January 2, 2024

Dear Clients and Friends:

In 2011 Sequoia Capital, a prominent venture capital firm that most recently earned notoriety for backing FTX and its now-convicted founder, Sam Bankman-Fried, invested a total of $60 million for a 19% stake in WhatsApp, a pre-revenue social messaging app. Three years later, WhatsApp was acquired by Facebook for $19 billion, generating a return of more than 50x for Sequoia's investors.[1] At the time of the Facebook acquisition, WhatsApp had become the most widely used messenger app in the world with 450 million users – many from Latin America, India and developing countries, who adopted the service to bypass the cost and inefficiency of traditional international calling services.[2] While WhatsApp's technology enabled this growth, demand was rooted in powerful economic and demographic forces, only now starting to reshape the environment for investors.

Understanding these factors will be among the challenges facing investors in the years ahead. Meanwhile, many investors seem lulled into complacency by an unexpected stock market rally and gravity-defying valuations for the largest U.S. technology companies. A reckoning awaits investors accustomed to returns higher than historical averages since the 2008-09 recession.

"Crowd folly, the tendency of humans to resemble lemmings, explains much foolish thinking" (Charlie Munger)

An adage in investing is to be contrarian, to question consensus and commit capital to undiscovered opportunities. It sounds easy but psychology in markets is a powerful force, causing investors to sell stocks after a market correction or buy the most widely owned (and expensive) companies at their peaks. Paraphrasing James Grant of *Grant's Interest Rate Observer*, to argue that markets are efficient is "to forget that people have burned witches, gone to war on a whim, risen to the defense of Joseph Stalin and believed Orson Welles when he told them over the radio that Martians had landed." As ever more investors flock to market cap-weighted index funds, the important mechanism of price discovery, exercised by informed investors, becomes less precise – ironically, giving value investors opportunities to go where the herd isn't.

In our letter one year ago, we predicted a strong year for stocks in 2023, supported by a robust economy, declining inflation and low valuations arising from near-uniform pessimism among strategists and investors. The consensus view, by contrast, was that the U.S. would enter a recession in 2023, driven over the cliff by the Fed's most aggressive tightening program since 1980.[3] Share prices, many believed, would fall as investors came to grips with persistent inflation and declining earnings, and sought safety in cash and bonds which, conveniently, offered real yields for the first time in years. The pessimists were wrong: consumers kept spending, unemployment remained near record lows and the Dow Jones Industrial Average hit an all-time high, gaining 13.7% for the year (16.2% including dividends). Turbocharged by seven mammoth technology stocks, the S&P 500 soared 24.2% (26.2% including dividends), trouncing the 5.5% return of the Bloomberg U.S. Aggregate Bond Index.[4]

[1] https://www.wsj.com/articles/BL-DGB-32973
[2] https://www.bloomberg.com/news/features/2020-12-09/facebook-fb-plans-to-turn-messaging-app-whatsapp-into-a-moneymaking-business
[3] https://fred.stlouisfed.org/series/FEDFUNDS
[4] Bloomberg

Buoyed by rising prices for most asset classes, many pundits expect a “soft landing” for the economy, believing the Fed has pricked the inflation balloon without causing a recession or high unemployment. Uncertainty – a misleading, over-used word by investment strategists – seems to be ebbing in a tide of optimism. Look closer, however, and the risks are elevated.

“Uneasy lies the head that wears a crown” (William Shakespeare, *King Henry IV*)

Companies topping the list of the world’s largest by market capitalization seldom stay there long. Consider Japanese banks in the 1980s or GE, Intel and Nokia in the 1990s. It is hard to know what unseen tremor will topple the likes of Apple, Meta and Nvidia – along with four other technology stocks, the “Magnificent 7” – but expecting them to generate superior returns from here seems farfetched. These seven stocks now represent 28% of the market capitalization of the S&P 500 and accounted for 60% of the market’s return last year.[5] Incredibly, their aggregate market value exceeds that of the Japanese, Canadian and U.K. stock markets, combined. Shares of Nvidia, for example, returned more than 230% in 2023[6] as its earnings estimates soared on demand for artificial intelligence chips. At the other end of the growth spectrum, Apple recorded its fourth consecutive quarter of negative sales growth vs. the prior year[7] and yet remains the world’s most valuable company with a market capitalization of nearly $3 trillion and a valuation of 28x forward earnings.[8] Such rarefied air leaves little margin for error, making the largest and most successful technology stocks vulnerable to earnings shortfalls or adverse macro events.

Mediocre prospective returns exist for companies outside the largest technology stocks too. An analysis by AQR Capital Management argues that equity returns for the S&P 500 in the decade ahead will fall short of returns experienced by investors in the past decade. The analysis cites the current valuation of the S&P 500 – an historically high 30x trailing average 10-year profits – and the near impossibility of sustaining above average earnings growth in an environment of high interest rates.[9] A reversion to the mean in p/e multiples or earnings growth (or both) seems likely, and either would hamstring shareholder returns. Even a mild recession in the U.S. brought on by the lag effect of the Fed’s rate increases last year would cause earnings to fall, making current stock prices appear even more expensive.

