THE BYCOFF GROUP

Welcome to the Fall

We welcome you to the fall and wish you a fantastic and productive back half of the year. In this brief piece we share our thoughts on the stories that are driving the markets and review our outlook and positioning for the stretch run of 2023.

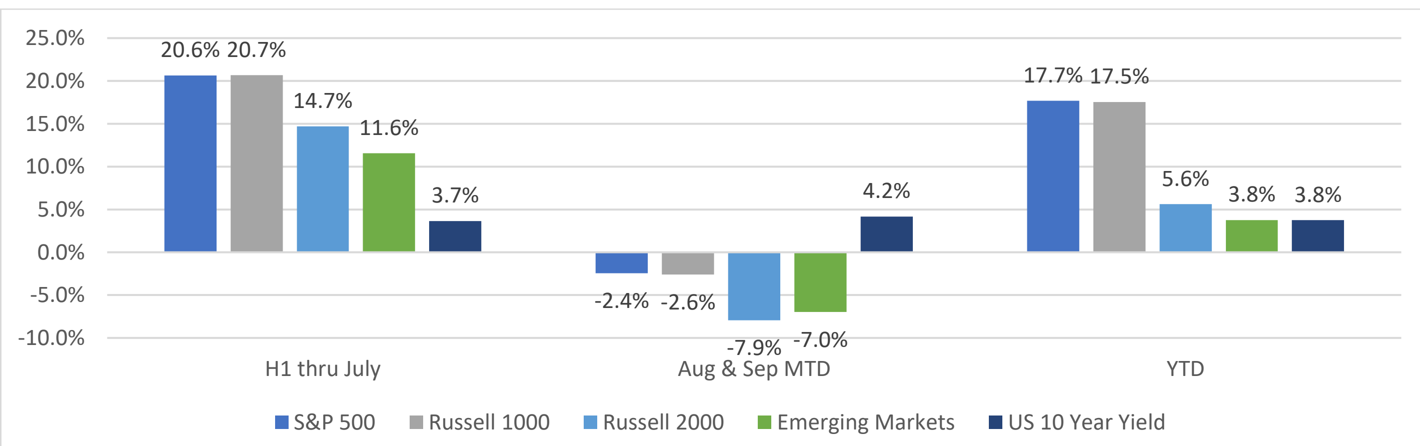
Key Takeaways:

- **Solid corporate guidance and stable consumer spending trends to drive resilient markets.**
  - Q2 results saw solid corporate guidance, lifting S&P 500 profit estimates, while consumer spending growth remains stable year over year, which we believe suggests a stable market environment.
- **Investors to be focused on some old and new stories into the stretch run of 2023.**
  - Well-discussed topics like inflation and the Federal Reserve actions to remain important while newer stories on the recent big tech regulations, the election and changing consumer habits to pick up steam.
- **Is the economy poised to have a major downturn in 2024? – We think No!**
  - Less chance of a major recession as demand for workers is strong as baby boomers have retired since 2008.
  - See below for key recent commentary from Walmart CEO, Doug McMillon.
- **Attractive set up for long-term investors.**
  - Most major public indices are down more than -10% over the last 2 years, offering investors a potentially attractive return versus other asset classes as public market assets continue to recover back to prior highs.
- **We are investing in a unique combination of opportunistic businesses and durable companies.**
  - We are excited by the number of new areas to invest in, including machine intelligence, coupled with durable industries that are trading at attractive valuations.

How are the public markets performing currently?

Major market indices sold off about -3% in August and early September despite a solid Q2 earnings season. Q2 earnings were relatively strong with about 70% of companies beating their Q2 estimates, above the historical average of about 60% companies beating numbers. We attribute the sell-off primarily to quiet summer markets and some trading protection with markets up strong going into August. Market corrections are a regular occurrence – sell-offs of 5% happen on average 3 times a year while 10% corrections have historically happened once a year per BofA Research.

Fig. 1: Major Index Returns Year to Date



Source: Bloomberg data, through Sep. 13, 2023.

