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WEALTH MANAGEMENT

Fourth Quarter 2023 Investor Letter

The S&P 500 Total Return Index rose 11.7% in the fourth quarter of 2023, and 26.3% for the year. The Bloomberg Aggregated Bond Index rose 6.8% for the quarter and 5.5% for the year. The beginning of the quarter saw a continuation of the market decline that began in the summer, which we addressed in a special letter last September. After three straight down months, the decline ended abruptly at the end of October and was followed by a ferocious rally that saw the market climb 9 weeks in a row, which was the longest such streak since 2004.

A large portion of the market gains in 2023 were attributable to a small group of stocks which are at the forefront of technology in artificial intelligence. Analysts have estimated that more than 60% of the gain in the S&P 500 was attributable to seven of these stocks. While this may seem like a dangerous situation, history shows it is not unusual for the market to have narrow leadership at the beginning of a new bull cycle. Furthermore, for the past generation, it is primarily technology which has pushed the American economy forward and ahead of its peers.

Review of 2023–Widely Anticipated Recession Fails to Materialize

By far the biggest event of 2023 was something that didn't happen: a severe recession. Recall that at the beginning of the year it seemed like every economist, broker, pundit, billionaire, and strategist was convinced a recession would occur in 2023. Economist Nouriel Roubini wrote an entire book predicting an epic financial crisis and depression. (See our fourth quarter letter from last year.) None of this happened. Instead, inflation declined, unemployment remained low, and the economy grew much faster than expected. In the third quarter of 2023, which should have been when the recession really kicked in, the US economy grew at an astounding rate of nearly 5%!

There are several reasons a recession didn't occur. First and most importantly, inflation declined more rapidly than anticipated as the economy recovered from the pandemic. Second, consumer spending in the US remained strong. A combination of pent-up demand from the pandemic years, cash from the stimulus programs and the seemingly never-ending willingness of Americans to take on debt all fueled an economy far in excess of expectations. Geopolitical factors such as the tragic war in the Ukraine did not have a material impact on the global economy.

In defense of the forecasters who were incorrect, it should be noted that previous episodes of high inflation followed by interest rate increases generally were followed by recessions. The problem was they were basing their forecasts on the historical experience of an economy which is very different from the modern US economy.

As we've written previously, our own view is that the US economy is less cyclical than it used to be, and that this change hasn't been properly incorporated into the way we think about the economy. To illustrate, consider that almost 40% of the economy is now government expenditures (including federal, state, and local). Another estimated 17% is health care. (There is some overlap of these two categories.) Another estimated 15-20% is composed of basic consumer goods and necessities. Here is the important point: *None of these categories are particularly sensitive to interest rates or inherently cyclical*. So, it is very possible that the US economy is less interest rate sensitive than is generally believed.

Technological innovation is another overlooked but very important factor in explaining the strong economic performance in the US. This insight is not new. In 1957, MIT economist Robert Solow wrote an article which showed that the traditional economic factors of labor and capital did not sufficiently account for economic performance. An overlooked factor, Solow showed, was technological progress. Countries which saved and invested in new technologies consistently had higher growth than countries which didn't make such investments. While the impact of technological advancement may be hard to measure quarter by quarter, it is very likely that previous investments in areas such as computer and medical technology are an important driver of current US growth. In the same way, today's investments in areas including artificial intelligence, genomics, electronic vehicles, and quantum technologies may be expected to drive growth in the future. For his insights, Solow was awarded the Nobel prize in economics in 1987. Thanks to an economist friend in California for highlighting Solow's work to us.

All that said, some parts of the economy are interest rate sensitive. Housing has been impacted by rising mortgage rates and other industry specific factors, although housing starts have been surprisingly strong, and homebuilders are doing very well. Purchases like cars and other consumer durables have been impacted by higher rates.

Saying that the economy is less cyclical than before is not saying there are no risks. A financial crisis, pandemic, government debt crisis or other unforeseen event could still trigger a severe economic slowdown.

