HUNT VALLEY WEALTH
A Connectus Partner

Market & Portfolio Commentary
Q2 2023

Second Quarter Market Review and Commentary

Inflation continued to moderate in the quarter, and earnings proved stronger than expected. However, the market remains cautious on fears of further rate hikes and an expectation that a recession may still be unavoidable.

John Heinlein
Managing Director,
Chief Investment Officer

The stock markets had another strong performance in the second quarter of 2023, with the S&P 500 index rising 8.7% while the Nasdaq Composite index outperformed, rising 13%. The market was helped by the absence of a recession, resilient earnings, and excitement about Artificial Intelligence (AI), which improved investor sentiment and valuations in the technology sector.

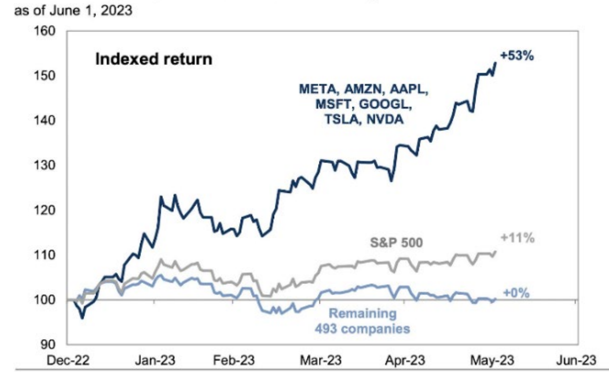
IN THIS ISSUE

There were significant divergences in performance in the stock market. Seven stocks (a.k.a. "The Magnificent Seven") account for roughly 30% of the entire S&P 500 Index (which is considered a proxy for the market), but contributed more than 80% of the Index's returns so far in 2023. The rest of the stocks had a flat performance on balance. These include:

1. Alphabet (GOOG) +36%*
2. Microsoft (MSFT) +43%
3. Amazon (AMZN) +55%
4. Apple (AAPL) +50%
5. Meta (META) +138%
6. Tesla (TSLA) +113%
7. Nvidia (NVDA) +190%

*2023 Total Return YTD through June 30th

Exhibit 2: Mega-cap tech has led the market higher YTD
as of June 1, 2023



Source: FactSet, Goldman Sachs Global Investment Research

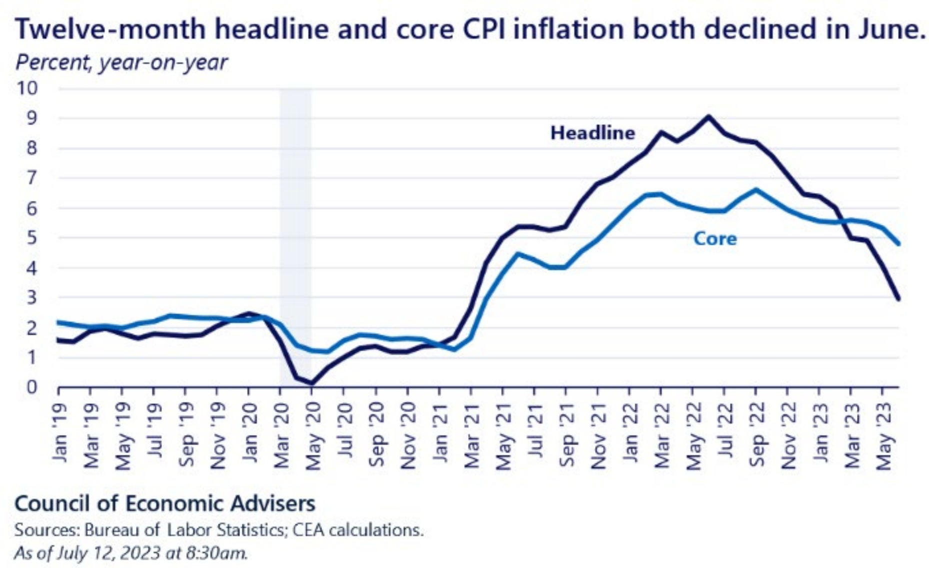
Normally, when the market is up a lot, a large percentage of stocks are up as well, so this extreme divergence is very unusual. Notably, the S&P 500 index, which is more traditionally quoted but weighted by market cap, gained 8.7% in the quarter, while the S&P 500 equal-weighted index only gained 4%.

