THE BYCOFF GROUP

2024 Investment Outlook

Key Takeaways:

- **We were pleased to see a much stronger year of returns in 2023 as markets recovered and aided by key positions in the internet and semiconductor sectors.**
- **2023 felt like a year in two parts as mega cap tech positions led the start of the year, while the market rally broadened in Q4 to see stronger returns from smaller and mid-sized companies.**
  - Internet companies drove H1 results, where revenue and profit growth came in better than expected leading to material, positive earnings revisions.
  - Quality mid-sized and retail companies drove strong Q4 returns as clean earnings and cheap valuations recovered meaningfully.
- **We believe the outlook for 2024 is solid driven by three key points.**
  1. Economists are forecasting positive economic growth in 2024.
  2. Federal Reserve interest rates are expected to fall and there is too much cash on the sidelines that will be invested or spent.
  3. Valuations for the market are within historical ranges, particularly for the equal weight S&P 500 and small cap index which are still below historical averages.
- **Investment positioning will be key to driving results in 2024 as market returns could slow.**
  - Position for companies that are cheap on 2025 valuations, investment in long term trends make a comeback (see our write up on cancer testing below), and international expansion is in vogue again.
- **Risks to monitor include unemployment, inflation trending the wrong way, and the election which will unfold over the year (historical returns in election year below).**

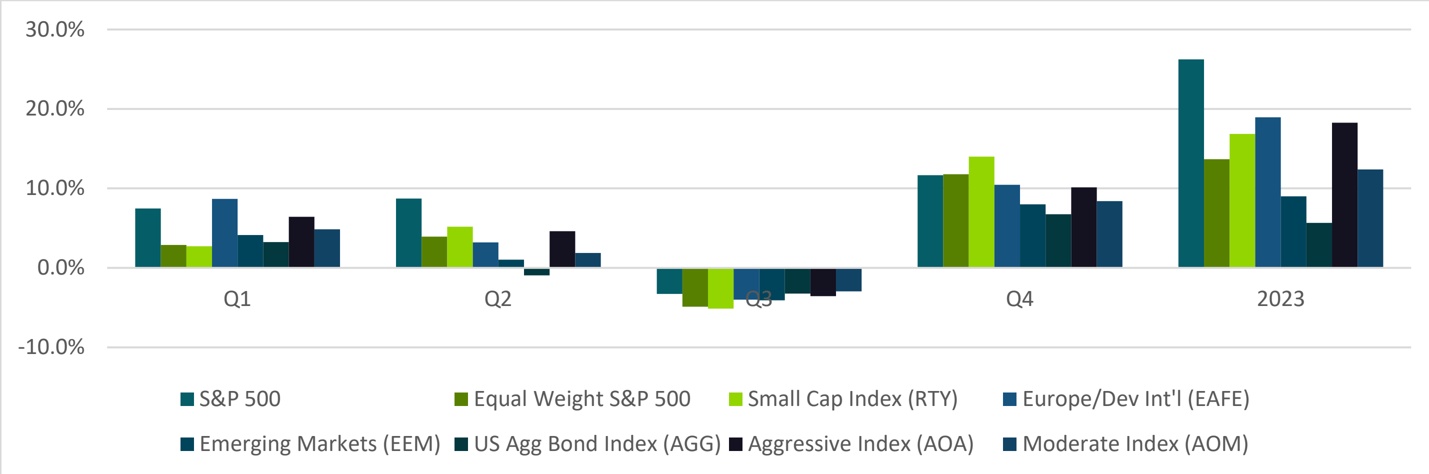
2023 Year in Review:

2023: A Year in Two Parts

We view 2023 as a year in two parts. The first part of the year was dominated by a meaningful snapback in the performance of Mega Cap Technology companies, the Magnificent 7 as they've been named. We had identified a recovery in large cap growth companies as a major opportunity in our 2023 outlook piece at the start of the year. Our first half results benefited from this thesis, primarily through our investments in internet companies, Meta and Google. Corporate layoffs at the end of 2022, improving foreign exchange rates, better revenue growth than expected, as well as cheap historical valuations catapulted them higher in H1. Meta for example saw its 2024 earnings per share forecast jump from $13/sh at the start of year to $16/sh by June 30th, a 25% jump in profit expectations. It now stands at $18/sh, up a further 12% from the midyear and up about 40% over the last 12 months.

