Investor Letter
First Quarter 2024

Market Review

Financial markets performed well in the first quarter, continuing their strong performance since the market low in October 2022. The S&P 500 Total Return Index rose 10.6% and the Barclays Aggregate Bond Index declined .8%. Growth stocks, led by high profile Nvidia were the best performers during the quarter, rising 10.9%. Value stocks rose 9.6% and dividend payers rose 8.3%.

Many investors have expressed concern that a few large tech stocks have accounted for much of the equity market gains during the recent run up. This is a reasonable concern since previous stock market bubbles have often been led by a small group of stocks which captured investors' imaginations due to a new technology or rapidly expanding market. The excitement around artificial intelligence (AI) feels to some investors like one of these periods.

That said, it is important to note that narrow stock market leadership is not always an indication of a bubble. In other cases, it reflects a significant transition in our economy from one period to another. This has been seen in the past as the US transformed from an agricultural to industrial economy, and then from an industrial to an information economy. The US economy is in such a transformative period now as rapid changes in fields such as artificial intelligence upend virtually every sector. Winners during this period may be companies supplying AI products as well as companies who successfully implement AI into their businesses. Some companies will get it right and prosper during this period, some will do poorly, and a few will not be affected at all. Early on, it is inevitable that a few companies will capture investors' hopes and dreams about a new technology. This whole process can be another cause of narrow stock market leadership.

Markets do a very good job at navigating transitions in our economy, but in practice the process is still complex and messy and will always to both good and bad surprises. Excited experts and analysts may overestimate the *short-term* impact of a new technology such as AI, leading to burst expectations when a company reports a disappointing quarter. At the same time, the same experts and analysts will often underestimate the impact of a new technology over the *long-term*, which creates great buying opportunities when short-term disappointment set in. Recall for example the excitement over the internet in the late 1990s which was followed by the huge decline in tech stocks from 2000-2003. Were investors in the 1990s too optimistic about that impact of the internet? In the short run maybe so. In the long run, however, almost nobody forecast the transformative impact that the internet would have on the economy. Importantly, the long-term winners in most cases were not the early dot.com stocks which attracted attention, but companies which created durable business models and came to dominate the markets they served. The same will almost certainly be true in the age of AI.

Interest Rate Reductions

After the significant increase in interest rates in 2022-2023, the Fed has signaled that it will cut interest rates at some point this year. Most forecasters estimate that there will be 2-3 rate reductions later in the year, and financial markets are to some extent pricing in such moves. As JP Morgan chairman Jamie Dimon recently pointed out, it is not clear why rate cuts are necessary at this point, and there is some chance that the Fed will decide to hold off.

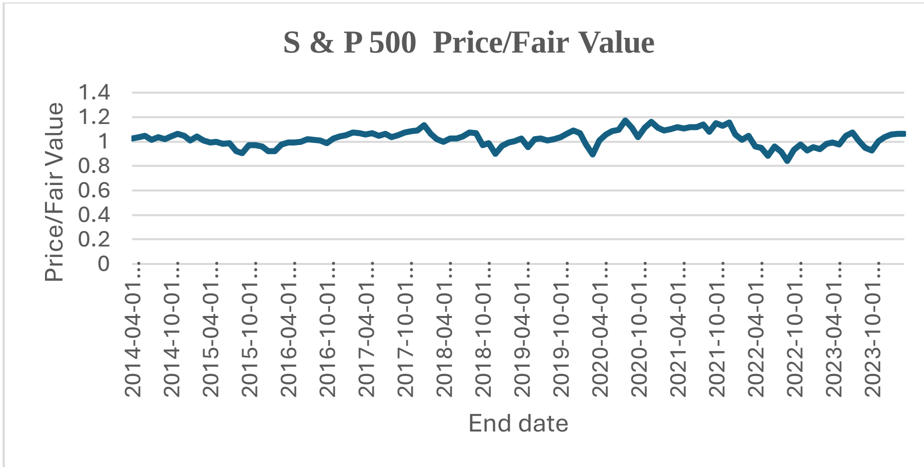
There are several reasons to hold this view. First, while inflation has come down significantly, it still has not reached the level the Fed would like. Second, the US economy remains incredibly strong, and higher inflation is still a risk. It seems like the previous Fed chairman would have considered it a mistake to cut interest rates with unemployment near 3%. Third, the US budget deficit has an expansionary impact on the economy, and so it is reasonable for the Fed to have a monetary policy which is mildly contractionary to balance it out. Finally, with an election this year, any rate cut will be looked at as political to some extent, which is something the Fed presumably wishes to avoid. If the Fed were to hold off on rate cuts, it could cause a market decline.

The expectations for interest rate cuts were reduced on April 9 when the inflation report for March was released and was slightly above expectations. It is likely that there will be both positive and negative surprises on inflation in coming months. Investors shouldn't overreact to either.