Investors went into the second quarter on high alert for a recession and thinking the Fed could soon be cutting rates. By the end of the quarter, there was no economic downturn in sight, and the Fed was expected to keep rates higher for longer. Inflation did subside, however, it remained stubbornly high despite the continuous Fed action of unprecedentedly rapid hikes.

The U.S. Economy remains resilient so far despite the Fed's most restrictive monetary policy in forty years. So far, the economy is defying predictions of a downturn. First quarter gross domestic product GDP was recently revised upward from 1.3% to 2%, the labor market is strong, and unemployment is historically low. The idea that the Fed can orchestrate a "soft landing" is beginning to seem credible.

Despite inflation trending in the right direction, the Federal Reserve has maintained a hawkish tone regarding interest rate policy. Wall Street, however, is skeptical that they will still need to raise rates multiple times. It appears that the market is anticipating that the bank is near the end of its tightening cycle.

Second quarter earnings season has begun, and Wall Street's attention will soon be focused on the earnings reports. The reports should provide additional insight into the health of the economy and how Corporate America is adapting to a slower growth environment.

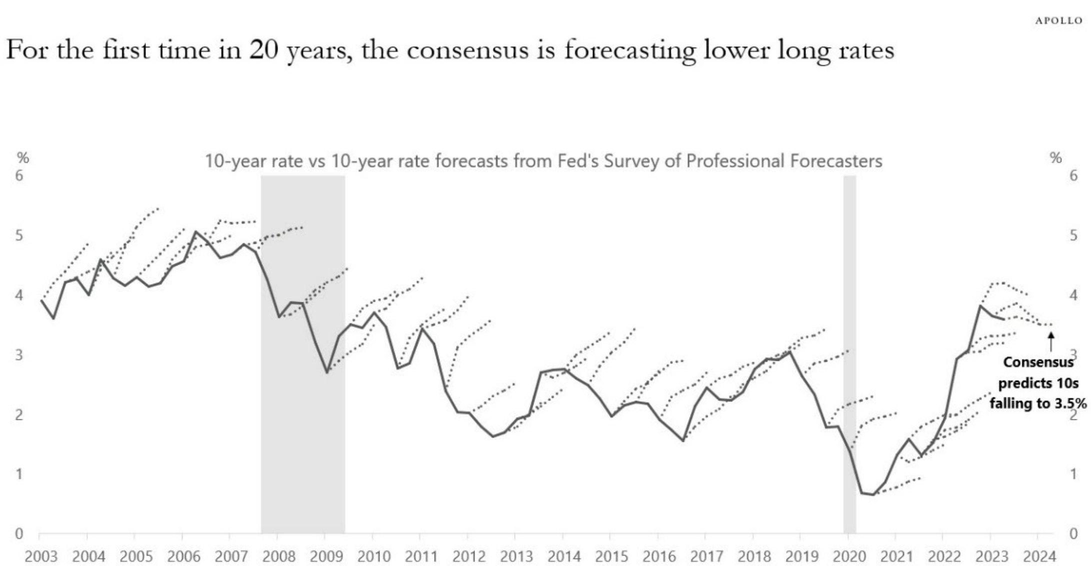


Are things “Different This Time”?

John Heinlein
Managing Director,
Chief Investment Officer

Why did markets keep rising, despite recession fears, a banking crisis, the threat of a U.S. default, and more interest-rate increases from the Federal Reserve? The answer: time and time again, investors’ worst fears failed to materialize. Ultimately, those who stayed out of the market this year in fear of another selloff missed out on robust gains. This year has reinforced the idea that it is difficult to predict which headline-grabbing events wind up having a lasting impact on market returns.