The second part of the year saw the start of recovery in smaller and mid-sized companies, particularly after October 31st once US interest rates began to decrease. In fact, Q4 marked the first quarter that the Equal Weighted S&P 500 index and Russell 2000 small cap index outpaced the cap-weighted, more concentrated S&P 500 index (see Fig. 1 below for quarterly performance by major index). This inflection change was welcome as we had positioned for a recovery in smaller and mid-sized companies, which we believed were trading at historically attractive valuations and bearing the brunt of the interest rates hikes.

Fig. 1: 2023 Performance by Index



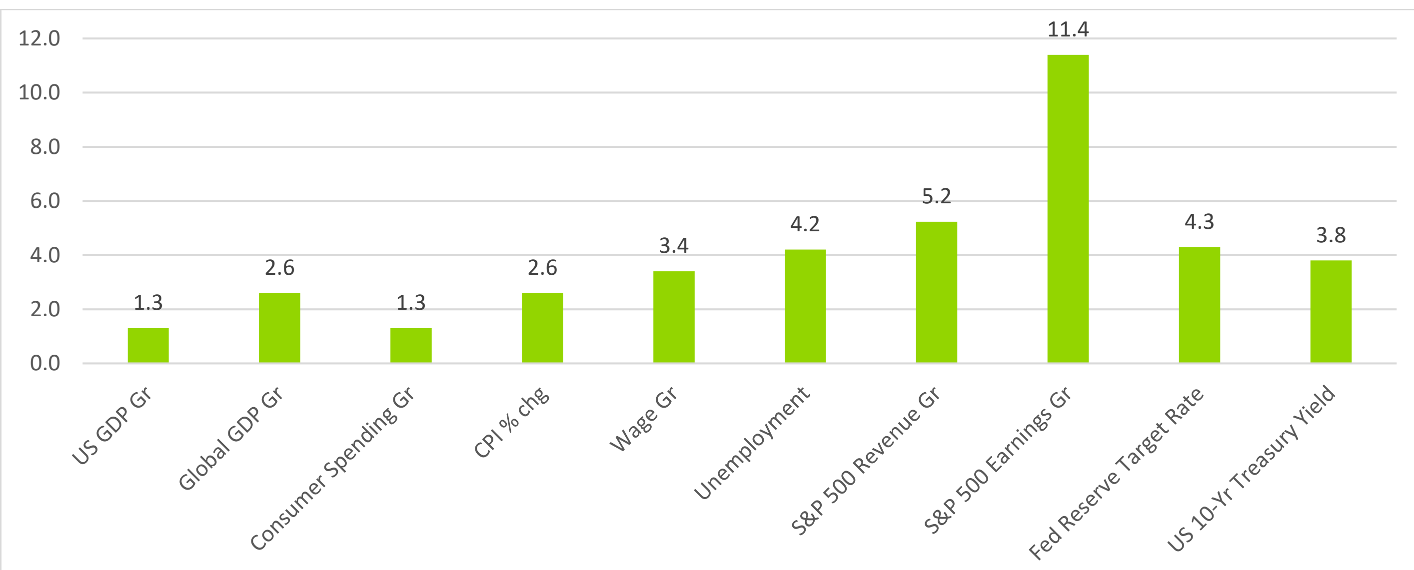
Source: Bloomberg data, through December 29, 2023.

2024 Outlook:

In summary, we believe 2024 should be a solid investment year as current economic forecasts are positive and falling interest rates should be supportive of market valuations. Three main points below.

1. **Economists are forecasting positive economic growth in 2024.**
   US economists are forecasting GDP growth of 1.3% on average for 2024, slower than 2023 estimated growth of 2.6% but still positive. U.S. consumers are entering 2024 with wage growth expected to be about 3.5%, pacing above estimated inflation of 2.5%. Estimates for S&P 500 companies are expected to grow faster at about 5% revenue growth and 11% earnings growth in aggregate. Summing this up, while we monitor for negative trends in employment data, these economic forecasts suggest a positive environment for the stock market.

Fig. 2: 2024 Key Macroeconomic Forecasts (% Chg)



Source: Bloomberg consensus forecasts as of January 15, 2024.

2. **Interest rates are expected to fall and there is too much cash on the sidelines still.**
   The Federal Reserve is forecasting a reduction in their target rate from 5.5% at the end of 2023 to 4.6% in 2024 and 3.5% in 2025 as they can lower restrictive interest rates with inflation dropping (see Fig. 3). Meanwhile, cash holdings are at record highs with U.S. households holding $3.6T in money market funds (see Fig. 4). As interest rates fall, we believe U.S. households will either invest this cash in longer duration investments like equities or spend them – both should be helpful to the stock market.
   Business update note – we were honored to be featured in Barron's multiple times in 2023. We made this very point in the December 22 issue in the Trader Column by Jacob Sonenshine ([Read the Barron's December 2023 Column Here]()).

