Q4 2024 Investment Update

Current Observations

The **ECONOMY** has defied conventional wisdom—so far—by not buckling under the weight of higher interest rates. Of course, current rates at 4%-5% aren't that high. Nevertheless, interest rates are the magic elixir that helps to make the economy go—or not go. Lower rates stimulate activity. Higher rates slow the economy. Usually. In the current environment the U.S. continues to run enormous budget deficits that provide extra stimulus to spending. Current estimates are deficits will be 5-7% of GDP over the next decade without any changes. Inevitably we'll have an economic downturn, also known as a recession. We preach—frequently!—that predicting the SHORT-TERM direction of the economy is a fool's game. Predictions about the short-term aren't useful in making long-term decisions.

Since the Covid-19 shock, **INFLATION** has been front and center for consumers, businesses, and therefore, politicians. Consumers are paying higher prices for gasoline, food, rent, mortgage payments, home and auto insurance, and just about everything else. The good news is inflation has receded significantly from a high of 9% to the current ~3.0% level. Paychecks have lately been increasing at rates above inflation, giving consumers some relief. However, higher pay also contributes to higher inflation. Regardless, the Federal Reserve still feels it has room for additional rate cuts over the next year or so.

INTEREST RATES play a vital role in investment, financing and consumption. Think cars, factories, homes, business equipment. The Fed has been reducing rates since September 2024 so it's still early in the process. Short-term rates have dropped about 1% since then, but a robust economy and recent stubborn inflation numbers are causing the Fed to consider hitting the pause button. Most observers had expected short-term rates to decline another 1% from the current 4.25%-4.50% range, but now it's less certain how much further rates will decline. It depends on the inflation trend over the coming months. Lower inflation leads to lower rates which stimulates spending on big ticket items such as homes, cars, business equipment and factories along with general consumer spending. The Fed has a balancing act of providing enough stimulus without igniting another strong bout of inflation.

One new wrinkle in the picture is the impact of incoming Trump Administration policies. While we can't predict exactly what will happen, we recognize that presidential policies can have an impact on many areas of our lives, and we'll provide our thoughts on the major elements a bit later in our letter.

Overall, our best guess is that the economy will continue to grow slowly with further modest interest rate declines providing some support and inflation continuing to moderate. But it's not a slam dunk certainty.

FINANCIAL MARKET CONDITIONS

Despite the dire warnings of numerous market pundits, the **STOCK MARKET** continues to progress upward, in its usual pattern of advances and declines. Market timers who thought they were smart enough to exit the market given challenging news on inflation, interest rates and multiple geopolitical conflicts are likely kicking themselves if they are still sitting in cash. Remember, ya gotta be in it to win it.

It's such an easy thing to talk about…yet difficult for so many investors to practice. We're talking about a LONG-TERM approach:

- Creating an investment plan based on your personal goals
- Selecting an appropriate asset allocation to meet those goals
- (Most importantly) sticking with the plan through the ups and downs that inevitably—always—occur over many years.

While we believe that market timing doesn't work, we also believe that at times the market can get too pessimistic, and too optimistic. We believe that certain areas of the stock market are today exhibiting what we'd call "**BUBBLE-LIKE**" too-optimistic tendencies. Investor enthusiasm for future stock market gains has in some cases wildly exceeded the abilities of some companies to meet extremely lofty expectations. **Artificial Intelligence** (A.I.)—which we think has enormous potential and we'll discuss further in a moment—and **Cryptocurrencies** are a couple of areas today where short-term hope might be exceeding long-term reality. In our humble opinion.

These bubble periods seem to occur every 10 to 15 years, after investor memories have been wiped clear of the previous disasters. Our mission in managing your capital is to steer clear of companies where excessive optimism has outpaced likely long-term realism. While this approach can result in lower short-term appreciation, it's designed to help you avoid long-term pain and regret. We've lived through prior periods of rampant speculation, and it never ends well.

FIXED INCOME investments certainly look better now that interest rates are higher than they have been in many years. It's much easier for us to find higher levels of income in relatively attractive fixed income investments. Our focus is shorter-term maturities in case interest rates rise instead of decline. Since fixed income generally fluctuates less than the stock market these holdings can provide a buffer during particularly volatile economic and financial market conditions.

CASH holdings are no longer "trash" since money market yields are over 4% today compared to near 0% just a couple years ago. In this environment we don't mind having a little extra cash on hand as it's generating a decent yield while we wait for attractive investment opportunities. As short-term interest rates decline in line with Fed policy, we'd expect money market rates to decline, so keeping large amounts in cash isn't an advisable long-term investment option.