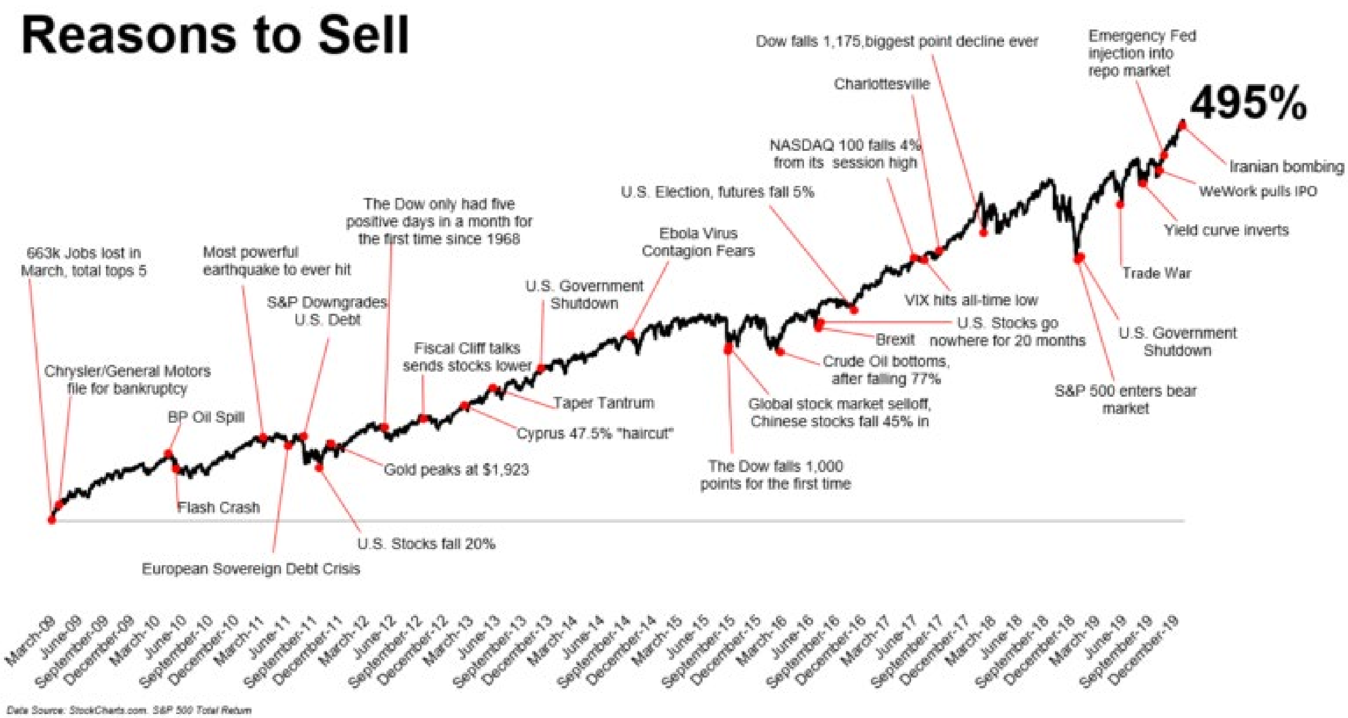
That said, it’s important to remain humble in making economic or market forecasts with any degree of certainty. This is why we do not rely on such forecasts as part of our investment process. Professional forecasters can’t even predict the *direction* of interest rates, let alone the magnitude. Refer to the chart below showing the interest rate forecasts of professional economic forecasters.



SOURCE: BLOOMBERG, PHILADELPHIA FED SURVEY OF PROFESSIONAL FORECASTERS, APOLLO CHIEF ECONOMIST

Fear often causes investors to worry, and there is always something to worry about. Think about it, when did we ever have a time in history when there was nothing to worry about? This will always be the case, as the future is inherently unpredictable. Our economy has had many extreme events over the last 130 years: multiple wars, pandemics, raging inflation, and more than a dozen recessions and financial panics. Despite these events, it continues to expand and grow, and the stock market has continued to advance.

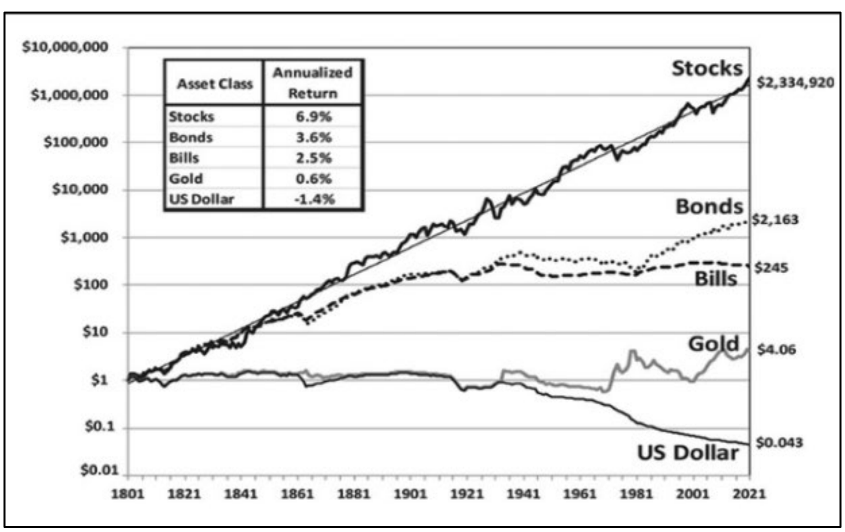
For example, the following chart shows the total return of the S&P 500 from 2009 to 2019. During that time, we can expressly point to dozens of major headline-grabbing events, along with many more that this snapshot omits.