While valuation poses an immediate challenge to higher share prices, investors would be well advised to consider risks not readily apparent in market statistics. Attacks by Iran-backed Houthi militia on shipping lanes in the Red Sea through which approximately 15% of global trade is transported[10] are causing sharp spikes in freight and insurance rates, stressing supply chains and potentially slowing global economic growth. Peace in Ukraine and Gaza seems far off, and both wars may ignite wider conflicts in their regions or beyond. Economic and strategic rivalry between China and the U.S. seems certain to intensify. Meanwhile, according to the *New York Times*, 50 countries including India, the U.S. and European nations, collectively accounting for 60% of world economic output, will hold elections in 2024 with implications for trade, industrial policy and great power relations.[11]

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[5] Bloomberg
[6] Bloomberg
[7] Company Filings and Bloomberg
[8] Using Bloomberg's 12m Forward Consensus Estimates
[9] AQR, Driving with the Rear-View Mirror by Jordan Brooks
[10] https://www.whitehouse.gov/briefing-room/statements-releases/2024/01/03/a-joint-statement-from-the-governments-of-the-united-states-australia-bahrain-belgium-canada-denmark-germany-italy-japan-netherlands-new-zealand-and-the-united-kingdom/#:~:text=Nearly%2015%20percent%20of%20global,world's%20liquefied%20natural%20gas%20trade.
[11] https://www.nytimes.com/2023/12/24/business/economy/global-economic-risks-red-sea.html

Finding value outside the most widely owned stocks

Neither valuation nor macro events correlate precisely with equity returns; it is possible that stocks can rise from elevated levels even as economic and geopolitical headwinds gather. A burst in productivity led by innovations in artificial intelligence or revolutionary medical therapies, for instance, could extend above-trend earnings for some time. But a reversion to modest earnings growth seems overdue.

In the slower-growth environment we envision, it is worth considering smaller stocks available at steep discounts to the largest stocks in the S&P 500. U.S. and international companies addressing global markets also offer attractive opportunities. The MSCI World ex USA Index, including the largest non-U.S. companies, trades for 13.7x forward earnings, significantly below the 19.7x multiple for the S&P 500. For the past 10 years, international stocks have lagged the U.S., with the FTSE 100 Index recording a total 10-year return of 67% vs. 211% for the S&P 500. Emerging markets have done even more poorly with the MSCI Emerging Market index returning 35% for the period. Investors should expect this performance gap to narrow.[12]

While our investable universe is limited to the securities of investment grade issuers in the U.S. and developed international markets, it is worth considering the demographic and economic factors that could drive global markets higher in the years ahead. Consider that the U.S., with 4% of the world's population,[13] accounts for 25% of global economic output and more than 40% of the world's equity market capitalization.[14] At the other end of this continuum lies Africa, home to nearly 1.5 billion people[15] (and encompassing 20% of Earth's land area),[16] accounting for less than 3% of global GDP.[17] This imbalance is bound to narrow as demographic trends and technological innovation create opportunities for companies and consumers. A case in point is the money transferring service, M-Pesa, an app comparable to Venmo that enables consumers, including the many Africans without bank accounts, to obtain credit and store and transfer funds using their cell phones. As WhatsApp transformed communication for many people outside the U.S., so too are companies like M-Pesa planting the seeds for economic growth in countries with the largest populations and youngest average ages.

Closer to home, bonds have finally become investable for clients who require income or a hedge against stock market volatility. In most of the past 15 years the equity risk premium (S&P 500 forward earnings yield vs. 10-year U.S. Treasury yield) has been close to 4.0%, considerably higher than the current level of 1.2%.[18] A higher equity risk premium generally means stocks are more attractive than bonds, whereas a lower figure implies the reverse as investors are less well compensated for owning stocks. Relative to inflation, bonds are also attractive as the *real* yield on the 10-year Treasury note is 1.7%.[19] Because the yield curve remains deeply inverted (i.e., short term rates are higher than long term rates), we believe laddered bond portfolios, favoring maturities up to 5-7 years, offer the best risk vs. return profile for most investors. In our view, long term bond yields have risk to the upside (i.e., rates

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[12] Bloomberg
[13] https://www.worldometers.info/world-population/us-population/
[14] World Bank data gathered from Bloomberg.
[15] https://www.worldometers.info/world-population/africa-population/
[16] Sayre, April Pulley (1999), *Africa*, Twenty-First Century Books. ISBN 0-7613-1367-2.
[17] World Bank data gathered from Bloomberg
[18] Douglass Winthrop Advisors analysis of data gathered from Bloomberg
[19] Bloomberg

could rise, sending bond prices lower) as the U.S. faces deep fiscal deficits that will require heavier bond issuance in the years ahead. For many clients a balanced asset allocation is worth considering.

Firm update

Our challenge as portfolio managers is to steward our clients' capital with care and insight, aiming to maximize risk-adjusted returns tax efficiently and with a fiduciary mindset informed by thoughtful wealth management advice. Reflecting on our 24-year history, we note that comparatively few companies have accounted for most of our returns, including Apple, Costco, Mastercard, Alphabet, Fastenal, Deere, Martin Marietta Materials and Berkshire Hathaway. The attributes shared by these companies, including wide economic moats, leadership in large addressable markets, pricing power, high returns on invested capital and management teams that seek to grow intrinsic value per share, are integral to our portfolio companies now and in the years ahead.

As we dedicate ourselves to continued excellence in investment and wealth management, we have an advantage not available to our competitors: our exceptional colleagues. This year, we are pleased to admit three new partners: Cody West, Zelle Richardson and Evelina Khorenko, bringing our partnership to 19 people and adding new perspectives and talents to the excellent work they have been doing on behalf of our clients in trading, wealth management and compliance, respectively. We also welcome our newest colleagues, Michael Marciante, Elise Tursi and AnnMarie Felle, who join us in equity research and client relations. Our partner, Mary Kush, has decided to leave the firm to pursue other opportunities and we wish her well as she begins a new chapter. Finally, we are expanding our leadership team by forming an Executive Committee comprised of the three managing members and Bryce O'Brien and Josh Huffard.

For our clients, please see the enclosed wealth management update. We are grateful for your support and send you our warmest wishes for a peaceful and prosperous new year.

Sincerely,

Douglass Winthrop Advisors