HUNT VALLEY WEALTH

A Connectus Partner

Market & Portfolio Commentary

Q4 2022

Fourth Quarter Market Review and Commentary

IN THIS ISSUE

Market Review and Commentary 1

2022 Top Performance Contributors 3

2022 Top Performance Detractors 4

2022 was a tumultuous year for financial markets.

There was no shortage of market drama in 2022. Instability gripped the world as the war in Ukraine raged, and a potential energy crisis loomed. Disrupted global supply chains led to shortages and surging inflation in select industries. Consumers continued buying, but their confidence weakened as the year came to a close. Central banks simultaneously raised interest rates higher and at a faster pace than investors expected in an attempt to combat runaway inflation.

With that economic uncertainty as a backdrop, it is not surprising that 2022 was a challenging year for investors as both stock and bond markets performed poorly. This is a rare occurrence, as equities and bonds typically have an inverse relationship.

The standard "60/40 portfolio" had its worst annual performance since 1937. Refer to the next chart showing annual past returns courtesy of Charlie Bilello of Pension Partners, LLC.

60/40 Portfolio: S&P 500 / US 10-Year Treasury (Total Returns, 1928 - 2022)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	26.6%	1947	3.5%	1966	-4.8%	1985	29.0%	2004	8.3%
1929	-3.3%	1948	4.2%	1967	13.6%	1986	20.8%	2005	4.1%
1930	-13.3%	1949	12.8%	1968	7.8%	1987	1.5%	2006	10.3%
1931	-27.3%	1950	18.7%	1969	-7.0%	1988	13.3%	2007	7.4%
1932	-1.7%	1951	14.1%	1970	8.8%	1989	26.1%	2008	-14.2%
1933	30.7%	1952	11.8%	1971	12.4%	1990	0.6%	2009	11.4%
1934	2.5%	1953	0.9%	1972	12.4%	1991	24.3%	2010	12.4%
1935	29.8%	1954	32.9%	1973	-7.1%	1992	8.3%	2011	7.7%
1936	21.2%	1955	19.0%	1974	-14.7%	1993	11.7%	2012	10.8%
1937	-20.7%	1956	3.6%	1975	23.6%	1994	-2.4%	2013	15.8%
1938	19.3%	1957	-3.6%	1976	20.7%	1995	31.9%	2014	12.5%
1939	1.1%	1958	25.4%	1977	-3.7%	1996	14.3%	2015	1.3%
1940	-4.2%	1959	6.2%	1978	3.6%	1997	24.0%	2016	7.5%
1941	-8.5%	1960	4.9%	1979	11.4%	1998	23.1%	2017	14.2%
1942	12.4%	1961	16.8%	1980	17.8%	1999	9.3%	2018	-2.6%
1943	16.0%	1962	-3.0%	1981	0.5%	2000	1.2%	2019	22.7%
1944	12.4%	1963	14.2%	1982	25.4%	2001	-4.9%	2020	15.6%
1945	23.0%	1964	11.3%	1983	14.7%	2002	-7.2%	2021	15.5%
1946	-3.8%	1965	7.7%	1984	9.2%	2003	17.4%	**2022**	-17.5%

Source: Data from Charlie Bilello of Pension Partners, LLC. (as of 12/31/2022)

Historically, stocks don't perform well when the Federal Reserve raises interest rates due to the higher discount applied to future cash flows. Meanwhile, high inflation combined with the restrictive actions of the Fed had a detrimental effect on bond prices.

Turning the page to 2023, the new year begins with many of the same headwinds that hurt the market in 2022. The Fed's battle with inflation is not over, and it may come at the expense of the economy. Despite this, we still see a few reasons for optimism:

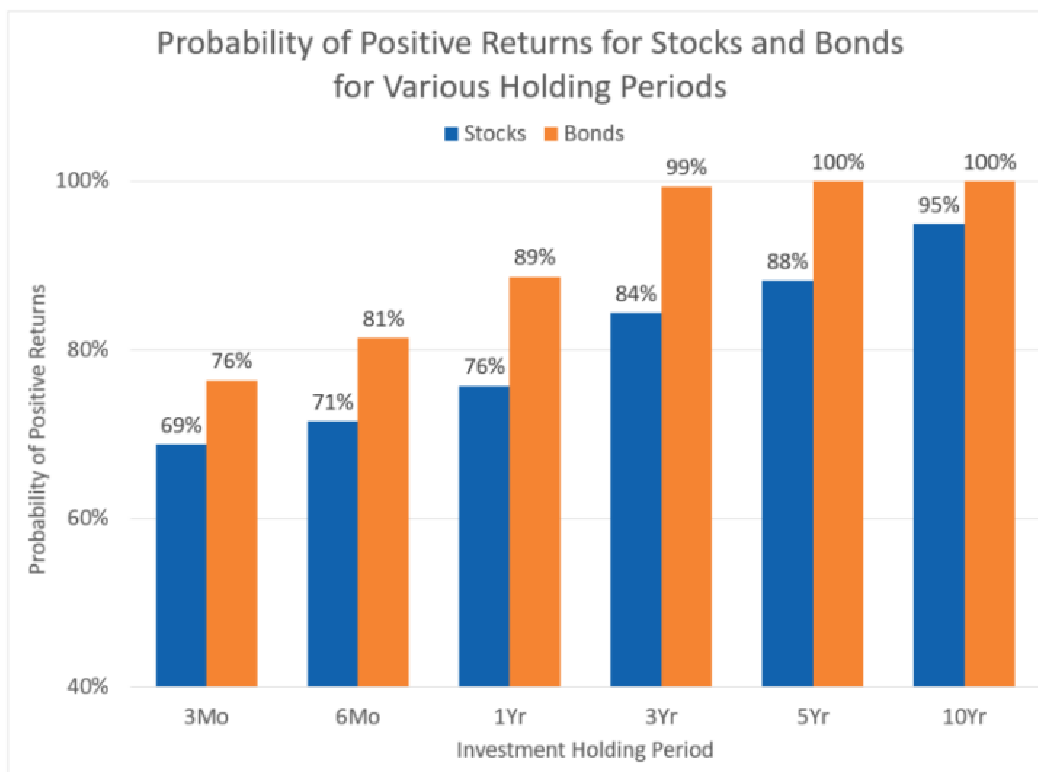
1. In our opinion, much of this negativity has been or is in the process of being reflected in sharply lower stock prices.

2. History teaches us that investment opportunities emerge from bad news, excessively bearish sentiment, and instability.

3. There seem to be a number of economic buffers that weren't present in previous downturns. For example, inflation is moderating, the jobs market is strong, and the banking sector is in relatively good shape.

Of course, there may be more shoes to drop, and the markets could fall further. Many pundits forecast a minor recession, but a longer or deeper one is always possible.

While guessing the direction of tomorrow's stock prices attracts a large audience, we believe that focusing our attention on the next ten years and not the next ten months will likely be more profitable. See the chart below for a historical perspective on the performance of stocks and bond returns through various holding periods.



Source: Morningstar Direct utilizing IA SBBI US Large Stock TR USD Ext to represent Stocks and IA SBBI US IT Govt TR USD to represent Bonds between 12/31/1925 and 7/31/2022.
Past performance is not indicative of future returns.

We often mention the ineffectiveness of market timing and the futility of forecasting the economy; however, predicting the market's movements in the short run often captures investors' imagination. This behavior typically heightens hysteria, creating emotional responses which drive volatility. Keep in mind that stock prices are much more volatile than the business values that underpin them. In the long run, it is our belief that business values and stock prices converge.

With that in mind, we are viewing the bear market as an opportunity and using it to find wonderful businesses at bargain prices. With patience, we believe we will be rewarded when valuations normalize over the long term.

John Heinlein

Managing Director,
Chief Investment Officer

Top Contributors

Below we have highlighted the stocks which had the largest impact on performance in 2022. You may notice that three of our top contributors this year (FICO, CSGP, and ATVI) were on our list of worst performers last year, while two of our top detractors this year (GOOG and MSFT) were among our best performers last year. This demonstrates the importance of analyzing stock performance over a multi-year period, as prices can swing wildly due to changes in fundamentals and sentiment. Nevertheless, we believe it is important to highlight these positions so that you can better understand your portfolio's performance going into 2023.

CoStar Group (CSGP) finished the year as one of our better performers, but it did not start the year that way. In February, the company announced it was ramping up investments into its residential real estate platform. Historically, the company had focused solely on the commercial market, so investors were wary of the investments, and the stock price dropped sharply. In our Q1 2022 Portfolio Activity, we explained why we thought these investments were both rational and in line with management's track record of long-term thinking. Given our conviction, this event gave us an opportunity to purchase more shares at attractive prices.

As the commercial business chugged along into the year, management reported positive early results within the residential segment as well. They revised their residential spending guidance downward twice, indicating that early returns on content and marketing investments had been better than expected. Suddenly, investors seemed to come around to management's vision, and the stock rose sharply in the latter half of the year. What a difference a few months makes.

We remain positive about CoStar's long-term future, and we believe the core commercial business has substantial operating leverage and untapped growth opportunities. We will continue to monitor the residential venture closely, but our optimism grows with each passing quarter.