SOURCE: RITHOLZ WEALTH MANAGEMENT

So, when you hear the phrase "it's different this time," it really isn't. History may not always repeat exactly, but it often rhymes.

One of the main reasons investors underperform is their behavior. Investors can be their own worst enemy. We know that the stock market is very volatile. Even in up years, there are many large intra-year draw-downs. So, the important question is, how do we combat our natural desire to worry about the near term? During these times, it is best to be patient, pull the lens back and look further out. In the long term, stocks win.



SOURCE: @BRIAN FEROLDI, TWITTER

Remember that macro conditions will drive daily market moves, but individual stock fundamentals historically dictate long-term investor outcomes.

Warren Buffett and Charlie Munger only discuss macroeconomic forecasts to say that they do not use them to make decisions on a stock or a company. Likewise, we maintain a long-term investment approach rooted in business values. Stock prices can be volatile, but business values often are not. In the long term, both prices and value eventually converge.

"Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you've invested."

- Peter Lynch

Another issue that often causes investors to underperform is their idea of risk. In academia, risk is defined by the volatility of stock prices. We would argue that volatility can be good when it allows you to purchase companies more cheaply. We view investment risk in terms of permanent loss or loss of purchasing power.

It is important to mention that risk and time horizon are inextricably linked. If you buy a stock today intending to sell it tomorrow, then you've entered into a risky transaction. The odds of predicting stock prices over short periods are akin to coin flipping. If you extend the time horizon to several years, the probability of it being risky declines meaningfully, assuming you made a sensible purchase.

"Price fluctuations have only one significant meaning for the true investor. They provide him with the opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to... the operating results of his companies."

- Ben Graham, The Intelligent Investor, p. 109.

In summary, consider the following key takeaways from this commentary and the ties to our core investing principles.

Key Takeaways from Commentary

- Do not rely on economic or market forecasts when making investment decisions
- Do not wait until you feel that there is nothing to worry about before investing
- Always keep a long-term perspective when investing
- Stocks are your best bet for compounding wealth over long periods of time

Q2-2023

Company Spotlight

CoStar Group™

Louis Foxwell, CFA
Portfolio Manager

CoStar (CSGP) is a leading provider of data and analytics, listing services, and marketplaces to the commercial real estate (CRE) industry. It sells software subscriptions and advertising space to brokers, property owners, lenders, property managers, investors, and agents. CoStar's notable assets include CoStar, Apartments.com, LoopNet, Homes.com, Homesnap, and Ten-X.

Commercial real estate transactions require market data and property-specific information. Brokers need comparable sales data to accurately price properties. Property managers need data on rents in their market so they can set optimal rates. Investors must know the potential earning power of target assets before investing, and banks that lend to them must have enough information to underwrite attractive loans. All these market participants need information, but information in commercial real estate is fragmented and non-standardized. Collecting it is time-consuming and costly, and obtaining inaccurate or stale information could spell disaster. This is where CoStar enters the picture.

CoStar collects data, sometimes with input from customers (e.g., brokers), before standardizing and repackaging it in various products. It is the closest thing in commercial real estate to a centralized repository of data and analytics. A subscription to CoStar's product suite is considered table stakes for those operating in the industry, as it saves them time and money while lowering their operational risks. As a result, the company has a formidable market position that we think could endure many decades. Revenue in this segment is mostly subscription-based, which is high-margin and recurring.

CoStar also owns numerous CRE listing services and marketplaces, notably Apartments.com and LoopNet. Multifamily landlords and property managers use Apartments.com to advertise units to prospective renters. Landlords and agents use LoopNet to advertise all commercial property types to tenants, buyers, and agents. We estimate that both sites are still under-monetized, as their addressable market is much larger than their current customer base. These assets also have attractive unit economics, and we think margins will widen as they scale.

CoStar is highly acquisitive, and it follows a very specific M&A playbook. It will acquire an asset, use its marketing expertise to aggressively promote that asset, and then monetize it once the customer base reaches critical mass. It applied this playbook and realized incredible results with its CRE listing services and marketplaces, and it recently implemented it to penetrate the residential real estate market. Management thinks there is a need in the residential market for an agent-friendly listing platform. Through its recently acquired Homes.com and Homesnap properties, it plans to create such a platform. We think this is the correct approach to market, as competitor Zillow's "Premier Agent" model excludes the majority of agents who are potential paying customers. We acknowledge that it will take time to build, but we are willing to be patient.

