January 15, 2024

For the year ended 2023, client accounts, in aggregate, finished several percentage points ahead of a benchmark portfolio weighted 70% to the S&P 500 and 30% to the Barclays aggregate bond index. For reference the S&P 500 rose 26% for the year and the Barclays index rose 6%.

Shares of large technology businesses rebounded this year, leading the S&P 500 higher. While shares of smaller companies also rose, most of the market's gains resulted from the strong performance of Microsoft, Apple, Tesla, Alphabet, Nvidia, Meta, and Amazon. These seven businesses now make up close to a third of the S&P 500. While we own Microsoft, Amazon and Alphabet, our total exposure to these large technology stocks is a fraction of their representation in the S&P 500.

These seven stocks have accounted for much of the S&P's gains over the last decade. Looking ahead, I project their outperformance will be less noteworthy, as earnings growth is likely to slow. Together these seven companies will report global 2023 sales of close to two trillion dollars, representing two percent of global GDP and close to ten percent of US GDP. That scale will make it harder to outgrow the US economy, leaving international sales to support sales growth. However, those international sales tend to be less profitable, reducing their contribution to earnings growth.

Many of these large firms also trade at high multiples of earnings, which tends to reduce future returns. At the same time most of our investments in smaller firms remain reasonably valued. Indeed, by late last year the valuation gap between large and small businesses was as wide as I can recall. To illustrate, if our investments in large companies like Microsoft and Amazon paid all their earnings as dividends, the yield would be around three percent. If our small company investments paid all their earnings as dividends, that yield would approach ten percent.

Given that disparity, I'm a bit more optimistic about our small company investments over the next few years. That said, I still see substantial longer-term potential for our investments in the large technology firms. These are among the most dominant firms in modern business and continue to expand into new areas like artificial intelligence.

Market/Economy Notes

Stock prices rose in recent months as inflation declined towards the Federal Reserve's two percent target, even as employment remained robust. Many observers had thought that lower inflation could only be achieved through higher unemployment. It now appears that supply disruptions and a surge in demand following Covid accounted for a large part of price increases. Many of those pressures are now easing.

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Lower inflation will likely lead the Federal Reserve to lower short-term interest rates. The Fed funds futures market currently imply rates are expected to approach four percent this year and three percent next. This would be a significant shift from the Fed's current target of 5.25-5.5percent and should support economic growth. It should also provide relief to banks. The solvency of some banks was a concern as they lost deposits to higher yielding alternatives. That worry appears to be abating.

There are still areas of economic concern. Business trends for the US freight industry remain weak, and overall economic growth is expected to slow from last year. Low wage workers appear to be struggling, evidenced by rising default rates for sub-prime loans. Even so, the risk of an interest rate induced recession appears lower than a year ago.

Notes on holdings

Limbach

Limbach was far and away our best performing holding last year, with the shares tripling in value after a series of very strong operating results. Limbach installs and services commercial heating and cooling systems. In recent years the company shifted its focus from large construction projects towards more profitable small projects and maintenance. That transition has led to better operating results this year. While the stock is no longer notably undervalued, I remain optimistic about the company's longer-term opportunity to expand into system maintenance. In addition, Limbach has a strong balance sheet that will support acquisitions.

I*WG PLC*

IWG, which trades on the London exchange, is our largest non-US listed holding. The company is the leading global provider of flexible office leases under the brand names Regis and Spaces. Flexible office occupancy rates declined sharply during Covid but have recovered since. There are indications that occupancy could improve further as workers shift their commute closer to home. With 3,500 global locations and long-standing relationships with large employers, IWG is well suited to meet this need. The company has also begun partnering with landlords to modify and manage vacant office space. Landlords benefit from IWGs well recognized brands and its ability to reach prospective tenants. IWG receives recurring management fees for these services, and those fees are growing steadily. Despite that, IWG's shares remain relatively inexpensive.

Arcosa / Newpark Resources

In recent months I acquired shares in two businesses, Arcosa and Newpark Resources, that should benefit from the Inflation Reduction Act (IRA). The IRA pays for road and infrastructure improvements and incentivizes alternative power sources like wind and solar. Those new power sources will require a substantial expansion of the electrical grid to deliver electricity to homes.

Arcosa has several businesses that should benefit from these initiatives. The company owns stone quarries in Texas and the southwest, which provide material for local road repair. Stone quarries have historically been insulated from competition because it's too expensive to transport rock long distances, and it's difficult to obtain permits for new quarries. That's led to stable pricing over time, even in recessions. Given new federal funding for road repair, I'd expect this business to perform especially well this year. Arcosa also makes heavy concrete poles to hold utility lines and onshore windmills. These products should benefit from upcoming investments in the electrical grid and wind energy.

Newpark Resources manufactures and rents durable plastic mats used by utilities to protect land, roads and equipment during construction. Historically utilities used less durable wood planking for this purpose. We are in the early innings of plastic mats replacing wood, and that substitution, combined with the need to expand the electrical grid, should support growth for some time. There is limited competition in this niche market, further supporting future profitability.

The Joint and GOGO

While the majority of our holdings rose in value last year there were a few notable disappointments. Among these was Joint Chiropractic. Joint clinics saw a slowdown in patient appointments over the course of 2023. That's said, the company continued to grow its network of franchisees, from which it receives recurring fees. If the company can stabilize patient trends that franchisee network will be worth far more than what's reflected in the current share price. While I sold most of our investment given the weak operating trends, I'm monitoring the company's results for signs of a turnaround. Under the right management I think the Joint has substantial potential.

GOGO was also a notable disappointment this year. GOGO has a near monopoly providing internet services for business and private jets. That profitable business has grown substantially in recent years. However there are some signs that Starlink, which currently provides internet to homes and large commercial jets, will compete aggressively for the business jet market. That concern has grown as Gogo delayed launching its own higher speed internet products, leaving the field open to competition. While Gogo remains profitable and well positioned today, the outlook is cloudier than when I originally purchased shares. In consequence I've sold most of our holding in favor of businesses whose prospects are more determinable.

As always, please contact me with any questions.

Sincerely,

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