October 10, 2023

Dear Clients and Friends:

Re: Q3 Investment Review

Over the first half of the year, all of our benchmark financial indexes did well with common stocks leading the way. However long-term interest rates began to rise substantively around the middle of the year. This continued through the 3rd quarter and the result was the negative results shown for Q3 below. Tech stocks continued to hold up but, as noted below, almost everything else declined in price.

Benchmark Index Total Returns	Quarter Ending 9/30/2023	Year to date Ending 9/30/2023
Lipper Balanced Fund Index	-3.00%	4.50%
S&P Dividend Aristocrats	-5.44%	0.10%
S&P 500 Stock Index	-3.27%	13.07%
Russell 1000 Value Index	-2.32%	1.80%
3-month US Treas. Bill Index	1.33%	3.64%
S&P-7-10-Year-US Treas. Bond Index	-4.42%	-2.50%
S&P U.S. Gov & Corporate 30 Year Bond Index	-12.72%	-9.17%

What is going on in the market?

Many believe that investing in a large index such as the S&P 500 provides an investor with plenty of diversification. After all, with one purchase an investor effectively holds shares in about 500 different companies. But the current reality is quite different, as the largest companies have come to dominate the market over the last decade or so. Companies that make up the index are weighted by market capitalization meaning that the biggest companies have the biggest impact on returns. Currently the highest weightings in the S&P go to Apple and Microsoft. Because they are so large each company comprises over 6.5% of the index, and both are up over 30% year to date. In fact, the top nine stocks in the S&P 500 make up 29% of the total index. On top of Apple and Microsoft these names include Amazon, Nvidia, Alphabet Class A and Alphabet Class C (Google), Tesla, Meta Platforms (Facebook), and Berkshire Hathaway.

Year to date the S&P 500 has been climbing entirely on the performance of these largest companies. The stellar performances of Apple and Microsoft were only the tip of the iceberg. Year to date through the end of September Nvidia is up 195%, Meta Platforms is up over 150%, and Tesla is up over 100%. These top nine companies now are priced at close to 100 times their trailing twelve months earnings, extraordinarily high by historical measures.

The total S&P 500 Index returned about 13% for the first nine months of the year. However, if we were to exclude the top nine companies from the index, the S&P 500 would have been down about 5% year to date. What we are seeing is an incredible performance discrepancy between the biggest companies and the rest of the index.

Meanwhile some of the well-known worst performers in the S&P 500 were Dollar General (low priced retailer), Etsy (online marketplaces) and Moderna (biotech), all down over 40%. However, those losses barely register for index performance as they are only a tiny fraction of the index (Dollar General makes up .06% of the index, Etsy is .02%, and Moderna is .09%).

In contrast, to get a perspective of how the market is doing as a whole, we can look at the S&P Equal Weight Index, which weighs each component equally. In an equal-weighted index, the top nine companies mentioned above would only make up 1.8% of the index value. For the first three quarters of 2023 the Equal Weight S&P 500 returned around 2%. This is what your return would be if you invested an equal amount of money in each company in the index, which is more in line with how we and most financial advisors tend to invest. We don't buy a bigger or smaller position in a company just because it is bigger or smaller in size. A similar discrepancy is seen with the indexes that are closest to our own style of investing. Through September 30 the S&P 500 Dividend Aristocrats index was flat, while the Russell 1000 Value Total Return Index was up less than 2%.

A brief note on Artificial Intelligence (AI)

It is difficult to read any financial news these days without seeing AI front and center, and AI was a substantial driver for many of the biggest companies in the S&P 500. Put simply, AI is the replication of human intelligence by machines. AI systems work by taking in large quantities of data and using recognized patterns to make predictions of future states. In this way a chatbot can learn to generate lifelike communications with real people, and new AI techniques can generate lifelike images, text and music. On the simple end, AI can be used to analyze large quantities of data much more efficiently than humans, and this technology is already being used in processes such as medical diagnoses. But AI is now being considered for more and more complex applications like cars that can drive themselves. The applications go well beyond helping our youth cheat on writing assignments a la ChatGPT. Clearly AI will have an impact on how the world works, much like we saw with the Internet in the late '90's.