Temperament Makes Good Investors

"If I could hire one of the top five graduates of the top three business schools, or my choice was somebody that was bright, but had Chapter 8 of the Intelligent Investor…they had it in their bones, I'd take the person from Chapter 8."   --Warren Buffett

We recently came across this quote from Warren Buffet. (The book he is referring to is the classic *Intelligent Investor* by Benjamin Graham.) While we read *Intelligent Investor* years ago, we didn't remember specifically what Chapter 8 was about, so we went back and reread it. Essentially Chapter 8 is about the temperament required to be a good investor. While the traits that author Benjamin Graham talks about are particularly important for people who invest for a living, they really apply to anyone who has investments in financial markets.

The most well-known part of Chapter 8 is Graham's famous story of the fictional investor known as Mr. Market. Mr. Market is a very excitable investor who on any day is willing to buy or sell shares of stock. On some days he is very optimistic and willing to buy at high prices. On other days he is depressed and wants to sell no matter how low the price. The important thing is that other investors do not need to buy or sell from Mr. Market. They are free to do nothing until Mr. Market offers a sufficiently low price to buy or a sufficiently high price at which to sell. Thus, the investor who can avoid making emotional decisions like Mr. Market can turn market volatility in his favor.

Taking the emotion out of investing is not easy, even for best practitioners. In our letter from the second quarter of 2021, we highlighted how Buffett and another great investor Howard Marks agonized over making buy decisions during the pandemic. They are as human as everyone else. The thing that sets them apart is their ability to make good decisions even when it is hard.

The point of reviewing these old examples is to remind investors that the same cycles of too much optimism and too much pessimism repeat themselves over and over. A clue to when you are seeing this is when a reporter or expert takes a single piece of data and extrapolates it to the best or worst-case scenario. A little inflation? It's the 1970s again, or maybe pre-war Germany. Inflation falls or prices drop? We are headed for deflation and probably a depression. In almost all these cases, the best or worst-case scenario don't materialize.

In the case of the worst-case scenario, one reason it usually doesn't unfold as expected is because there is almost always a reaction to it, and in many cases the reaction may be as important or more important than the event itself. Consider the recent pandemic. When it started the big fear was of an economic collapse. One expert on television called for shutting the entire world down for 30 days. In response the Fed cut interest rates to zero and the US government sent trillions of dollars into peoples' checking accounts. Within a few months the concern had gone from an economic collapse to an economy which was overheating and suffering from inflation. The big story in term of the economy had shifted from the event itself to the impact of the reaction to the event.