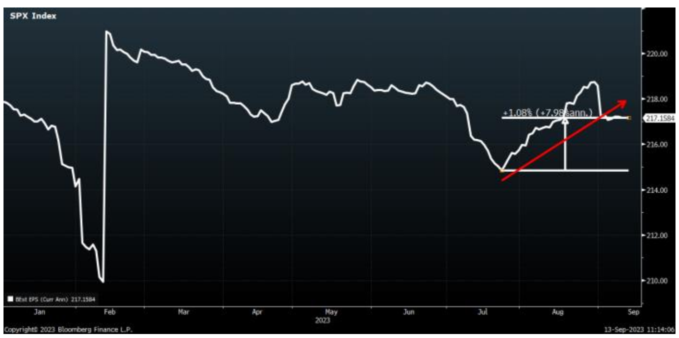
Market Outlook for the Back Half of 2023:

We expect markets to be resilient for a few reasons in the back half.

- For one, corporate guidance was solid on Q2 earnings. The ratio of corporate guidance above Wall Street earnings estimates jumped to 1.3x which is the highest level since 2021 and greater than the typical average of 0.8x (data per BofA research).
- Profit estimates for the S&P 500 increased from $215 per share to $218 per share. Increasing profit expectations are typically a positive for share prices as companies are getting more profitable with cheaper valuations and hence on the margin more attractive to own.
- Consumer spending remains stable. Recent spending growth by US households is still growing year on year at about 1%, a stable trend and slight uptick from the summer despite hurricanes and rainy weather in much of the country.

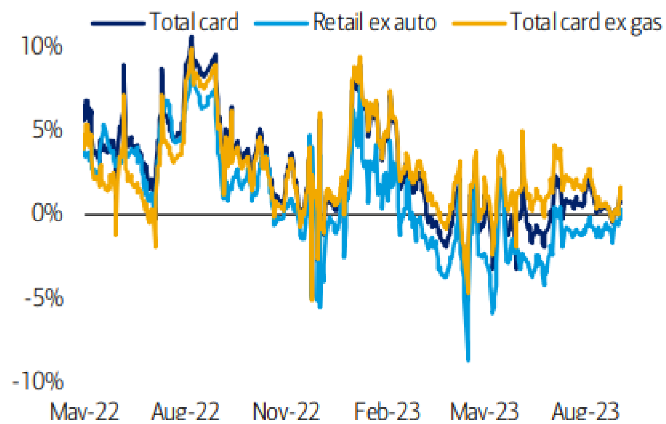
Solid corporate commentary, increasing profit expectations and stable consumer trends suggest at the very least a stable market environment to us.

Fig. 2: S&P 500 2023 Profit Estimates



Source: Bloomberg Consensus Estimates, as of Sep. 13, 2023

Fig. 3: US Consumer Spending % Change y/y



Source: Bank of America "BofA on USA", Sep. 12, 2023

What stories will investors be following into the end of the year?

Some well-discussed topics will continue to remain top of mind for investors and the media.

- Inflationary pressures and the subsequent Federal Reserve decisions to increase (or potentially decrease) interest rates will remain of great importance.
- The strength of the consumer going into the holiday season will also be a story line.
- Corporate investment plans in technology areas like climate and AI will continue to be important.

New topics that could gather more headlines include:

- Economic strength in China and other international markets.
- The election drumbeat will pick up into 2024 and from an investment standpoint we are focused on potential changes in regulatory or fiscal policy over the next 12 months.
- We anticipate more headlines on regulations confronting big technology companies.
- Changing consumer habits from new cutting-edge products like AI and even the implication of new pharmaceutical products.

Should we be concerned about a major cliff in 2024?

We acknowledge there remains uncertainty regarding inflation, the Federal Reserve's decisions to control inflation, politics and the impact of those factors across the economy. However, recent research suggests an environment that should be supportive of the US worker and consumer. Demographics are much different than the Global financial Crisis in 2008. Baby boomers have increasingly retired since then creating more stable demand for workers. While this demographic trend is driving an increase in wages and inflationary pressures, it also suggests unemployment will not reach levels we saw then (see Fig. 6 below for a chart on labor participation over time). Estimates from Goldman Sachs forecast discretionary cash flow could grow next year among multiple income cohorts as we lap the major inflation headwinds of 2022 and early 2023 and wages remain strong. The CEO of Walmart, Doug McMillon, similarly discussed his expectation for a solid outlook for the holidays and 2024 at a recent investor conference:

> "It felt to me like because of inflation, that things were going to be tougher this year than they've been… The more disinflation happens in categories like dry grocery and consumables, the more discretionary income they have to buy general merchandise, so we may see mix shifts, but the spend level kind of hangs into where it is. I would expect the behavior to be about what it is now. And I think holiday is going to be pretty good. So, I don't go into next year feeling too pessimistic." Doug McMillon speaking at the Goldman Sachs Global Consumer Conference, Sept. 12, 2023

How are we positioning for the second half of 2023?

Favorable set up for new investments in the equity markets.

- The above analysis suggests a stable and resilient macroeconomic environment.
- Stable and resilient markets are crucial for smaller companies.
  - Even if the major market indices are flat or up slightly, companies underneath the index can still execute business plans and see their valuations appreciate.
- Investors are getting the opporutnity buy companies at discounted share prices.
  - The S&P 500 is flat over 2 years while Emerging Market, Europe and Developed Asia, US Investment Grade Index, and US Small Cap Stocks are all down between -10 to -20% over the last 2 years (see Figure 4 below).
  - Mathematically for a US small cap company to recoup a -20% draw down (the index average), the stock price must appreciate 25% - a return far outpacing cash or inflation or other asset classes.

The performance torch could be passed from large to mid- and small-sized companies going into 2024.

- We have benefited from investments in large internet companies like Meta and Google this year.
- However, we believe the investment relay torch could be passed to mid-sized and small companies in the US going into 2024.
- The 7 largest companies in the S&P 500 trade at ~ 30x P/E while the remaining companies are much less expensive from a valuation perspective (see Figure 5 below).
- We have seen an increasing number of headlines on regulatory issues for large tech companies.
  - Just in the last month, China has contemplated a ban for Apple phones for government workers, a trial between the DOJ and Google has commenced, and Microsoft has been forced to unbundle it's Teams product from the Office Suite in Europe.
  - While these regulations could weigh on the large cap indices, smaller companies should not be affected.

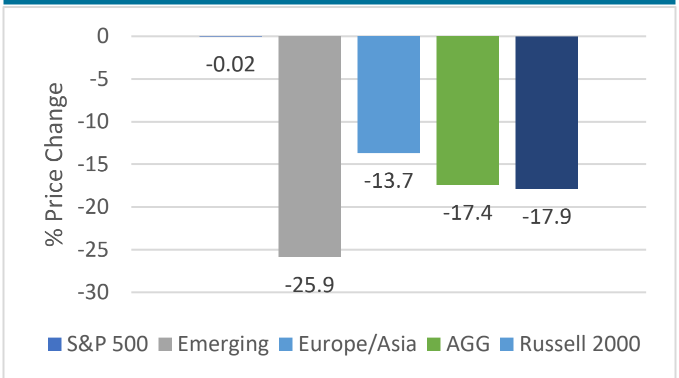
We are investing in a unique combination of nascent themes as well as durable companies in consumer-adjacent areas that are undervalued by historical standards.

- We are excited by the opportunity to invest in companies in nascent themes that have substantial upside including in areas like climate change, robotics, self-driving cars, communication services and health and wellness.
- Separately, we are pairing these opportunistic investments with durable companies in consumer-adjacent sectors, including financial services and apparel.
  - Many of these companies have seen their valuation multiples compress meaningfully but we believe are unlikely to be disrupted in the long term.
  - AI does not replace the need for running sneakers or a place to buy toys for children.
  - Valuations in these consumer areas are below average and factoring in some economic uncertainty.

Overall, we remain patient and cautiously optimistic, deploying capital into strong investments.