OTHER CURRENT TOPICS

While our investment focus is still centered in the United States, what's occurring outside of our borders has important implications for our domestic economy and increasingly, our long-term national defense.

Politics is an important component of our investment decision making. What happens in China, other parts of Asia, the Middle East, or Europe can have multiple direct and indirect impacts on our economy and living standards. In our opinion, the world is now at its most complicated and dangerous point since World War II. And likely to stay that way for now. Buckle up and wear a helmet.

The Trump Administration is hitting the ground running both in the United States and around the globe and should continue over the next 18 months. The administration wants to get as much done as possible before the midterm election cycle begins next Summer. Since Trump doesn't have to worry about reelection, it's possible he'll be emboldened to act more forcefully than a politician worried about another election. Something to consider.

We've already seen comments about Trump wanting to buy Greenland, make Canada the 51st state and take back control of the Panama Canal. Stay tuned for what is likely to be a lively political environment with potentially positive and negative surprises. We think Trump is a negotiator and will stake out maximum U.S. positions as a starting point.

The most consequential policy changes likely include **TARIFFS** to renegotiate trade agreements. Given the unfair trade policies of some of our trading partners we don't disagree with the Trump administration's tough talk. Many countries use government subsidies such as grants, cheap loans, donated land, bureaucratic "red tape" for competitors and other methods to tilt the scales in their favor. The biggest risk is that tariffs can drive up prices and inflation, putting upward pressure on interest rates.

We also expect major **IMMIGRATION** policy changes including border crossing restrictions and deportations. We support sensible immigration policies, not an unrestrained border free-for-all. However, while our immigration policies need reform, the impact could be reduced labor availability in agriculture, construction, restaurants and other service-oriented areas—and higher wages, another pressure point for higher inflation.

TAXES are another area of potential change. Trump will attempt to maintain some tax cuts while reducing other taxes and offsetting those tax cuts with spending cuts. Cutting spending will be a challenge. Most spending is mandatory, not discretionary, so it will require a Herculean effort to cut $trillions of dollars from the U.S. Federal budget. Most observers, including us, believe that all levels of government don't spend funds wisely, and broadly speaking, taxes are everywhere you look. We wish the Trump Administration good luck tackling this beast.

We'll be watching the policy changes to come for signs of positive and negative impacts. It's difficult to handicap what's going to happen and what the global effects of those changes might be. Remember we say, you can't predict but you can prepare. We'll be watching closely and preparing as best we can.

CHINA remains our biggest long-term geopolitical concern. It's a large nuclear power with global ambitions to reorder the world. Oh, it's also run by a dictatorial regime with strong ideological beliefs—in the effectiveness of dictatorships. Combine that with China's partnership with other dictatorial regimes, Russia, Iran and North Korea (CRINK), and the stage is set for global strife, unrest and conflict. It's Dictators versus Democracies for the foreseeable future. Whatever your views of the Trump administration, at least they're taking a proactive stance in confronting the march of Dictatorships around the world. We hope World War III isn't on the horizon.

A new President will result in changes as we've discussed. However, ***over the longer-term stock markets measure business results***. Remember we invest in living, breathing businesses, not pieces of paper. The stock market very effectively separates the business winners from the losers over the years. If we look at various administrations, we find that whether the presidency is in Democrat or Republican hands, the stock market tends to make forward progress either way:

President	Return
Carter	12.0%
Reagan	15.1%
Bush 1	14.6%
Clinton	17.5%
Bush 2	-4.5%
Obama	16.3%
Trump	16.3%
Biden	12.7%

Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.
*Presidential Term measured by Inauguration dates.

We don't want to leave the impression that the world is falling apart. Yes, consuming the news might make it seem that way at times. Remember, the news industry needs your eyeballs or ears to sell advertisements and survive. Despite the often-negative headlines progress is occurring, often quietly, every day in the world. Let's look at one example.

ARTIFICIAL INTELLIGENCE, or A.I., is a big development. While we are far from technology experts, we think it's possible that A.I. will be a significant game-changer for the global economy in the relatively near future, say over the next 3 to 5 years.

A.I. is machine learning based upon massive data that's ingested by superfast computers that use tens of thousands of incredibly powerful semiconductors with each semiconductor consisting of 200 billion+ transistors and massive memory banks to "learn" about relationships between trillions of bits of data. A.I. is made possible and economical because semiconductors have become so powerful that they can process enormous amounts of data. The simplest example is feeding 100,000 pictures of a cat to the computer. The computer learns what a cat looks like, so the next time a cat picture is presented, the computer recognizes it. But A.I. is much more than recognizing cat photos.