Valuation

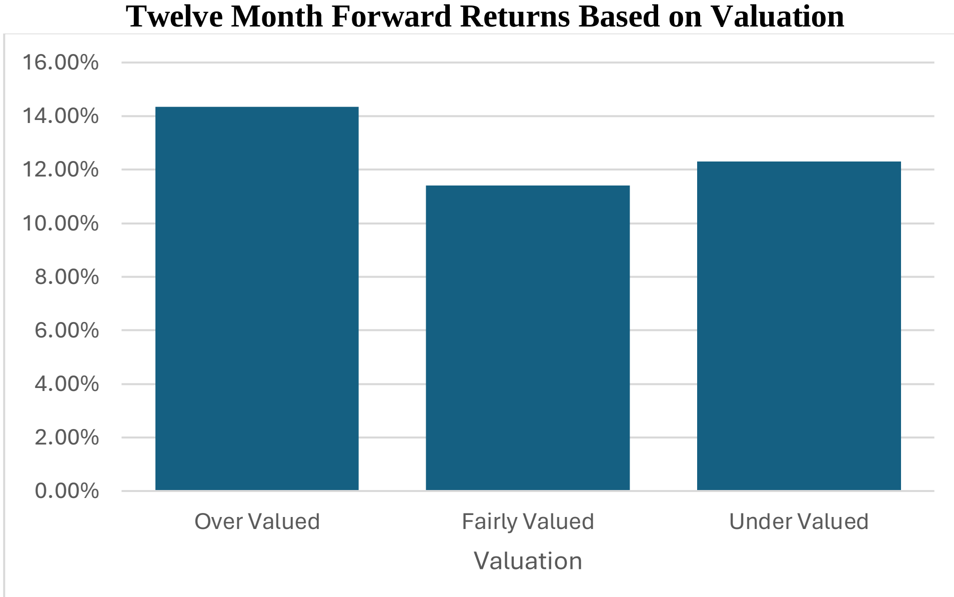
So after the big run-up in the stock market, is it overvalued? One of the most common valuation measures is the Case Schiller Cyclically Adjusted P/E ratio, or CAPE. This ratio is currently 34, which is higher than average over the past 25 years, and significantly higher than the average over the 140 years of data for which the index is available. (Our view is that, given the significant changes in the US economy over the past several decades, the more recent data is more relevant.) Other valuation metrics we use show the market trading around fair value overall. Obviously, all measures of market value show a significant disparity in valuation between large cap tech stocks and the rest of the market.

All that said, when thinking about valuation there is another important factor to consider which is often overlooked by market participants. Research shows that, except under extreme circumstances, *valuation turns out to be a poor predictor of future market performance*. In fact, data for the past ten years (the longest period available) show that markets may actually perform better when they are overvalued than when they are undervalued. The following graph from Morningstar shows the level by which the S&P 500 has been over or undervalued since 2014.



As you can see, the market generally oscillates between about 10% undervalued and 10% overvalued. One might think you could develop a successful strategy of simply buying the market anytime it is undervalued and selling it anytime it is overvalued. Unfortunately, one would be wrong, as shown below:

Twelve Month Forward Returns Based on Valuation



The chart above shows the actual returns for the next 12 months for an investor based on whether he or she bought when the market was undervalued, fairly valued or overvalued. Look carefully at the results. Somewhat surprisingly, the market performed better when it was overvalued than when it was undervalued. Does this mean that valuation does not work as an investment metric, or that the premise of buy low and sell high is wrong? No, it does not. A better interpretation is that valuation becomes important when it is at extreme levels (either high or low) and that the rest of the time it doesn't make much difference. Most of the time the market moves in trends. During the past 10 years the market was in an uptrend (as it usually is) which continued even when it reached levels that were expensive.

Western Pacific tracks the valuation of our clients' portfolios. Most of the time these valuations are within the normal range. During such periods, we do not make significant adjustments to portfolios based on valuation metrics. It would only be at extreme levels that we would use this data for making shifts in our clients' portfolios.

Why We Use Outside Investment Managers

From inception, Western Pacific has had a philosophy of seeking the best outside investment managers for our clients' portfolios. The reason is simple: this approach is best for our clients. Our experience over many years has been that the best investment results come from investment with firms which share a few key characteristics:

- Well defined investment philosophy
- Ability to attract and retain great talent
- Reasonable fee structure
- Independently owned

We spend considerable effort to identify firms with these qualities, and then monitor them closely. We speak to our managers regularly and meet with them in person when possible. We track their performance, organizational changes, portfolio changes and portfolio characteristics. Our research is designed to ensure that our clients' funds are invested with the best investment firms available. Importantly, this is the same portfolio construction philosophy used by institutional investors. In fact, all the managers we invest with also manage significant investments for large institutions.

Thank you as always for being a client.

Best regards,

William R. Andersen, CFA
Principal and Chief Investment Officer