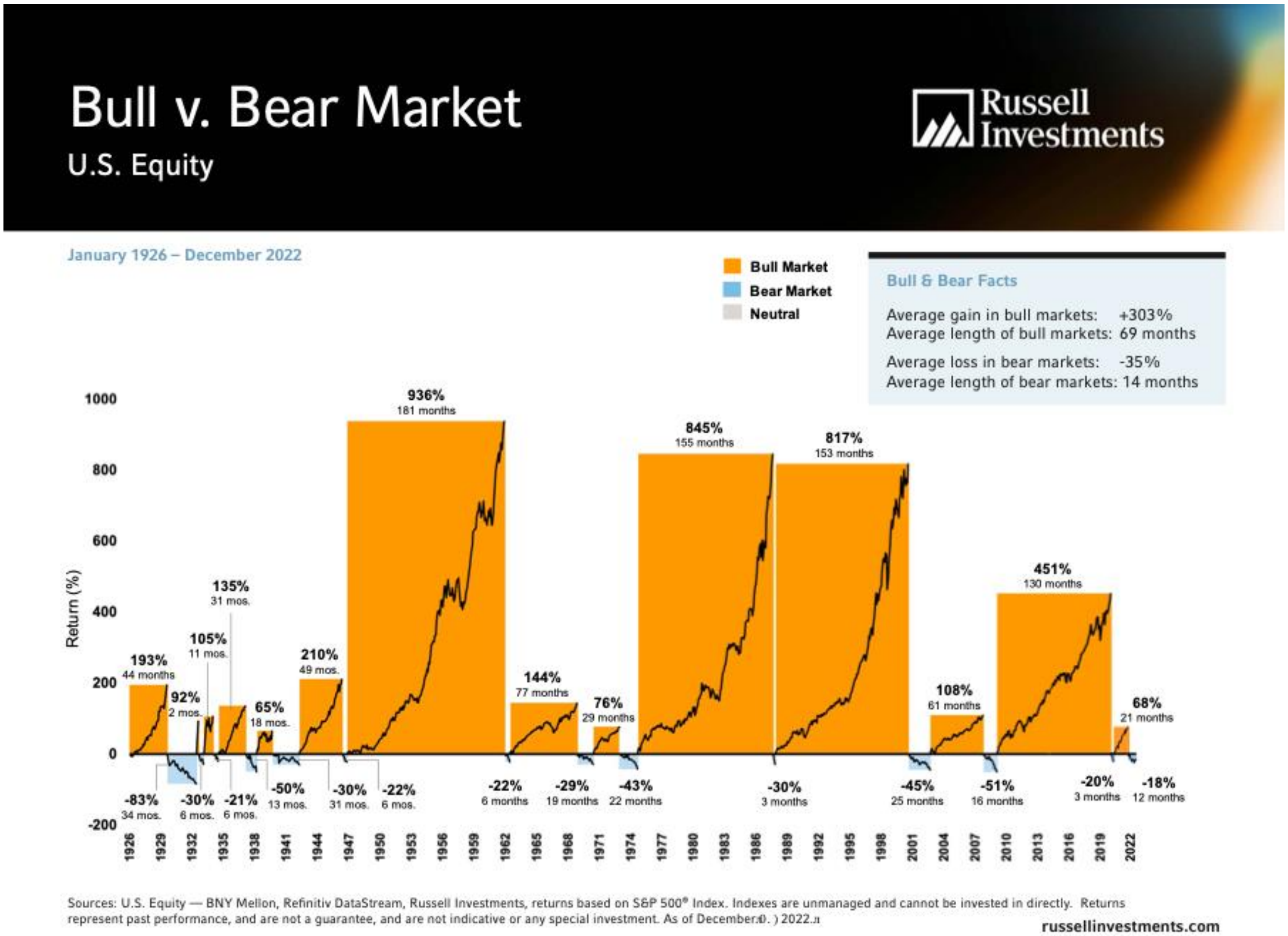
Charles Munger 1924-2023

Charles Munger, vice chairman of Berkshire Hathaway, passed away in November at the age of 99. Munger was a lawyer by training but found early success as an investor, managing a highly successful investment partnership in the 1960s and 1970s. He is, of course, best known as Warren Buffett's partner, and the person who urged Buffett to transition from his focus on buying assets purely based on their discount to current value to buying stocks in outstanding companies which could grow for many decades. Buffet credited this change in investment philosophy as the reason Berkshire was able to achieve its astounding long-term success. Munger was known for his keen insights and sharp sense of humor which he often used to comment on topical issues. Asked once about his view on cryptocurrencies, he said "the country does not need a currency that is good for kidnappers." His philanthropic interests included education, architecture, and medical and scientific research.

Is this a New Bull Market?

After the strong market performance last year, investors might wonder if all the gains have been made and it is time to be more defensive. While it is impossible to say with certainty, history would not support this view. As the following chart shows, since 1926 the average length of a bear market has been 69 months. By most measures the current bull market started in June 2023, so if the past is of any value as a predictor, this one still has a way to go. We recall that after the financial crisis in 2008, the stock market staged a rally in the first half of 2009. Experts at the time worried that all the gains had been made and that it was too late to get into the market. It should be noted that the Dow Jones average at that point stood at 8,500, compared to today's level of 37,000. Investors who remained out of the market missed a stock market rally of more than 300%. This is just a reminder that historically, investors have done better being in the stock market than regretting that they missed the mythical "perfect" buying opportunity.

The following chart from institutional consultant Frank Russell shows how bull markets have historically been longer and of greater magnitude than bear markets.



Thank you as always for being a client. Please feel free to call Roger or me anytime.

Best Regards,

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