We've been experimenting with A.I. via a subscription to ChatGPT. We want to learn more about its capabilities, and eventually use the system to inform our investment decisions and perhaps make our business more effective for you, our clients. Below is an illustration that we asked ChatGPT to create. We didn't type a command, but rather used a spoken command to create an intersection with the roads labeled as shown. While it took 5 or 6 tries, eventually we got what we asked for. It took only 5 minutes. A simple example, but the capabilities of this technology are likely to grow exponentially:

A.I. is likely to improve business processes, education, healthcare, legal and financial services and just about every aspect of modern life. Some observers believe the impact will rival the inventions of the steam engine, electricity and the personal computer. While there will be some job losses—think call center employees who are replaced with an A.I. "agent"—the history of the U.S. is innovation always results in new job opportunities. Farming required almost half the workforce around 1900, while today's machinery and modern methods means roughly 2% of our workers are now needed in agriculture. In addition, some jobs will be assisted by A.I. such as teachers who will utilize the technology to assist in the important task of educating the children who will be our future leaders.

A.I. should help with our aging workforce and worker shortage while boosting workplace productivity, both leading to higher standards of living for all Americans.

U.S. EXCEPTIONALISM

We'll remind you again why the United States continues to outperform so many other countries in economic terms. We're not overly optimistic cheerleaders, but rather rational observers of what we believe are certain obvious truths.

The U.S. has some incredible advantages. Let's list a few, although this isn't an exhaustive list, and you might include some others:

Our educational system is world class, particularly in higher education. Yes, we need to improve our grade schools and high schools, but the U.S. continues to be an education magnet globally, feeding our innovative technology industries, entrepreneurial culture, robust venture capital and business formation. A.I. will likely make us stronger here.

In previous letters we've discussed China's declining population, and Russia is also shrinking. We don't see many people clamoring to enter

China or Russia. The U.S. continues to exhibit **POPULATION GROWTH**, and a growing population leads to a larger, stronger, higher-growth economy. Importantly, a prosperous economy provides the economic resources to protect our country and defend against foreign threats. The U.S. won World War II because we had the industrial capacity to provide weapons and equipment in sufficient quantity to defeat the Axis powers. Without a strong American industrial capacity during WWII, we'd perhaps be speaking German today. The bottom line? Economic strength fosters military strength.

Our **LEGAL SYSTEM** has created a relatively predictable environment where citizens and businesses can expect the rule of law to prevail. Cue the lawyer jokes!

We also benefit from our **GEOGRAPHY**. We have oceans on both sides, protecting us from would-be aggressors. Yes, this is less of a benefit in a nuclear world. Regardless, we have two friendly nations to our south and north. Yes, Mexico could be doing more to secure the border and stop the drug flow into the U.S. Canada could spend more on national defense. However, it beats having China or Russia on our doorstep.

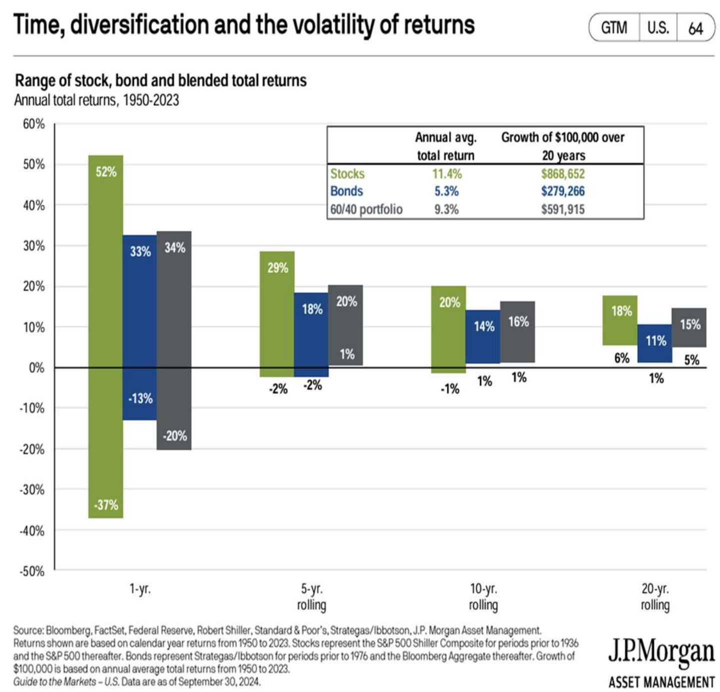
We also have some of the most **FERTILE FARMLAND** in the world. Not only are we self-sufficient in food, but we are also largely energy independent today given our large oil and natural gas resources and production.

