenstein, as edited in *How to Invest*, shared a perspective that aligns with our own:

Q: Is it hard to resist the temptation to buy the latest high-tech, crypto-currency, software and e-commerce companies?

A: I don't find it hard to resist any of those temptations. A value investor has a certain

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discipline. When something just doesn't make sense, you can't figure it out, you don't play. I'm not drawn to hot areas or to what other people are doing. Obviously, I want to see if I'm missing something, but I haven't been able to find opportunity in areas like crypto, and have no interest in chasing things just because they're going up.

To borrow a well-known line from Mr. Munger, "I have nothing to add."

Returns and cash flow matter. After disappointing returns and increased regulatory scrutiny, the sustainable investing or ESG craze is seemingly subsiding. Higher interest rates along with inadequate revenue levels crushed many clean energy related companies. Wall Street is generally in the business of selling stuff and will gladly package investment concepts that appeal to consumers' emotions even if the fundamentals of the underlying investments are suspect. Our investment process helps us steer clear of fads. By way of example, we had no technology exposure in the late '90s and early '00s when internet-related stocks were all the rage, but at that time, many lacked viable business models and/or traded at unrealistically high price-to-value relationships. Only after valuations contracted – a lot- and business models were proven did we add technology exposure to our portfolios.

In a similar vein, Electric Vehicle ("EV") makers have resorted to steep discounts to move inventory and delayed expansion projects in the face of slowing demand. This, in part, is due to changes in the \$7,500 EV tax credit. Although EVs are here to stay, the pace of adoption is likely to be slower than currently forecasted for a host of reasons, such as an inadequate charging infrastructure, cost of production and battery performance in cold weather. According to a Wall Street Journal article around year-end, "It takes a dealership around three weeks longer to sell an EV than a gasoline vehicle. A year ago, battery-powered models were selling faster than their gasoline counterparts." Demand for EVs is lumpy across the U.S. with "nearly one-quarter of all vehicles sold in California" being EVs as compared to "3% in Michigan" between July and September. We are entering a more pragmatic phase, in our view.

Fixed Income & Commodities

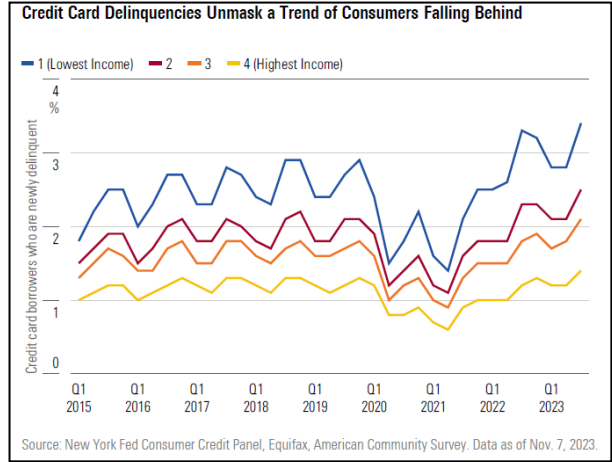
Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, increased 5.6% during the quarter and ended the year up 7.4%. U.S. Treasuries and Agencies, as measured by a similar index, gained 3.9% and 4.2%, respectively. **Our** fixed-income strategies posted solid results for the quarter and year after holding up well during 2022's turbulent, fixed-income market. BBB yields declined and credit spreads tightened slightly across the maturity spectrum during the quarter.

Credit card **delinquencies** are on the rise (as illustrated in the accompanying top chart). This dovetails with declining excess savings as discussed in our 2Q 2023 letter. Consumers are seemingly becoming more stretched and may have to reset spending patterns in future quarters.

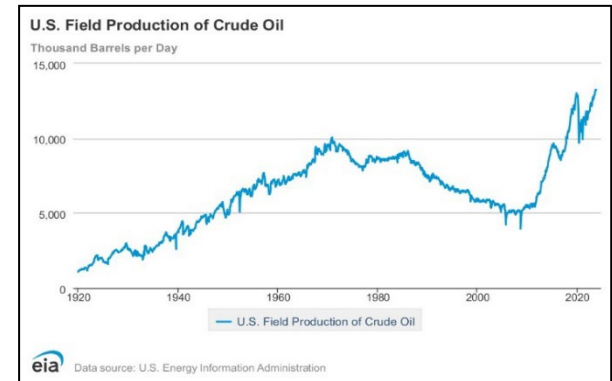
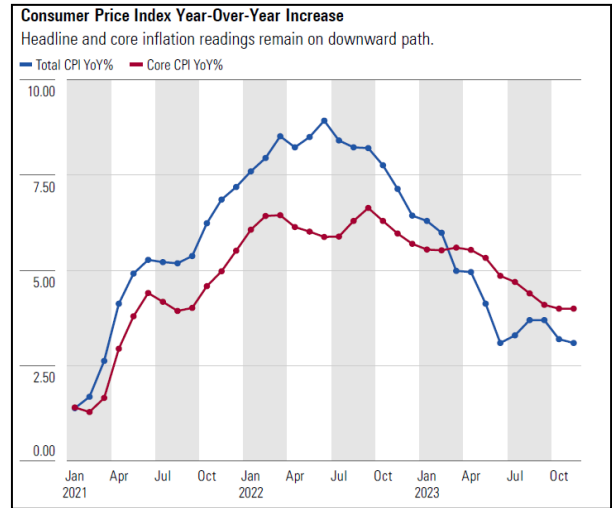
Treasury yields fell during the quarter with the **2-Year** (“2s”) decreasing 79 basis points to **4.25%** and the **10-Year** (“10s”) decreasing 69 basis points to **3.88%** at year-end. With a **negative 37 basis point** (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve **remains inverted** but is less so than at the end of 3Q. The probability of the yield curve normalizing in 2024 – longer maturities yielding more than shorter maturities – has increased with the Fed’s most recent communique.