Fair Isaac Corporation (FICO) had an excellent year, both operationally and in terms of stock market performance. The company demonstrated better-than-expected progress on its decision management platform while simultaneously avoiding the cannibalization of its legacy software business. Additionally, the software unit is displaying operating leverage more quickly than many investors expected.

On the Scores side of the business, FICO grew revenue and income despite a challenging mortgage environment. In our Q3 2022 Portfolio Activity, we

highlighted FICO and opined that investors were overweighting the risk of the impending FHFA decision. This decision was announced shortly after our last letter, revealing that the FICO Score would continue to be mandated for mortgages alongside the VantageScore. This positive development reinforced our belief that the FICO Score is deeply embedded in the consumer lending ecosystem. With the FHFA decision no longer looming over the company, we believe FICO has a long runway to raise the price of its underpriced scores annually.

TJX Industries (TJX) shares mostly traded in line with the market through the third quarter but outperformed in Q4. This outperformance coincided with heightened concerns about the near-term outlook for the broader economy.

TJX and other off-price retailers tend to perform well under turbulent economic conditions. This is because cost-conscious consumers turn to cheaper alternatives to manage tighter discretionary spending budgets. A challenging economic backdrop also tends to create buying opportunities for TJX stores as manufacturers and big-box retailers liquidate inventory to meet cash flow needs. Therefore, TJX tends to be more resilient and relatively insulated during economic contractions. Investors also flock to companies like this when they have less clarity on the near future, which is why TJX's shares held up well during the recent market decline.

Shares of **Activision Blizzard (ATVI)** held up well in 2022, while the broader markets declined. Microsoft's proposed acquisition in January helped keep Activision's shares range-bound for most of the year after an initial 25% pop.

The proposed deal would pay Activision shareholders $95 per share but likely will not close until at least this summer. This has been a slow approval process because competitors allege that the merger would be anti-competitive. Regulators are weighing the potential for Microsoft to exclusively release certain titles on its Xbox platform and restrict distribution for its rival, Sony's PlayStation. This raises concerns over whether the deal will go through, thus explaining why shares are still trading at a sizeable discount to the $95 per share take-out price.

We view this as an opportunity to potentially earn a very attractive annualized return from today's prices in a strategy that is relatively uncorrelated with market fluctuations. Should the deal not go through, we would continue to own a high-quality business, with a sizable windfall from the break-up fee Microsoft would be obligated to pay Activision.

Top Detractors

Many of our core holdings were impacted by similar macroeconomic drivers in 2022, so you will notice some common themes as we highlight our biggest performance detractors. As a reminder, we constantly review each company's investment thesis. When a stock has a significant price swing, we need to determine which of the following two cases explains the move:

- Did new information emerge that changed the company's outlook and the underlying intrinsic value of the business?
- Is the new information inconsequential, and is the price change driven more by an unjustified shift in market sentiment?

If the former, we discuss whether the position is still worth owning and act accordingly. In the latter case, it could be a textbook example of the market inefficiencies we seek, where the price change overshoots any change in intrinsic value.

Amazon (AMZN) benefitted from the pandemic but faced a few challenges in 2022. Shelter-in-place guidelines accelerated a secular trend of consumers preferring online shopping to in-person

while simultaneously allowing Amazon to gain market share in the E-commerce market. It also expedited the need for companies to move their operations to the cloud and support remote work environments. Lastly, with consumers spending more time at home with their digital devices, advertising focus has shifted to more digital outlets.

However, abnormal growth like this tends to be followed by periods of lagging growth as the trajectory normalizes back to its original path. A few macroeconomic issues exacerbated this trend. Specifically, fiscal stimulus programs ended, inflation spiked on supply chain disruptions and inventory shortages, and the Fed raised interest rates to suppress inflation. This resulted in stalled consumer discretionary spending, which impacted Amazon's retail, cloud, and advertising customers.

We believe these headwinds are cyclical and short-term in nature. We think Amazon still has a wide moat in its core businesses, a long runway for growth, and a path to margin expansion. Combined with depressed share prices driven by macroeconomic fears and short-term cyclical headwinds, we think this is a recipe for strong shareholder value creation.

Microsoft (MSFT) was one of the biggest beneficiaries of the pandemic, which accelerated the growth cycles for many of Microsoft's offerings. The pandemic also created a rush to digitize operations and re-platform, or risk being passed by competitors. As such, sales of its Azure cloud solutions spiked, while demand for its Windows operating system, Office suite, and Dynamics CRM products grew with employees shifting to more remote work arrangements.

