



Quarterly Investment Commentary

FOURTH QUARTER, DECEMBER 2023

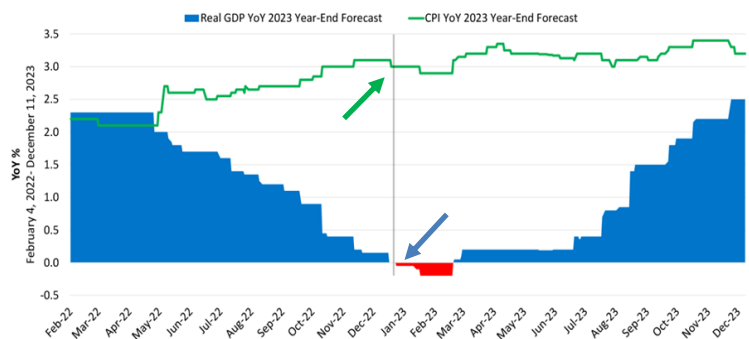
The staff at AMI Investment Management would like to extend our best wishes to clients, friends, and their families for a healthy and prosperous New Year. We are privileged to work with many great people and institutions that share a commitment to making a positive impact in their communities and the lives of others. As AMI enters its 29th year in business, we strive to maintain the high level of service and prudent investment management process that our clients have come to expect. We want to perform at our best every day, thereby allowing our clients to focus on what's important to them. Thank you for your continued trust, and we look forward to working with you in the New Year.

2023: A Year of Surprises

Each calendar year has its own distinct story. 2023, from an investment standpoint, may well be remembered for the much-anticipated recession that didn't happen or the strong returns in financial markets in what was expected to be another challenging year. Twelve months ago, investors were convalescing following a difficult year in which stock and bond returns declined sharply in tandem, inflation was stuck above 6%, and interest rates were continuing to climb. The outlook was gloomy. The Wall Street consensus expectation was that the U.S. economy would enter a mild recession at some point during the year, which contributed to the overwhelming sense of investor pessimism. The logic behind the bleak forecasts seemed straightforward and commonsense; a rapid rise in interest rates and the burden of higher costs on consumers and businesses will lead to a slowdown in the economy, which in turn will lower inflation.

A number of historically reliable economic indicators also signaled an approaching downturn. As the chart below illustrates, the consensus forecasts for inflation at the beginning of last year turned out to be spot on (3% versus the actual CPI reading of 3.1%) while the economic growth projections were way off the mark before being revised higher as the year rolled on.

U.S. Real GDP and CPI: 2023 Year-End Consensus Forecasts



Source: Doubeline

So how did the U.S. economy manage to avoid an all-out recession despite so many obstacles going into last year? Although there were pockets of weakness (housing, manufacturing), perhaps real interest rates did not get high enough to derail the economy. Or maybe we should thank Taylor Swift and her Era's concert tour—estimated to deliver Super Bowl like spending for each of the 20 performance destinations¹. Those of us with teenage daughters likely won't dismiss the Taylor Swift effect, but with a large economic machine the answers are almost always more nuanced.

¹ <https://www.ustravel.org/news/taylor-swift-impact-5-months-and-5-billion>



Our June 2023 investment commentary noted the mixed economic signals and the challenges of the recessionary forecasts: *“Given the oddities and one-offs of the pandemic, using a classic playbook to forecast the future direction of the economy will be challenging. These pandemic-era forces are also contributing to the mixed economic signals we’re seeing and the wide range of market predictions. It’s anyone’s guess on the ultimate outcome, but the future direction will largely depend on the biggest concern, inflation.”* The disinflationary backdrop of the past year, coupled with a strong labor market, has been a driving force in propping up the economy, boosting stock prices, and changing expectations on the future direction of interest rates. As it currently stands, we find ourselves with the ideal alignment of moderate economic growth, easing inflation, higher corporate earnings forecasts, and the prospects for interest rate cuts in the not-so-distant future. Whether you call it a “Goldilocks” scenario (not too hot, not too cold) or a “soft landing” (avoid recession), can it get any better from here? This situation obviously gives us some pause. As markets reprice for a world with lower interest rates, it’s important to note that any disruption to these lofty expectations along the way (i.e., earnings, economic growth, path of inflation) can also result in a repricing in the opposite direction. Although the waters are less turbulent today than a year ago, that does not mean smooth sailing from here.