Fig. 3: Federal Reserve Dot Plot

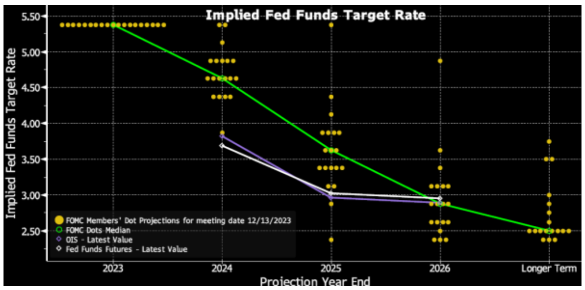
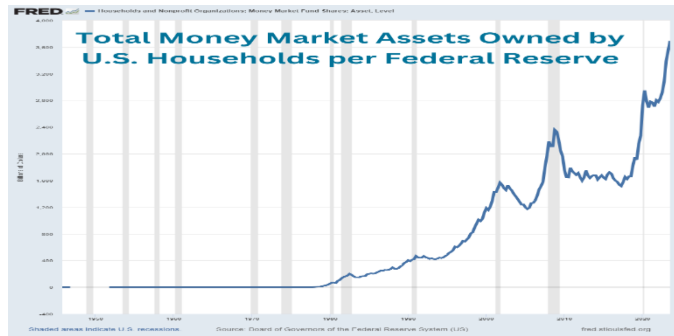
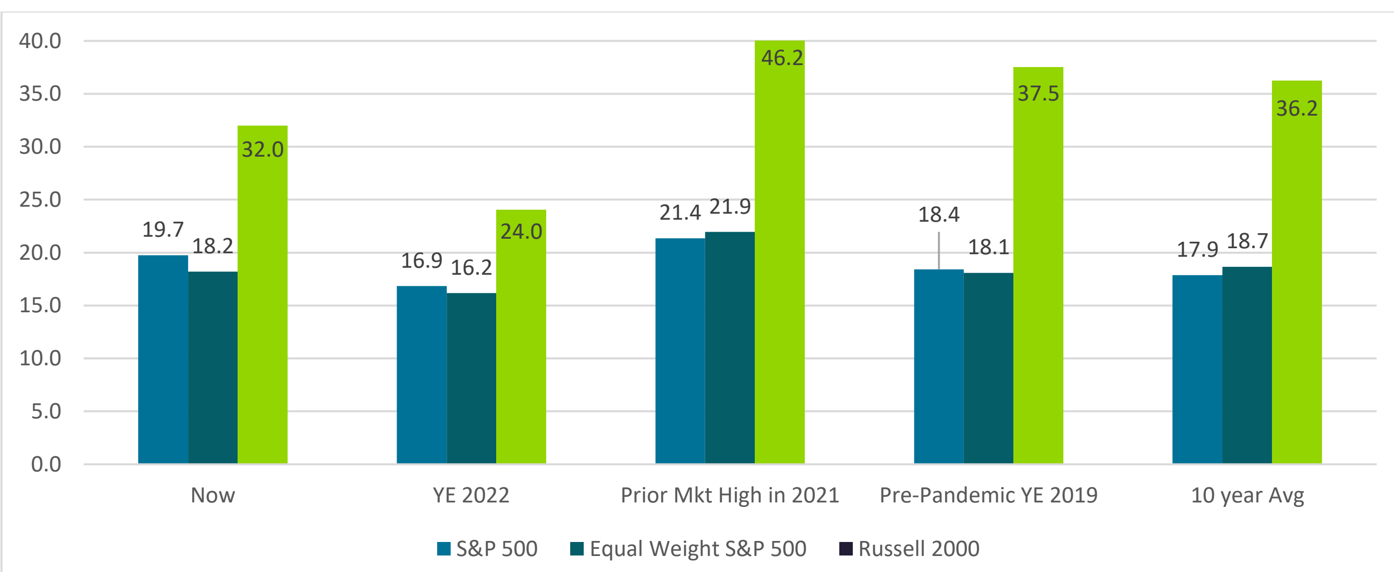