The bigger question might be whether we ought to be investing in AI. The answer is that we already are, as many of the companies we invest in are beginning to use AI in meaningful ways, some more obvious than others:

- Microsoft is embedding AI in the products it sells to help companies become more efficient with fewer people, and it is also using AI to enhance cybersecurity.
- Qualcomm is building generative AI into its next generation Snapdragon chips which are set to debut later this month.
- Abbvie is using AI to enhance its research and development by creating vast libraries of biomedical literature that are searchable across languages, while its peer Amgen is using AI to enhance its risk prediction and improve outcomes for many conditions such as osteoporosis (where only 25% of patients ever receive treatment) and cardiovascular health (where it is aims to predict risks before disaster strikes). Amgen is also using AI to determine the most effective treatment for individual patients and to support patient compliance with treatments.
- Home improvement store Lowe's has been a pioneer in creating a digital twin of several of its stores in order to better serve customers and make sure shelves are stocked with the right products in the right configurations.
- UPS is using AI in order to more efficiently ship packages and also to fend off porch pirates.

Overall, a majority of the companies we are invested in are looking to adapt to AI in order to become more efficient, reduce errors, improve customer experience, and improve workflow for their employees. While still in its infancy it is clear that the technology is not going away, and like the Internet, AI is likely to be transformational in having significant impacts regarding how business is done across all industries and across the globe.

Over the last year many companies that are closely associated with AI technology have taken off in price. Perhaps the most noteworthy is Nvidia (which we don't own), up roughly 240% over the last year though it has come down from recent highs. Nvidia makes processing units (GPUs) that provide the heavy lifting for AI systems. Trading at over 100 times earnings, we believe Nvidia is priced for perfection with little room for error, which is why we aren't rushing in to buy the stock now – price risk is very high. Analysts are predicting over 80% growth in revenue for fiscal 2024 and nearly 50% for 2025. While Nvidia has done a terrific job so far meeting and even exceeding analysts' lofty expectations, anything less than the stellar rate of growth that is anticipated going forward will likely be severely penalized in the stock market.

The current valuations for many AI companies could become reminiscent of the dot com boom in the late 1990's, when anything ending in .com was bid up in price. Remember Pets.com, eToys.com, Webvan (grocery delivery), DrKoop.com (WebMD of the dot com bubble) or Boo.com (high-end fashion)? While the Internet was as transformational as many predicted, this did not translate to profitability for the majority of companies in this market space. The flow of money into internet companies eventually led to more and more wasteful spending. Even Amazon, perhaps the biggest success story of the dot com era, tumbled over 90% in price over a nearly two-year period as the tech bubble began to burst in 1999, and it took over ten years to recover to its peak 1999 price.

We believe something similar may be happening in the AI space because the AI buzz is starting to pull money out of other sectors. Many analysts predict that the majority of AI start-ups will be bankrupt within a few years, and the basic reason is that they will never be able to turn a profit. We tend to agree, though we may still be early in the cycle and any potential correction could take a long time to occur. Companies like Nvidia with real products, real applications, and positive earnings and cash flow are not in danger of bankruptcy, though they are at risk of the stock price getting well ahead of even outstanding fundamental growth. If the AI bubble were to eventually burst, even the strongest companies could see a substantial erosion in their stock prices. With the future uncertain we aren't rushing out to invest in AI technology stocks today, even high-quality ones like Nvidia. However, we are paying a lot of attention to the implication AI may have on our portfolio holdings, and what it means for the underlying businesses. We look forward to seeing what our companies can do with AI to make their businesses more efficient.