The past year is also a good reminder of the perils in making dramatic changes to portfolios based on “expert” short term forecasts. An investor that heeded the recessionary warnings last year and sold stocks in anticipation of economic calamity missed out on large gains. Despite the failure of several large banks, wars in the Middle East/Europe, and another debt ceiling standoff, U.S. equity indexes delivered impressive returns. The S&P stock index was up 26% with dividends while the Dow Jones Industrial Average ended up 16% for the year. Yields on the 10-year U.S. Treasury made a round trip, starting the year at 3.9% then touching 5% in the fall before retreating back to 3.9% at year-end.

Despite the volatility, high quality taxable bonds delivered a respectable return of 5.2% for the year². Although we admit to being surprised by the magnitude of the gains this past year, in particular the fierce rally in the 4th quarter, it underscores the unpredictability of markets over the short term. We maintain a cautious outlook as we enter the New Year. The recent “everything” rally has reignited some euphoria in areas of the market, which are entering bubbly valuation levels. Selective investing, attention to quality, and actively managing risks will continue to be our areas of focus in 2024.

The Magnificent Seven

The Magnificent Seven for some is a reminder of the classic 1960 Western film starring Yul Brynner, Steve McQueen, and Charles Bronson. The seven title characters are gunfighters hired by a small Mexican farming village to protect them from a group of outlaw bandits. Although a small group, they come together to fight like a much larger force against the bad guys. Today, the financial press’s lexicon has moved on from the FANG or FAANG stocks to the “Magnificent Seven”²: or the seven mega-cap growth stocks which, like the gunfighters, have a much larger influence than their actual numbers. The seven stocks include: Apple, Alphabet (Google’s holding company), Meta, Amazon, Microsoft, Nvidia, and Tesla.



² As measured by the Bloomberg Intermediate Corp/Govt Bond Index



These seven companies now represent around 30% of the S&P 500's market value, which is approaching the highest ever for any seven stocks. Collectively, the Magnificent Seven returned 75% last year versus a more modest 12% for the remaining 493 stocks represented in the index. As their stock prices have risen, so have valuations. The average price/earnings ratio for the Magnificent Seven is over 32x next year's earnings estimates in comparison to the broader index of 19x. Higher valuations accompany higher risks as these stocks are generally less able to absorb bad or unexpected news.

The S&P 500 index is meant to represent America's most meaningful publicly traded companies and weighs them according to market cap or size. As such, we eventually enter periods where the most successful companies tend to gain more relevance and the index tilts toward the higher performing constituents while shifting away from its weaker ones. The run-up in this concentrated group of growth stocks and its influence on the returns of the S&P 500 can make it a particularly challenging benchmark, especially for those tasked with managing risk.

We believe sound investment management entails not going "all-in" on the dominant companies of the moment or chasing performance by buying the leaders and selling the laggards to keep pace. A boat crowded on one side is susceptible to tip. The same can be said with index crowding; eventually (emphasis on eventually) the top performing stocks will enter a period of underperformance. The same mechanics that assisted on the way up can then work in reverse to unwind the concentration and the underperformers become relevant again. We believe the Magnificent Seven are truly remarkable U.S. companies, but even for the best company, growth becomes harder the larger you get.

As the table below illustrates, the leaders of today may not be the leaders ten years from now. Our job is to be mindful of this while managing risk through adequate diversification and being on watch for opportunities on the horizon.