Fig 4: U.S. Household Money Market Holdings



3. **Expect returns to be closer to fundamental growth in 2024 as market valuations have recovered.**
   The S&P 500 market forward price-to-earnings valuation has recovered from ~17x at the end of 2022 and October 2023 to 20x currently. This PE multiple of 20x compares to the prior market high valuation in 2021 of 21.5x and a 10-year average of 18x. However, we note the equal weight S&P 500 index and small cap Russell 2000 index are still trading slightly below their long-term averages (see Fig. 5). We find these valuations reasonable. In addition, 2024 is unlikely to benefit from major corporate actions that the Magnificent 7 provided in 2023. For example, Meta had major corporate layoffs and Nvidia saw their revenue rebase by more than double driven by AI, one-time accelerants that rebased profit higher. As a result, investors should expect market returns to be closer to fundamental growth levels.

Fig. 5: Market Valuation (NTM Price-to-Earnings Ratio)

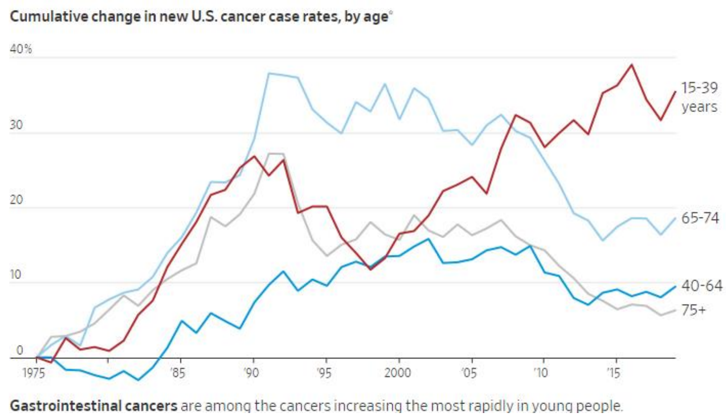


Investment Positioning for 2024:

As stated above, our expectation is market returns are likely to be closer to fundamental growth in 2024, which are typically in a range of 5-15% for most large companies (S&P 500 earnings growth forecasted at 11% as shown in Fig. 2). These results would be welcome as markets would finally attain new highs after two years. However, in order to attain excess returns, we are looking at three primary themes for investments this year.

1. **Maintain portfolio winners and invest in ideas that are cheap on 2025.**
   We believe it could be important to maintain some winners, including some of our mega cap tech positions, into 2024. While the pace of returns may slow in 2024, we believe investors should maintain some of these long-term compounders, especially as AI beneficiaries still unfold.
   As we evaluate both these winners and new ideas, we believe there are many companies that offer compelling investment cases on 2025 earnings. We believe in these ideas we still have the potential to get paid twice – both as the company executes on earnings growth plans for 2024 and the multiple expands.
2. **Investments in multi-year trends at the cross-section of consumer trends and other sectors.**
   One benefit of the reduction in interest rates is in a real sense you can build longer investment cases. The lower cost of capital allows you to physically fund business plans for longer and this same principle works for investment cases as well.
   One new theme we are investing in in 2024 is cancer detection. A recent Wall Street Journal article highlighted that several cancers are affecting people at much younger ages, including colorectal cancer (see Fig. 7 below). Many of us will recall actor Chadwick Boseman of Black Panther fame passing away tragically from colon cancer at the age of 43 after his cancer was caught in late stage. Technology allows for more efficient testing and testing has the potential to save lives. Today roughly one out of three adults over 45 years old in the U.S. are unscreened for colon cancer, and it would take about 10 years to test this population with colonoscopies alone (capacity for colonoscopy procedures in the U.S. estimated at 6mm per year).
   To express this trend we have invested in one of the largest cancer testing companies in the U.S. with the only current FDA and Medicare approved test for colon cancer. We believe consumers will begin to demand these tests as they become increasingly aware of the technological capabilities to test for these major illnesses. Cancer test volumes are likely to expand for years as they increasingly are incorporated into the standard of care. The volume growth of tests should drive revenue and profit growth even if competition enters, and an important trend we hope more people become aware of.
3. **International expansion.**
   A final theme we see as investable in 2024 is international expansion. Many companies sought to conserve capital in 2022 and 2023 as macroeconomic uncertainty weighed on corporate actions. We believe there are U.S. companies that have major international expansion opportunities. However, these companies have not been rewarded for this potential as the market environment was incredibly short term in nature.

Fig. 6: Incidence of Cancer by Age Group in the U.S.