While Microsoft's growth pull-forward was not as pronounced as other core holdings like Amazon, it is going through a similar deceleration period. The company sells to commercial customers and directly to end users. In either case, any weakening of consumer spending will trickle through to Microsoft. Therefore, Microsoft's near-term outlook could include a more muted growth pace when compared to the past few years.

That said, we view Microsoft as one of the highest-quality positions in the portfolio. The company is well-positioned to capitalize on the secular trend of cloud digitization. Its products are deeply ingrained in users' everyday processes and would be very difficult to displace. It is transitioning many of its legacy on-premise products to cloud-based subscription contracts, which should help improve revenue visibility and drive profit margins higher. In short, we continue to see attractive opportunities for Microsoft to generate high returns on capital.

The pandemic-induced surge in global digital advertising provided a boon for **Alphabet (GOOG)** in 2021, but advertising revenue growth decelerated in 2022.

We believe revenue was pulled forward and "borrowed" from future years as the pandemic accelerated the growth of the digital economy. While this gave Alphabet additional capital to invest and return to shareholders in the short term, it also created a higher revenue base from which to grow. At the same time, demand for advertising inventory waned due to macroeconomic conditions, further challenging growth.

We think the company could face additional challenges in 2023 if a recession further impacts advertising budgets. We also acknowledge the risk of market share loss to Amazon and Apple. That said, we remain confident in the long-term earning power of the business, and we believe shares are undervalued relative to that earning power.

We still view Google Search as a public utility with an enormous value proposition, and we are pleased with the progress of Google Cloud, which will soon become the company's second-largest revenue source. We also view YouTube as the most valuable

video entertainment platform in the world despite its recent growth struggles. Android remains the market share leader for mobile operating systems, which should continue to keep traffic acquisition costs in check. In summary, we do not see a structural problem with the business, and we are willing to purchase shares at a discount given our long-term time horizon.

When **Meta Platforms (META)** reports full-year financial results, it might report its first annual revenue decline since going public in 2012. Additionally, margins have compressed, and capital expenditures have ramped up considerably. While Meta faced the same macroeconomic challenges that Alphabet did (i.e., the pullback in advertising spend), many of the contributors to Meta's poor performance are company-specific.

First, the company was severely impacted by Apple's introduction of App Tracking Transparency (ATT), which gave iPhone users a choice to opt out of being tracked across apps. This made ad targeting and attribution more difficult, thus limiting the effectiveness of ads across Meta's platforms. In addition to impacting revenue, it also prompted management to increase its capital expenditure budget as the company focused on improving its AI infrastructure for ad targeting and attribution.

The second major driver of META's poor stock performance was its ramp of Reality Labs investments, which were already more than $10 billion per year. These riskier investments in augmented and virtual reality, neural interfaces, and a social metaverse platform became much less attractive to investors as risk-free interest rates increased. Many investors continue to view the investments as a passion project for CEO Mark Zuckerberg, which we think is a poorly formulated thesis given his track record of strategic pivoting and long-term shareholder value creation.

Zuckerberg has stated that investments in Reality Labs will continue to grow and may take as long as a decade to bear fruit. We are willing to be patient, especially with the core social media business producing ample cash flow. We trust that management is rational enough to slow down investments if necessary, and we believe the technological assets being produced by Reality Labs have marketable value despite them not currently generating profits.

Central to our analysis, though, is our belief that the company's social media platforms will be even more attractive assets after this investment cycle. Given the high upfront investment in AI infrastructure and content moderation, we believe Meta will have a substantial infrastructure advantage over its competitors. Furthermore, it appears new monetization avenues like Reels and click-to-message ads are gaining traction, providing additional sources of optionality.

We sold META in select accounts during the year, primarily for tax-loss harvesting, but we continue to hold the position for accounts that did not qualify for these sales.

Louis Foxwell, CFA

Portfolio Manager

Matthew Holman, CFA

Portfolio Manager

We are here to support you and your wealth management objectives.

Especially now, we invite you to connect with your advisory team to discuss the markets, inflation, or your personalized wealth management strategy. We remain committed to your goals, both near and long-term.

(800) 592-7534

20 Wight Avenue, Suite 155, Hunt Valley, MD 21030

The foregoing content reflects the opinions of Hunt Valley Wealth and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security. There is no guarantee that the statements, opinions or forecasts provided herein will prove to be correct. Past performance is not a guarantee of future results. All investing involves risk, including the potential for loss of principal. There is no guarantee that any investment plan or strategy will be successful. Hunt Valley Wealth is a d/b/a of, and investment advisory services are offered through, Connectus Wealth, LLC, an investment adviser registered with the United States Securities and Exchange Commission (SEC). Registration with the SEC or any state securities authority does not imply a certain level of skill or training. More information about Connectus can be found at www.connectuswealth.com.