BECK MACK + OLIVER

Newsletter: January 2023

The S&P 500 generated a total return of approximately negative 18% in 2022, which was the worst year for the index since 2008. The sharp drawdown in the US equity market last year was essentially a first half phenomenon, with the S&P down 20% through June and then up 2% in the second half.

The repricing of financial assets last year was remarkably broad-based, extending well beyond the US and across various asset classes. One of the worst-performing asset classes last year in fact was long-duration US Treasury bonds, which were down more than 30%. Treasury bonds may have effectively zero credit risk, but their market prices are sensitive to changes in interest rates (and the longer the duration, or remaining maturity, of the bond, the greater the sensitivity). Over the course of 2022, the federal funds rate increased from a range of 0.00-0.25% to 4.25-4.50%, which represented the largest 12-month increase in the federal funds rate since the early 1980s, when Paul Volcker chaired the Federal Reserve and inflation ran hot in the double-digits.

2022 Total Returns	
S&P 500 Index	(18.1%)
Global Equities	(17.7%)
Emerging Markets	(20.6%)
Real Estate	(25.5%)
US Treasurys (short-duration)	(3.9%)
US Treasurys (long-duration)	(31.2%)
High-Yield Bonds	(11.0%)
Gold	(0.3%)

If we consider the performance of these asset classes on a longer-term basis, not only has the S&P consistently generated superior total returns, but multiple other asset classes have generated negative or barely positive total returns over the last 3, 5, and 10 years.

Annualized Trailing Total Returns through 12/31/22	3-Year	5-Year	10-Year
S&P 500 Index	7.6%	9.4%	12.5%
Global Equities	5.5%	6.7%	9.5%
Emerging Markets	(3.6%)	(2.1%)	0.6%
Real Estate	(0.7%)	3.7%	6.2%
US Treasurys (short-duration)	(0.6%)	0.6%	0.5%
US Treasurys (long-duration)	(8.1%)	(2.7%)	0.4%
High-Yield Bonds	(1.2%)	1.5%	2.9%
Gold	6.3%	7.0%	0.9%

Over the very long run, equity market returns should approximate nominal economic growth plus the impact of capital deployment over and above reinvestment requirements. Principal examples of excess capital deployment include the payment of dividends, share repurchases, and acquisitions of other companies. S&P performance over multiple decades has registered in the high-single to low-double digits, with variation from decade to decade.

Annualized Trailing Total Returns through 12/31/22				
	20-Year	**30-Year**	**40-Year**	**50-Year**
S&P 500 Index	9.8%	9.6%	11.2%	10.3%

Annualized Total Returns by Decade					
	'72-'82	**'82-'92**	**'92-'02**	**'02-'12**	**'12-'22**
S&P 500 Index	6.7%	16.2%	9.3%	7.1%	12.5%

Over shorter time periods, however, stocks can seemingly trade anywhere. Valuation multiple swings sometimes drown out the impact of earnings growth and capital deployment. To wit, the aggregate earnings-per-share growth of the S&P constituents will probably end up being close to 10% for 2022, but the price-to-earnings multiple of the index contracted over the course of the year from approximately 23x to 17x, resulting in the 18% negative total return noted above.

We believe that the primary reasons for the significant decline in the price-to-earnings multiple of the S&P last year include:

- The ~23x multiple at the beginning of the year was unusually high.[1]
- Interest rates rose substantially throughout the year, which improved the *prospective* returns of bonds while lowering the present value of future earnings.
- The perceived likelihood of an economic recession also rose; therefore, the probability-weighted expectation for earnings over the next 1-2 years declined.
- Inflation intensified, especially during the first half of the year, which pressured operating margins.

Whenever there is such a severe downward repricing in financial assets, as there was in 2022, there tends to be a larger number of individual securities whose prices deviate meaningfully from their fundamental value—the proverbial baby getting thrown out with the bathwater. Hence, amid last year's market drawdown, we remained quite busy both searching for new investment ideas and determining whether existing investments, especially our highest-quality businesses, had become incrementally compelling at lower prevailing valuations. Given the dynamic macroeconomic environment, we were particularly sensitive to how various businesses might perform during a recession, the strength of their balance sheets in the face of rising interest rates, and their ability to raise prices in response to inflationary cost pressures. Even under these more adverse economic conditions, the prospective returns of most of the stocks we own or otherwise follow became *more* attractive during 2022. From a portfolio standpoint we were constantly force-ranking the most actionable risk/reward opportunities with a view towards high-grading client portfolios. At the same time, we aimed to realize capital losses where applicable in taxable accounts and to maintain appropriate cash levels.

[1] As we noted in our January 2022 newsletter: "Multiples have risen in response to very low interest rates and the creation of enormous amounts of liquidity. Both monetary and fiscal policy were unprecedentedly aggressive in the wake of COVID, and some of these newly created dollars found their way into financial assets, including the stock market."

As 2023 gets underway, we are excited about our client portfolios, in part because of the portfolio actions we have taken in the last several months but largely because we believe we own excellent businesses that are trading at attractive valuations. We expect these companies, as a group, to generate strong earnings growth, to deploy excess capital intelligently, and to improve their competitive position over the next several years. The more attractively these stocks are priced today, the better we would expect their prospective returns to be, all else equal.

Regarding the economy and financial markets more generally, in our October 2022 newsletter we noted, “There are incipient signs of disinflation…Further progress in this direction could pave the way for the Fed, in the not too distant future, to slow and then cease its current sequence of interest rate increases.” In the last few months, further evidence of disinflation has surfaced, the most recent increase in the federal funds rate was 0.5% rather than 0.75%, and the Federal Reserve is now widely expected to stop raising interest rates at some point later this year. Greater stability in interest rates and inflation should provide a more constructive backdrop for financial assets and economic activity. Our best guess is that absent some kind of new exogenous shock—and we arguably have had more than our fair share of those in recent years—the probability of something worse than a mild recession over the next year or so remains low. <u>But whether we manage to avoid a recession altogether or encounter a more adverse economic environment in the coming year, we prefer to own great businesses at good prices as we approach that unknown</u>.

Partners of Beck Mack + Oliver