Top Twenty Holdings

Once again there was not any great turnover in our portfolio as eighteen of our top twenty holdings remain the same. We did see US Bancorp and Essex Property Trust replace T Rowe Price and Target in the third quarter. Our current list of top holdings is below:

9/30/2023 Top Twenty Holdings

ABBV	AbbVie Inc.	FAST	Fastenal Company
AMP	Ameriprise Financial	ITW	Illinois Tool Works Inc
AMGN	Amgen Inc	LOW	Lowes Companies Inc
ADM	Archer Daniels Midland	MSFT	Microsoft Corporation
CAT	Caterpillar Inc	PII	Polaris Industries Inc.
CSCO	Cisco Systems Inc	QCOM	Qualcomm Inc.
CMCSA	Comcast Corporation	XLK	SPDR Technology Sector ETF
DLR	Digital Realty Trust Inc	SWK	Stanley Black & Decker
EPD	Enterprise Products Partners LP	TFC	Truist Financial Corp
ESS	Essex Property Trust	USB	US Bancorp

Essex Property Trust is a Real Estate Investment Trust (REIT) that owns and manages a portfolio of over 250 apartment communities along the West Coast. These areas have strong demand for rentals because most of the land is already developed and construction is lengthy and expensive, so there is limited ability to expand housing. Single homes tend to be very expensive in these areas as well, providing more incentive for people to rent. The markets Essex targets tend to have household incomes that are well above the national average. Recent profitability has been strong as the company is expected to post record funds from operations for both 2023 and 2024 due to higher rental prices despite recent headlines highlighting people moving out of markets like California. Additionally, the company has raised its dividend for the 29 years since it went public, making it a dividend aristocrat, and the current dividend yield of 4.4% is also at a record high. Debt levels are reasonable, with a very low weighted average interest rate of 3.2%, and we consider the dividend very safe with room to continue increasing. With the news generally positive we are not quite sure why Essex Property is down so much in price, except that real estate companies are generally down largely due to multiple pressures associated with rising interest rates. In the case of Essex (and several of our other REITs) we believe the downturn is overdone. For now, we are biding our time, but as we look forward, we will likely add more high-quality real estate investments including Essex and others to portfolios, as real estate is one of the cheapest sectors in the current market.

U.S. Bancorp is one of the nation's largest regional banks and also one of many that has seen its stock price pummeled following the banking liquidity problems that severely impacted the west coast and banks across the country. U.S Bancorp operates branches in roughly 26 states, primarily in the Western and Midwestern US. In addition, operating conditions are tough for banks right now because their deposit rates are climbing. After all, if you can earn greater than 5% in a US Treasury Bond with near zero risk, then why keep all your money in a checking or savings account earning near zero percent?

Additionally, earnings per share disappointed for the most recent quarter. However, not all is doom and gloom for USB. The market seems to be pricing in less than 1% earnings growth relative to pre-pandemic levels, which just seems too low given the growth in its local economies. Meanwhile the stock is paying a relatively safe and generous 5.8% dividend, and USB has more than adequate reserves to weather any short-term industry challenges from higher interest rates or tighter capital requirements. By holding on to U.S. Bancorp stock right now we are earning a very good rate of return while we wait for the stock to recover. In recent months we have continued to add some USB shares to our holdings (along with Truist which we discussed in our last quarterly letter).

On the other side of the equation, there is not much magic in T. Rowe Price and Target dropping out of our top holdings. Target is out largely due to tax loss selling. In addition, Target shares have not performed well recently for a number of reasons: Initially Target shares took a hit as many customers viewed it as taking "woke" policies a little too far, which is around the time we became interested in the stock. Additionally, many investors view Target as vulnerable to a potential recession, as the company sells more "discretionary" items than competitor Wal-Mart, a factor that seems well priced in at this point. Lastly, Target has faced tremendous issues with theft and organized retail crime. Target is addressing this last issue by announcing the closure of a few stores where the problems are the worst, including stores in New York City, Seattle, Portland and San Francisco. We believe the company is addressing these issues.