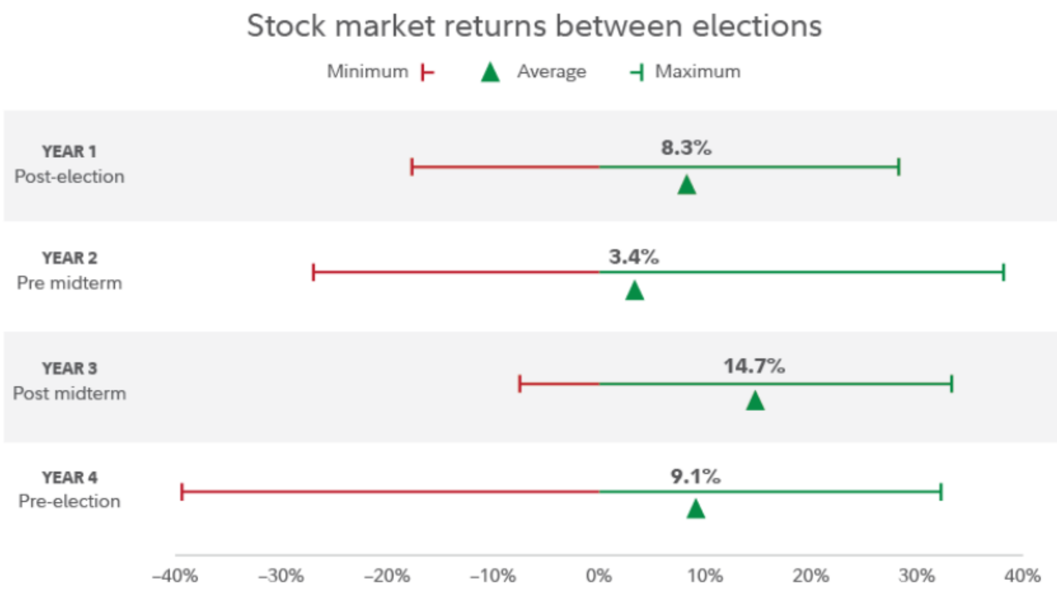
Source: Wall Street Journal, "Cancer is Striking More Young People…", by Brianna Abbott, Jan. 11, 2024

Risks

As with any year, there are always risks. We believe we can be patient to add to winning positions throughout the year as there is still some uncertainty around the magnitude of Federal Reserve interest rate cuts as well as the pace of economic growth. We monitor the following risks:

- **Labor and unemployment trends**. Job growth has been far stronger than most economists predicted in 2023. We do not make any forecasts for these trends. We of course recognize that meaningful unemployment trends create headwinds to consumer purchases, such as travel. As of now, labor trends have been strong and unemployment rates are still well off the 10% level seen in 2009 during the Global Financial Crisis, the 13% hit in 2020, or the country's 30-year average unemployment rate of 5.5% per Bloomberg.
- **Risk of Recession.** Coupled with unemployment risk is recession risk as a slowing consumer could pressure the economy. However, it is important for asset prices that the Federal Reserve is now signaling they are likely to begin reducing interest rates this year. We consider that with public stocks there are two main factors: earnings (or profitability) and the valuation multiple the investor is willing to pay for that company. In October 2023, the S&P 500 sold to about 4100 after reaching 4600 earlier in 2023. What made investing at that level difficult was you had to worry about the risk of recession impacting your earnings as well as the dramatic increase in U.S. Treasury rates impacting your valuation. Rising Treasury interest rates pressure equity valuation multiples. Once long-dated U.S. treasury rates began to fall in November, the market rallied as valuation multiples expanded. The Federal Reserve's signal in December that they will lower interest rates therefore reduces one of investors' main worries in valuation multiples. This doesn't mean there isn't risk, but it could help to limit the downside to an amount more in line with the drop in earnings, as opposed to a much larger multiple of that.
- **Inflation.** There is some risk that inflation will not cooperate and continue its recent downward trend. Pressures such as the Red Sea attacks and resulting increases in oil and freight costs create some upward bias to inflation. Currently, we do not view these as thesis changers, but we believe it is worth calling out.
- **The Election**. We will circle back on the election throughout the year. We note as of now that returns in the average election year are in line with stock market returns in any average year per Fidelity Research.

Fig. 7: U.S. Market Returns by Term Year



Source: Fidelity Research, "Election 2024: Anticipating the Market Impact," Nov. 28, 2023.