After fewer than three years into the residential venture, early results are even more promising than anticipated. Homesnap has over a million registered agents on its platform (out of ~1.5 million potential agents in the U.S.). Homes.com is the fastest-growing residential platform in the market and has surpassed management's user growth targets thus far. We think the potential for this platform is enormous, given the size of the untapped residential listing market. Further, we believe the company will eventually create a software suite for data and analytics for the residential market once it reaches scale.

CoStar's management is founder-led and highly aligned with shareholders. It knows its strengths and leverages them to grow its business through high-return acquisitions and performance marketing. The company's end markets are still in the early stages of digitization, so we think there is a long runway for this growth.

As with many information services businesses, intelligent capital allocation can often lead to non-linear outcomes due to the scalability of data assets. CoStar has the industry's most valuable data assets, in our opinion. This is primarily due to the unmatched size of its research team and its relationships with customers – which are uniquely attractive because these customers contribute to the very product they are buying. This is more akin to a partnership than a traditional one-sided sales relationship, which lowers costs and creates a barrier for competitors.

Some investors have expressed concern that a downturn in commercial real estate or a recession will have a significant impact on the business. While a recession would undoubtedly be suboptimal for CoStar (and most businesses), we think this concern misses the mark given the current revenue composition of the company. Its exposure today to more macro-sensitive small brokerage firms is a fraction of what it was during the financial crisis. Further, the business is hedged more today with platforms like Ten-X (which is positioned to auction distressed properties) and the marketplace businesses, which do well when occupancy rates fall. We believe CoStar is positioned to weather short-term challenges while also investing in high-return ventures that will bear fruit many years into the future. Therefore, we consider it a core holding for client portfolios.

Company Spotlight

Microsoft

Matthew Holman, CFA
Portfolio Manager

Microsoft's (MSFT) business has evolved over the past decade to become a true technology conglomerate. Its products touch every industry in the global economy – many of which have become essential to users' daily workflows.

The company is perhaps best known for its Office and Windows OS products. It also has exposure to social media (via LinkedIn), search and digital advertising (Bing), gaming (Xbox), and enterprise and customer management (Dynamics), among others.

But a recent pivot towards cloud computing and artificial intelligence (AI) has helped re-ignite the company. When Microsoft launched its cloud product, *Azure,* more than a decade ago, it was only a modest revenue contributor that required significant capital investment and thus was a headwind to overall profits. Today, cloud and server products are not only Microsoft's largest and fastest-growing business but also its most profitable.

We view this as a very high-quality business due to its ability to compound capital well above our required rate of return. We believe there is a good opportunity to sustain these high returns due to competitive advantages that are both tangible and intangible in nature. Let's examine a few in detail:

- *Tangible:* Microsoft has invested billions of dollars over decades to build the infrastructure behind its cloud and software solutions. Its customers have also spent extraordinary time and capital integrating Microsoft's solutions. This means Microsoft has scale advantages that competitors cannot match and prohibitive switching costs that dissuade users from leaving.

- *Intangible:* Microsoft is one of the strongest brands in tech – one that even the most novice user would recognize and trust. Its gaming, social media, ERP, and Office products have embedded network effects – meaning users want, or often need, to use products that their friends or colleagues use. Therefore, disrupting that dynamic would require converting large user groups rather than just a few at a time.

The distinction between these moat sources is an important one. Tangible competitive advantages often require significant investment to develop in the form of both time and capital. These are slower to create value, but also more challenging for a competitor to disrupt once established. The upfront investment creates an asset base capable of sustaining value through varying economic cycles and competitive environments.

In contrast, intangible advantages can be quicker to develop and generate economic value. The downside is that these intangibles can unravel as quickly as they form. Ideally, we look for businesses that have established both. If an intangible moat is threatened, the business can rely on its tangible moat to sustain cash flows until it can adapt.

For example, let's say a new competitor emerges and threatens LinkedIn's platform. If this were Microsoft's only business, there would be more pressure to respond quickly and perhaps impulsively. Management would also have limited resources at its disposal. Raising the necessary capital needed to respond would likely involve changes such as temporarily cutting marketing spending or issuing new debt or equity capital at a potentially disadvantageous time. While either could resolidify LinkedIn's competitive position, they would also weigh on the company's (and shareholder's) longer-term performance.