Target is a great store that its customers generally love to shop in, and we believe the current issues will blow over. While we aren't in a rush to add shares, we do believe the stock price is on sale right now based on what will likely prove to be short-term issues.

Meanwhile T Rowe Price is out of our top holdings due to relatively poor performance in the third quarter. There is nothing particularly new to report, as net net the stock has not done much either positive or negative since it was initially purchased. T Rowe Price remains a high-quality company that has increased the dividend for each of the last 36 years, making it another dividend aristocrat. It has a very strong balance sheet that consists of plenty of cash and no long-term debt. The dividend yield of over 4.5% compares very favorably to the general stock market and is well protected. We expect future growth will be lower over the next several years, and that is likely why the stock price is struggling a bit on top of normal market pressures. This is a company that will take a better market environment to turn around, but as one of the country's preeminent asset managers and mutual fund companies it undoubtedly will, as the broader market improves.

Interest Rates and Implications for the Markets going Forward

Rising bond yields and lower bond prices have been dominating the market in recent weeks, and this tends to be negative for stocks. The new headline of "higher for longer" is a reflection that the Federal Reserve is not likely to bring short-term rates down any time soon. The implications are both good and bad. Higher yields on cash and bonds mean that investors have more options for income investing.

Investors did not have a lot of options when interest rates were close to zero, but now they can hold money market funds or short-term US Treasury securities and earn 5% or more with little to no risk. Bonds are now a much more reasonable alternative to stocks than they were a year ago. Retirees who are drawing down on their portfolios are in much better shape as they can now earn a reasonable return rather than be penalized for holding cash.

Additionally, higher rates have a substantial impact on the companies we hold. Many companies are in a very good position right now having locked in very low debt rates for the foreseeable future. But ultimately, they may have to renew at least some of their debt at higher rates.

Lastly, as the risk free rate has increased, any future dollars and future projects must be discounted to the present value using a higher interest rate as well. This means that a project or acquisition that was worth pursuing a few years ago may not be worthwhile now as costs of funding are considerably higher.

This is the main reason why the Federal Reserve has been pushing rates up. The cost to everyone of higher interest rates is one way of cooling off an overheated, inflationary economy. Unfortunately, the other pieces of the inflation puzzle are more difficult to resolve, the first among them being overspending by the Federal government. Too much deficit spending accelerates economic growth but, as with many things, too much of it creates problems like inflation and we still have a lot of that today.

If we consider an individual earning about $48,000 per year but spending about $62,000 the dimension of the problem is evident and the outcome is eventual bankruptcy barring more income or less spending. If we substitute trillions of dollars for the thousands above, we are roughly where the Federal government is today based on recent estimates for 2023 with spending of $6.2 trillion versus revenues of about $4.8 trillion – a very tough spot. The two choices to resolve the issue are to raise taxes (generate more revenue) or to cut program spending. One or the other is anathema to the other side of the political aisle. There is no easy way out, but one way or another these competing forces will eventually have to be reconciled. And, of course, all this is further complicated politically by the current house speaker being ousted. Further, if nothing is done the deficit spending will continue to rise.

The above suggests that the markets in the short term are likely to be very bumpy. If you believe in Murphy's Law (anything that can go wrong will) it wouldn't take much for the economy to be tipped over into recession, though expectations seem to be leaning against recession. While the odds have improved, it still seems like less than a 50/50 chance that we will resolve the many issues facing us without recession.

The good news is that uncertainty always brings many high-quality stocks to prices where we find them irresistible and that is where we always focus our attention. With the average stock having gone nowhere now for about two and a half years (despite the rise in the S&P 500) there are bargains to buy, and they will eventually result in superior returns. We remain bullish on the stock market for the long run.

Sincerely,

Loudon Investment Management

ELS, DML, JJS, LRO