% Weights of the Largest Stocks in the S&P 500

| 1980 | | 1990 | | 2000 | | 2010 | | 2023 | |
|--------------------------|-------|----------------------|-------|------------------|-------|--------------------|-------|--------------------|-------|
| Int'l Bus Machines | 4.3% | Int'l Bus Machines | 3.0% | General Electric | 4.1% | Exxon Mobil | 3.1% | Apple Inc | 7.0% |
| AT&T Corp | 3.9% | Exxon Corp | 2.9% | Exxon Mobil | 2.6% | Apple Inc | 2.5% | Microsoft Corp | 6.9% |
| Exxon Corp | 3.8% | General Electric | 2.3% | Pfizer, Inc | 2.5% | Microsoft Corp | 2.0% | Alphabet Inc | 3.8% |
| Standard Oil, Indiana | 2.5% | Philip Morris Cos | 2.2% | Citigroup Inc | 2.5% | Berkshire Hathaway | 1.7% | Amazon.com | 3.5% |
| Schlumberger | 2.4% | Royal Dutch Petrol | 1.9% | Cisco Systems | 2.4% | General Electric | 1.6% | NVIDIA Corp | 3.0% |
| Shell Oil | 1.9% | Bristol-Myers Squibb | 1.6% | Wal-Mart Stores | 2.0% | Wal-Mart Stores | 1.6% | Meta Platforms | 2.0% |
| Mobil Corp | 1.9% | Merk & Co | 1.6% | Microsoft Corp | 2.0% | Google Inc | 1.6% | Tesla Inc | 1.8% |
| Standard Oil, California | 1.9% | Wal-Mart Stores | 1.6% | AIG | 2.0% | Chevron Corp | 1.5% | Berkshire Hathaway | 1.6% |
| Atlantic Richfield | 1.6% | AT&T Corp | 1.5% | Merk & Co | 1.9% | Int'l Bus Machines | 1.5% | Broadcom Inc | 1.2% |
| General Electric | 1.5% | Coca-Cola Co | 1.4% | Intel Corp | 1.7% | P&G | 1.5% | JP Morgan Chase | 1.2% |
| | 25.6% | | 20.0% | | 23.5% | | 18.6% | | 32.0% |

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Charles T. Munger 1924-2023

Lastly, we want to acknowledge the passing of a giant in the investment world, an individual that has been the subject of past AMI investment commentary. Charlie Munger, Vice Chairman of Berkshire Hathaway, passed away on November 28th at the age of 99. Charlie served as Warren Buffett's business partner and more importantly his right-hand man for over 50 years. Like Buffett, Charlie was a profound intellectual who resisted allowing wealth to change his attitude toward life. Despite a net worth in the billions, he demonstrated restraint in spending (living 60 years in the same house he designed) and gave generously to philanthropic causes he believed in. Warren and Charlie were also the faces of Berkshire's annual shareholders meeting in Omaha. Up until the most recent meeting in May, both would hold court for hours in front of thousands of shareholders, answering questions and dispensing financial wisdom. Buffett has even credited Munger with helping to change his "cigar butt" investment style of buying troubled companies at deep discounts to "buying wonderful companies at fair prices." Charlie's often blunt perspectives on life and investing will be missed—R.I.P.

Below are some notable quotes that have been compiled in the book *Poor Charlie's Almanack: The Essential Wit and Wisdom of Charles T. Munger*.

- "The big money is not buying and selling...but in the waiting."
- "Spend each day trying to be a little wiser than you were when you woke up."
- "In my whole life, I have known no wise man who didn't read all the time—none, zero."
- "I constantly see people rise in life who are not the smartest, sometimes not even the most diligent, but they are learning machines."
- "The best way to get what you want is to deserve what you want."
- "Investing is about identifying exceptional companies and exercising patience."
- "We have three baskets for investing: yes, no, and too tough to understand."
- "The allure of quick wealth is a perilous path."
- "Recognizing the bounds of one's knowledge is a skill possessed by the exceptionally astute."