Commodities, as measured by the Bloomberg Commodity Index, decreased 4.6% for the quarter and contracted 7.9% for the year. Oil (WTI) decreased 21.1% for the quarter and 10.7% for the year. After **peaking** at 9.1% in June 2022, the rate of inflation has cooled (as measured by the CPI in the middle chart to the right).

Record U.S. oil production (bottom chart to the right) of roughly 13.3M barrels of oil per day has greatly diminished authoritarian states’ influence on global oil prices and their ability to hold the U.S. hostage. It was not that many years ago that an uprising in the Middle East would have caused oil prices to skyrocket, crippling the U.S. economy. Record production coupled with a pragmatic transition to alternative energy sources should bode well for U.S.



Source: North America Market Outlook: Q1 2024



Data through October 2023

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consumers, industry and politics. Europe's hasty transition to "green energy" has left it in a bind and at a competitive disadvantage. Market forces are seemingly working to correct an overly aggressive adoption schedule in the U.S.

Risk vs. Uncertainty and the Decision-Making Process

Last quarter we discussed "Resulting" (i.e. outcome bias) and how it relates to our investment decision-making process. In this piece, we discuss the differences between **Risk** and **Uncertainty**.

The terms Risk and Uncertainty are often mistakenly used interchangeably. Although both refer to unknown outcomes, there is a subtle but important difference. **Risk's** potential outcomes are known and the probabilities of those outcomes are known or can reasonably be estimated (known, unknowns). **Uncertainty** means all possible outcomes are not known or predictable (unknown, unknowns) and therefore the probabilities cannot be estimated.

- **Risk** – Assume we are flipping a standard coin. We know there is a 50/50 chance of landing on heads or tails. We have known probabilities with an unknown outcome. Other examples include playing games of chess, checkers or rolling dice. In these games, you do not know the outcome, but you can see the board.... knowing what moves are possible.
- **Uncertainty** – Take that same coin flip example, but assume the coin is biased and the bias is unknown. We know there is a chance of landing on heads or tails, but those probabilities are unknown, plus there are the unknown outcomes (biases) with unknown probabilities. Uncertainty is prevalent in games such as poker. In poker, we know what cards we are holding and can estimate the probabilities of winning a given hand. But unlike chess and checkers, we cannot see the whole board. We do not know what cards other players are holding, do not know what they will do, and do not know what cards are yet to come. Life, business and investing are full of uncertainty. Similar to poker, we can make decisions with the best information available, but luck and chance will sometimes result in unpredictable outcomes.

The key difference between Risk and Uncertainty is knowing the potential outcomes. Let's consider risk and uncertainty in a typical situation like picking up a friend from the airport. There is a risk that the flight is delayed, arriving hours later than expected. We know there is a chance this happens and can assign a probability to the flight arriving late. The potential outcomes are knowable; the flight is either on time or delayed. Uncertainty is you

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are late to the airport because you got a flat tire. Who could have predicted such bad luck? We know any number of wild circumstances could have delayed you, but we could not have reasonably predicted this outcome based on prior experiences.

Investment Decision-Making Process

Both Risk and Uncertainty considerations are critical to our investment decision-making process. When possible, we quantify risks and apply them to our framework (e.g., earnings, cash flows, sales, etc.). However, uncertainty dominates decision making in business and investing. As such, we lean on our core values of **margin of safety** and **humility** to help guide us.

Investing with a margin of safety should lessen the impact of risk and uncertainty on long-term investment results. Although there are still unknowns, investing at a significant discount to intrinsic value reduces the likelihood of a permanent loss of capital and is more likely to produce “heads I win, tails I don’t lose much” scenarios.

Mark Twain famously said, “It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.” Having the humility to admit we do not have all the answers, even in areas where we have a deep knowledge base, is key to continued success in our view. Having humility leads us to seek a margin of safety. Humility also helps protect us from overconfidence, which often leads to excessive risk taking.

Last quarter we focused on the decision-making process (Decision Quality), which we can control. It should generally lead us to “Earned Rewards.” When it does not because “Bad Luck” strikes (uncertainty adversely affecting returns), our goal is to have minimized any permanent loss via a healthy margin of safety.

In summary, what defines Risk is having unknown outcomes with known potential outcomes. Whereas, Uncertainty presents still unknown outcomes, but we also don’t know all potential outcomes (nor can we reasonably estimate those outcomes). Relying on a margin of safety and humility allows us to account for uncertainty in our investment decision making process. Next quarter we will discuss the different types of Risk and how it impacts our decision-making.

Looking Ahead

The “consensus” amongst market prognosticators for the year ahead is that inflation will continue to moderate, the Fed will cut interest rates several times and a soft landing is

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almost certain. This cheery outlook seems embedded in stock prices given the elevated valuation level of market averages.

With falling consumer confidence, slowing wage growth, dwindling Covid-era stimulus savings and the potentially delayed effect of higher interest rates, embedded corporate earnings growth assumptions, on average, may prove challenging to achieve.

Our focus on individual companies and their business models, free cash flow, balance sheets, return on capital capabilities, and of course, being mindful of the price we are paying relative to the value we are receiving, should prove beneficial and allow us to navigate a shifting investment landscape if reality turns out to be different than the current “consensus” view.

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