ALTA
CAPITAL MANAGEMENT
A member of Guardian Capital Group Limited

MARKET LETTER

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2023 YEAR-END MARKET LETTER

One of Alta Capital's favorite investors, the late Charlie Munger, was fond of saying, "The big money is not in the buying and the selling, but in the waiting." After enduring the disappointing investment results of 2022, patient investors were richly rewarded with a robust bounce back in both equities and fixed income in 2023. The stock market delivered an impressive year, pushing the benchmark S&P 500 higher by 26.29%. This was the S&P 500 benchmark's 4th best return in the last 25 years. The large cap technology names that underperformed in 2022, were largely the names that drove the market higher in 2023. Patience, which is quite often overlooked, is a key ingredient in any successful long-term investment strategy.

The primary factor driving the strong markets in 2023 was the effectiveness of the Federal Reserve in bringing inflation under control without doing significant economic damage in the process. By the end of 2023, inflation (CPI) stood at 3.1%, down significantly from the highs of 9.1% in June of 2022. After aggressively increasing rates seven times in 2022, the Fed more measuredly raised rates an additional four times in 2023, with the interest rate topping out at 5.5%. With inflation in retreat, investors turned their focus to the attractive lower valuations, the improving corporate earnings outlook and the ever-expanding U.S. economy, propelling the equity markets significantly higher in the second half of the year.

The lion's share of this renewed investor focus and interest centered on the so called "Magnificent Seven". These seven companies (NVIDIA, Meta, Tesla, Amazon, Google, Microsoft & Apple) accounted for 16.3% of the S&P 500's 26.3% total return. The concentration of returns in these seven mega cap technology companies was so dominant that 72% of the companies in the S&P 500 underperformed the benchmark in 2023. The primary driver of investor enthusiasm for these companies is Artificial Intelligence or AI. This past year saw an explosion of interest in generative AI companies and start-ups. We are in the first innings of this new AI marketplace and economy. Many companies, , are committing substantial capital investment into new AI initiatives and technologies. Microsoft has invested more than $13 billion in its AI partner OpenAI, widely considered the early frontrunner in Artificial Intelligence. AI will undoubtedly become an increasing part of our everyday lives and a key driver of your equity portfolios, much like the internet has been over the last 25 years.

What can we, as patient investors, expect from the markets in 2024? There are several positives in the current investment environment for equities. Interest rates look to have peaked and are trending lower. The Fed itself is anticipating three rate cuts in 2024, bringing interest rates to around 4.5%. With lower inflation and lower interest rates on the horizon, we believe the environment for equities looks rather promising. Other bullish positives we see in the economy as we enter 2024 are continued low unemployment, improved regional bank health/stability and lower energy prices. It is important to note that most companies in our Alta portfolios are raising their earnings estimates higher, with balance sheets that are as healthy as they have been in years. Wall Street consensus on the long-term future earnings growth for the S&P 500 companies is a rate of 7.0%. We believe our companies can deliver this level of earnings and cash flow growth in the coming year.

Notwithstanding our positive view of the overall prospects for stocks in 2024, our biggest concerns for equities remain the potential for renewed inflation, although unlikely, and the dangers of widespread optimism surrounding the U.S. economy and equity markets. This unbridled optimism manifests itself in the rising valuations and higher PE ratios we currently see in the markets. Most market strategists predict that stocks and the U.S. GDP will be higher in 2024. This level of consensus gives us pause and creates unrealistic expectations. With this current economic expansion getting long in the tooth (going on 15 years now) in combination with the optimism surrounding the stock markets, we once again feel it prudent to warn our investors that the coming years will likely bring periods of lower overall returns. The question is when?

Although we at Alta continue to look for undervalued companies in the current market, we cannot help but grow more cautious about the higher valuations for many companies and industries. In the last year, the markets have experienced some significant price-to-earnings multiple (P/E) expansion, particularly in the best tech companies. The price-to-earnings ratio on equities rose nearly 3 points to 19.6x in 2023. The spectacular recent moves in the Magnificent Seven companies are not without risks, as we will unlikely benefit from further multiple expansion in 2024. As we have previously warned, when valuations climb at a much faster rate than earnings and cash flow growth, the corresponding investments become less compelling and expose the shareholder to more risk. We understand this valuation concern and are focused on ensuring our companies continue to deliver strong, sustainable earnings and cash flow growth, all the while maintaining their required discount to fair valuation. We believe our portfolios are positioned to take advantage of any resulting market volatility. We at Alta are looking at the valuation component as fastidiously as we are the growth components.

When there is intense global upheaval (the Mid-East, Ukraine) and the potential of dramatic change in the political landscape (the upcoming 2024 Election Cycle), investment uncertainties will abound. During these times, we must remain focused on companies and sectors that demonstrate inherent growth, regardless of policy changes and their ultimate impact on the economy. Alta Capital strongly believes that companies with strong sustainable growth and wide economic moats (quality) not only have fantastic upside potential, but also offer good relative downside protection in challenging times like these.

We wish you a happy and prosperous New Year.

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