We often ask ourselves, "***where else in the world would we want to live if we could live anywhere***?" Very few alternatives come to our minds.

Let's conclude with some important long-term investment ideas.

We think it's helpful to periodically remind ourselves that investment progress comes ONLY over long periods, as the short-term fluctuations of the economy and markets tend to be smoothed over time. The chart below demonstrates that ***as you extend your investment time horizon, the probability of earning a positive return increases***.

In simple terms, anything can happen over one year, whether it's big gains or big declines. As you extend out to 5-, 10- and 20-year rolling periods, we've seen positive results in just about every period under consideration since 1950. Something to remind yourself the next time the financial media talking head screams at you to dump your investments. That's a road to financial disaster, in our opinion. The other important consideration is that your nest egg will be inherited by children, grandchildren, relatives or charitable organizations, so the lifespan of your funds is very likely measured in years if not decades beyond your own lifetime.



And finally, this chart reminds us that progress never occurs in a straight upward path. But investors have been rewarded over time despite enduring numerous but inevitably **SHORT-TERM** crises, pandemics, natural disasters, recessions, political upheaval, rising interest rates, wars, terrorism, market declines, inflation, deflation, etc.

The stock market has historically provided **above-inflation returns**—which means real, after inflation, growth of your wealth, which can maintain or increase your ability to spend far into the future. Long-term success can result for those who remain patient, realizing that periodic volatility in economies and markets is an inevitable part of long-term business progress, and stay focused on their personal long-term goals, not what the stock market did today.

There have always been reasons to sell, but markets have been resilient

Sources: Capital Group, Refinitiv Datastream, Standard & Poor's. Chart shows daily returns from March 31, 2009 through September 5, 2023. Past results are not predictive of results in future periods.

General Principles

Together, we are **long-term, goal-focused, planning-driven investors**. We've found in our experience that the best course for you is to formulate a financial plan—and to build portfolios to serve the plan—based **not** on a short-term view of the economy or the markets, but on **your most important lifetime financial goals**.

- Since 1960, the S&P 500 Index has appreciated approximately **76 times**; the cash dividend of the Index has gone up about **33 times**. Over the same period, the Consumer Price Index has increased **10 times**. So historically, **equities have functioned as an extremely efficient hedge against long-term inflation and a generator of real wealth** over time. We believe this is likely to continue in the long run, hence our investment policy of primarily owning successful companies rather than lending to them.

- We believe that **acting continuously on a rational plan**—as distinctly opposed to reacting to current events—offers the best chance for your long-term investment success. The best recent example of sticking to the plan was seeing the market's reaction to COVID. Simply stated: **unless our goals change, there is little reason to alter your financial plan**. And if our portfolio is well-suited to that plan, we don't often make significant changes to that, either.

- **We do not believe the economy can be consistently forecast, nor the markets consistently timed**. We're therefore convinced that the most reliable way to capture the long-term return of equities is to ride out their frequent but ultimately temporary declines. In practice, this means being mentally prepared to handle roughly 15% short-term declines annually, and roughly 33% declines every 5 years or so.

- **Avoiding costly changes in reaction to short-term volatility provides you the potential to earn higher long-term returns.**

- The performance of your portfolios relative to their benchmark(s) is irrelevant to your investment success as we define it. **The benchmark we care about is the one that indicates whether you are on track to achieve your financial goals**. **One of the biggest goals is making sure you don't run out of money during your lifetime.**

- Our investment philosophy is to invest in businesses with a history of providing essential products and services. We prefer significant management ownership to create an alignment of interests with us. We seek to invest at reasonable prices and hold these exceptional businesses for many years. Assuming no nuclear annihilation or World War III…we expect this approach will do well over long periods.

As always…please keep us updated with any changes to your financial situation that might suggest altering your asset allocation and investment portfolio and let us know if you'd like a current copy of our Form ADV Part 2.

Your LOYALTY and PATIENCE remain our secret weapons. We value our relationship with you and appreciate the opportunity to continue to serve you and your family.

Thank you for being our client. It is our privilege to serve you.

Sincerely,

John Dave

John Heldman, CFA Dave Hutchison, CFA

January 22, 2025

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go. In the end, what matters isn't crossing the finish line before anybody else but just making sure that you do cross it."

-Benjamin Graham, <u>The Intelligent Investor</u> (and Warren Buffett's mentor)

"Forecasts are highly uncertain. Forecasting is very difficult. Forecasters are a humble lot with much to be humble about."

-Jerome Powell, Federal Reserve Board Chairman

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