Conversely, since Microsoft has a more diversified set of assets and competitive advantages, it can be more nimble in its response. First, management could tap into the cash flows generated by its more stable businesses, like Azure, Office, or Windows, as a quick, and potentially cheaper, source of capital. There should also be less pressure to respond impulsively, which helps limit the potential for poor decision-making. Therefore, management has more options to make the necessary decisions to re-establish LinkedIn's economic moat.

Both types of assets can also create *strategic optionality* benefits, although this is especially prevalent in intangible assets. A good management team can leverage these assets to explore new growth avenues. Fortunately, Microsoft has one of these management teams, led by Satya Nadella – the primary visionary behind the Azure shift.

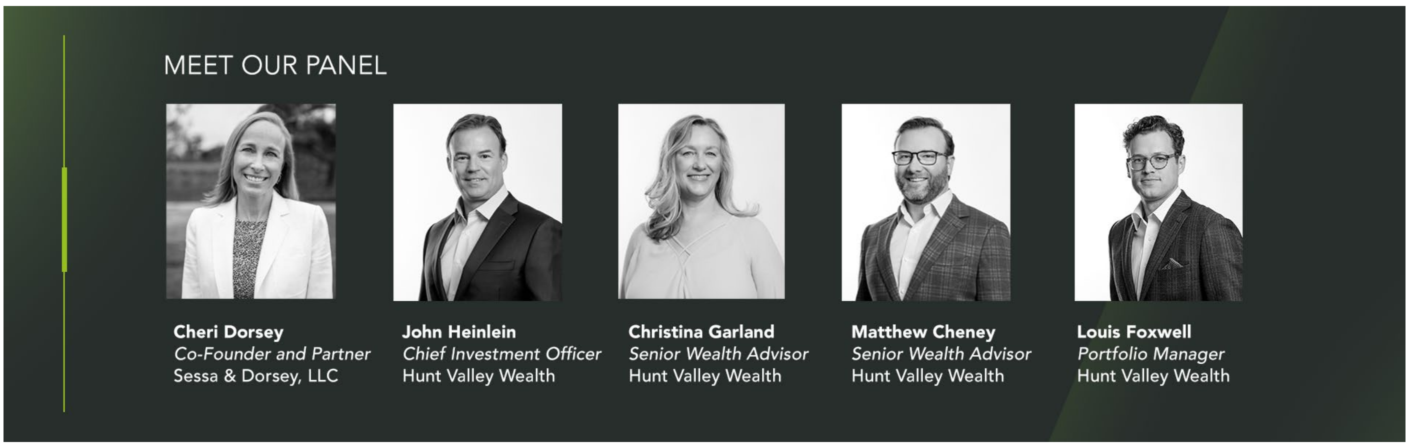
The next growth chapter will likely come from gaming, with its proposed acquisition of video game publisher *Activision Blizzard*, and from AI, with its investments in OpenAI's *ChatGPT* platform. Generative AI technology looks like it will play a prominent role as there are use cases to integrate the technology throughout Microsoft's product portfolio. While management is still developing its strategy here, this is a prime example of the *strategic optionality* benefit that we seek, in action. Notably, this optionality can uncover new growth avenues (and upside potential), which investors often cannot predict in their initial research.

New Webinar Series

The Hunt Valley Wealth team is launching a new webinar series coming this Fall '23 - "Grow Your Wealth, Leave Your Mark." The webinars will feature valuable market insights and thoughtful dialogue to guide clients on their personal wealth management journeys.

> The first webinar, "Leave Your Mark": Navigating Major Life Events, Investing Through Headline Noise, and Leaving a Purposeful Legacy is scheduled for Wednesday, September 13th, 2023, from 2:00 pm - 2:45 pm ET.

Join us and our expert panel as we delve into three topical segments that form the foundation of a thriving financial journey: Lifestyle, Growth, and Legacy.



You will learn:

- Lifestyle – How to navigate major life events from becoming an empty nester to retirement.
- Growth – How to stay the course and continue investing through headline noise.
- Legacy – When to transition assets and how charitable giving can leave a lasting impact.

Prepare to gain insights and practical knowledge that will empower you to leave a lasting mark on your financial journey. **Register for our webinar** and don't miss this opportunity to participate in this live discussion!

REGISTER NOW

Scan To Register

HUNT VALLEY WEALTH
A Connectus Partner

(800) 592-7534 • huntvalleywealth.com

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