BECK MACK + OLIVER

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The S&P 500 generated a total return of +26% during 2023, ended the year near its year-end 2021 level (thereby recouping its losses from 2022), and closed within striking distance of its all-time high. This equity market appreciation occurred in the face of four additional quarter-point increases in the fed funds rate, which came on top of the historically rapid monetary policy tightening in 2022. Throughout 2023 the market grappled with the relationship among monetary policy, inflation, and economic growth: would a higher fed funds rate quash inflation but tip the economy into a recession? If inflation did not slow down, how high could interest rates go? Between late July and late October, these concerns predominated and the S&P 500 fell from approximately 4,600 to 4,100, while the 10-year Treasury yield rose from approximately 4% to 5%, its highest level since 2007. But over the last two months of the year, as the inflation data continued to move in the right direction and as the Federal Reserve signaled that additional increases in the fed funds rate were therefore unlikely, the S&P rallied to nearly 4,800 and the 10-year Treasury yield fell back below 4%. By year-end, the verdict of the equity and bond markets seemed to be that the Federal Reserve had done its part to bring inflation down without catalyzing a recession.

Beneath the surface of the S&P 500's +26% total return last year, however, was significant variation across individual stocks. As we discussed in our July 2023 letter, the S&P 500 is weighted by market capitalization, such that stocks with larger market caps have larger weightings. The S&P 500 Equal Weight index is an alternative measure that applies an equal weight to each constituent stock in the S&P 500 and which generated a total return of less than +14% last year. The more than 12% difference between the S&P 500 and the S&P 500 Equal Weight was the widest such performance gap in a calendar year since 1998. In 2023, more than 70% of the constituent stocks in the S&P 500 underperformed the overall index and more than 30% generated a negative total return. Among the 25 best-performing S&P stocks, 15 had market caps of more than $100 billion, while among the 25 worst-performing S&P stocks, 15 had market caps of less than $20 billion. Thus, larger companies tended to outperform smaller companies and the median stock in the index substantially underperformed the overall index.

Various factors likely contributed to the salience of size, or market cap, in the distribution of S&P stock returns last year. As we also touched on in our July letter, the field of artificial intelligence has created a great deal of exuberance in the valuation of companies perceived to be potential leaders in or beneficiaries of AI-related innovation. A stark illustration of this exuberance is the company NVIDIA, demand for whose graphics processing units, which are critical components in AI computation, has increased dramatically. NVIDIA was the best-performing stock in the S&P last year and now has a market cap in excess of $1 trillion. Another reason why larger companies outperformed was that they tend to have less debt on their balance sheets, which has partly insulated their earnings from the impact of higher interest rates. Apple, Microsoft, Alphabet, and NVIDIA, for instance, all have market caps over $1 trillion and net cash on their balance sheets. Yet another factor was the regional banking crisis in March, which we wrote about in our April letter, and the ongoing challenges facing the sector, which comprises numerous small and mid-sized banks. Higher interest rates have placed pressure on banks' deposit franchises, as depositors seek higher-yielding alternatives such as money-market funds, and have also led to declines in the market values of their bond portfolios. At the same time, the industry is dealing with a stricter regulatory regime. There are 15 bank stocks in the S&P, of which eight generated a negative total return and all but one underperformed the index in 2023. And the one that outperformed was JPMorgan, the largest bank in the country.

Because the S&P 500 is weighted by market cap, it can sometimes exhibit momentum-driven behavior: a company's market cap increases; its weighting in the S&P therefore increases; of every new dollar invested into a S&P index fund or exchange-traded fund, a greater portion is used to purchase more of the stock, which in turn leads to further increases in its market cap, etc. Under these conditions, a buyer of a S&P index fund or ETF is effectively buying large positions in stocks, such as Apple and Tesla, that have recently appreciated substantially and trade at expensive multiples of expected future earnings.

Our overarching objectives as investors have always been to identify great businesses and management teams, to remain disciplined with respect to the valuations at which we initiate and maintain investments, and to own these businesses for long periods of time during which they compound their earnings and intrinsic value at attractive rates. Whether a business is large or small does not per se matter to us, though the size of the company is often relevant to the nature of the investment opportunity—e.g., a small business may have a long runway to expand market share in a fragmented industry, while a large business may enjoy durable competitive advantages by virtue of its status as the dominant incumbent in an attractive end-market. We believe that our client portfolios comprise a healthy mix of large and small businesses, which is an outcome of our investment process rather than a portfolio-construction target.

Partly in response to some of the market dynamics described above, we have been looking for and finding actionable investment opportunities among small and mid-sized companies. The most recent additions to Beck Mack + Oliver's "buy list" have been Zurn Elkay Water Solutions, Rush Enterprises, and Fortrea Holdings, whose market caps are approximately $5 billion, $4 billion, and $3 billion, respectively. Not only are the market caps of these three companies much smaller than the median S&P stock, which has a market cap of approximately $34 billion, but the stocks themselves are not even in the S&P 500. In each case, we believe that we have invested in an excellent business at a good price and with a long runway for future growth.

We control the analytical criteria pursuant to which we underwrite potential new investment ideas, but we do not control the investment opportunity set, which waxes and wanes and changes shape based on market conditions. As those conditions change, so too will the places in which we are able to identify exciting future investments.

Partners of Beck Mack + Oliver