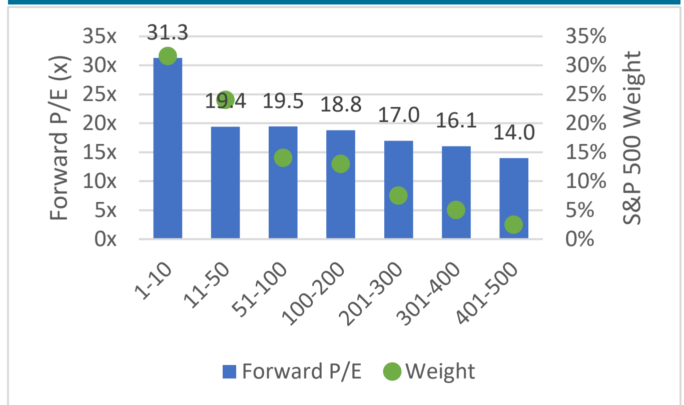
- Markets are encouraging patience and lower returns right now, however, appreciation can happen at any time, as it did in the early 1980s.

Fig. 4: Major Market Index Returns over 2 Years



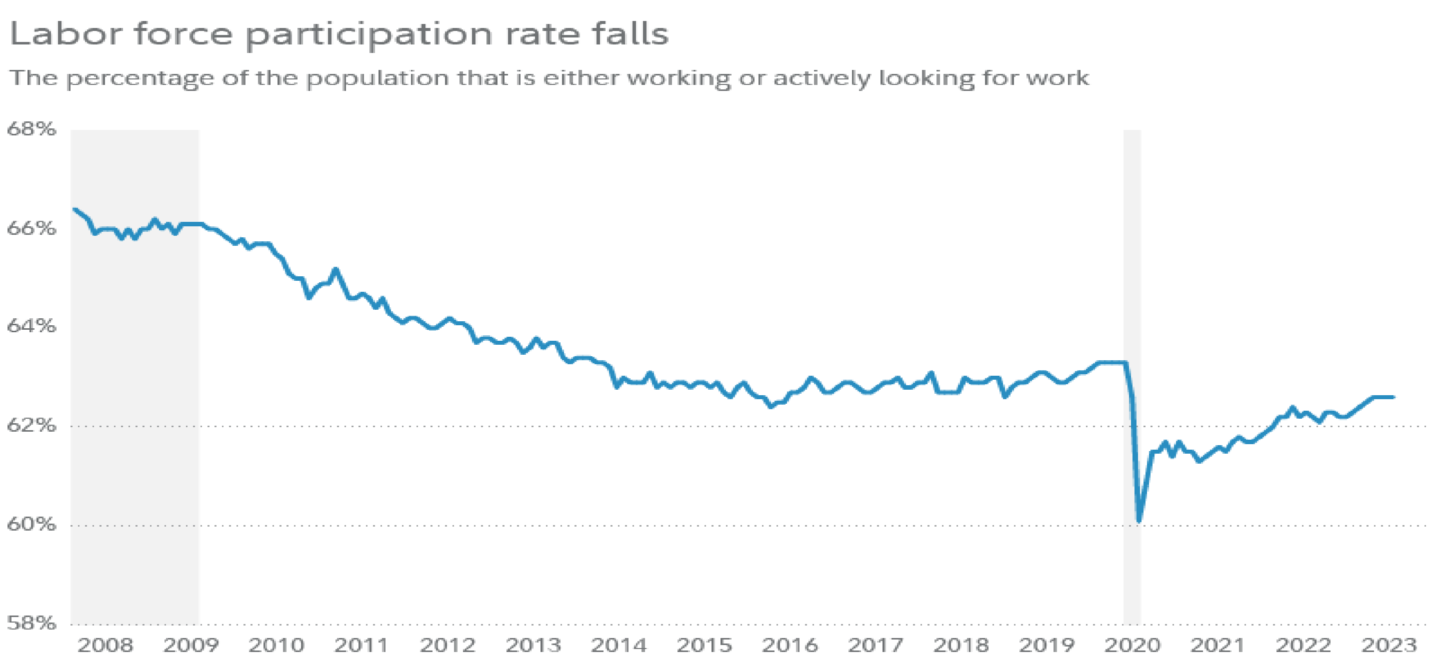
Source: Bloomberg 2 Year Returns as of Sep. 13, 2023

Fig. 5: Valuation of S&P 500 by Market Cap Range



Source: Bloomberg Estimates, Sep. 14, 2023

Fig. 6: Labor Participation Rate over Time



Source: Fidelity Investment research, Fidelity Viewpoints, Aug. 1, 2023.