BECK MACK + OLIVER

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The S&P 500 was up nearly 17% during the first half of 2023 in the face of a banking crisis, a debt ceiling showdown, rising interest rates, predictions of a recession, and ongoing inflation. This strong overall market performance would appear to be in tension with the challenging economic environment—the proverbial "wall of worry" that stocks have been climbing.

The 17% total return for the S&P 500 as a whole masks a significant amount of variation across the approximately 500 individual stocks that constitute the index. The S&P 500 is weighted by market capitalization, such that stocks with larger market caps have larger weightings. During the first half, the market was characterized by the outperformance of large, primarily technology-oriented stocks. The salience of size in the market's returns is indicated by the respective performance of the following two related indexes: the S&P 100 index, which comprises the largest 100 stocks in the S&P 500, was up more than 22%, while the S&P 500 Equal Weight index, which applies an equal weight to each constituent stock in the S&P 500, was up only 7%. The best performing sector of the S&P 500 was technology, which was up more than 40%, and the best performing stock was NVIDIA, a semiconductor company whose market cap increased from approximately $360 billion to more than $1 trillion. Meanwhile, the median market cap in the S&P 500 is about $30 billion.

Various factors contributed to the first half outperformance of large technology stocks. The field of artificial intelligence of late not only has experienced a great deal of innovation but also has induced a great deal of exuberance in the stock market. More broadly, many technology stocks are, or at least are perceived to be, less sensitive to today's major macro risks. A debt-free software business, for instance, may be less vulnerable than a leveraged industrial company to an economic slowdown, inflation, and higher interest rates. Especially when a sizeable sector like banking underwent an outright crisis a few months ago (which we discussed extensively in our April newsletter), technology struck many as a relatively safe sector. But exuberance and perceived safety have a price—e.g., NVIDIA currently trades at a price/earnings multiple of approximately 55x and the overall technology sector trades at 30x, which compare to S&P 500 at 20x.

Any consensus on the aforementioned macro risks is limited to emphasizing the very murkiness of their respective outlooks, whether it's growth, inflation, or interest rates. In this kind of environment, in which it feels like certain key variables could go either way, we are witnessing a greater dispersion in the performance across different corporate end-markets and individual businesses. While there's an ongoing debate about whether the US economy will enter a recession, this discussion of the *aggregate* economy, like the performance of the S&P noted above, obscures significant variation beneath the surface. Some economic sectors are *already* in a recession, while others continue to thrive, as higher interest rates, inflation, declining household savings, persistent strength in the labor market, tighter credit conditions, normalizing supply chains, fluctuations in fiscal stimulus, and continued post-pandemic shifts in spending between goods and services wreak differentiated effects throughout the corporate landscape.

We hope that the combination of a murky macro backdrop and dispersion within the economy will continue to create new stock-specific investment opportunities, as individual businesses benefit or are harmed by this fluctuating mix of headwinds and tailwinds to a greater or lesser extent than implied by their prevailing valuations. On the other hand, equity valuations in general (and not just those of large technology stocks) have expanded over the last several months, as indicated by the first-half returns discussed above. If the total return

of an individual stock can be usefully reduced to (i) revisions to the company's future earnings stream, (ii) changes in the multiple at which that earnings stream is capitalized, and (iii) dividends, then we suspect that the second variable has played a significant role in the market's behavior so far this year. And at higher price/earnings multiples today—whether for individual stocks, sectors, or the market as a whole—the lower the prospective returns, all else equal.

These economic and market conditions are informing both our portfolio management decisions and where we are looking for and finding potential new investment ideas. We target strong absolute returns, and hence our opportunity set tends to wax and wane in light of prevailing equity valuations. <u>And we always want to own portfolios of "compounders"—that is, great businesses that will generate attractive earnings growth and returns on capital for long periods of time and over multiple cycles</u>. We are especially attracted to companies that can become even better over time, especially during downturns when they can improve their competitive positioning relative to weaker rivals. From within an environment characterized by various crosscurrents and limited visibility, we hope there emerge further opportunities to invest in undervalued compounders, whether they are new investment ideas or businesses that we already own.

Partners of Beck Mack + Oliver