HUNT VALLEY WEALTH
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Market & Portfolio Commentary
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Fourth Quarter Market Review and Commentary

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A strong fourth quarter capped off a tremendous year for U.S. equities. Near-term recession fears appear to have largely abated – while a "rotation to quality" helped propel *seven magnificent companies* to the top of 2023's biggest winners list.

John Heinlein
Managing Director,
Chief Investment Officer

The U.S. inflation situation continues to improve, which has caused treasury market yields to move notably lower. The lower rates have been a reaction to the continued moderation in price growth and the expectation that the Federal Reserve is done raising rates. Even though the Fed continues to say that rates need to stay high for an extended period to effectively fight inflation, Wall Street thinks it will pivot in 2024 and begin cutting rates later this year. This, along with the belief that a "soft landing" for the economy is still plausible, has been a major contributor to the strong recent market performance.

By most counts, the U.S. economy has been doing very well. GDP growth was an exceptional 4.9% last quarter, unemployment remains near all-time lows, inflation has been heading lower, wage growth is outpacing inflation, and corporate profits are robust. This "goldilocks" scenario of moderating inflation in a still-expanding economy has emboldened equity investors, powering equities higher. However, it should be noted that this buying has pushed market valuations to elevated levels, which could leave stocks vulnerable to some profit-taking on any disappointing news.

Market Review

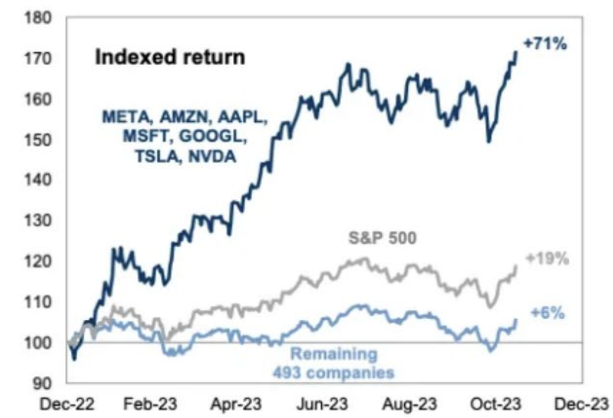
The markets closed out 2023 on a strong note. The benchmark S&P 500 was up 26.3% (including dividends), while the tech-heavy NASDAQ index finished up 44.7%. It's important to note that the strong market performance comes after a nearly 20% decline for the S&P 500 in 2022, its worst annual performance since

2008. Although these indices showed strong gains in 2023, the advance was driven largely by a handful of stocks. Remember, these indices are market cap-weighted, meaning the larger the company, the more influence it has on the index's return. In fact, the seven-largest stocks by market cap accounted for nearly 75% of the S&P 500's return. For the NASDAQ, the returns of only three stocks (Apple, Microsoft, and NVIDIA) were responsible for 30% of its gain.

Exhibit 22: Share of largest seven companies' market cap in S&P 500 is at an all-time high

Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 23: The Magnificent 7 have led the index higher in 2023



Source: FactSet, Goldman Sachs Global Investment Research

Research from Goldman Sachs shows the S&P 500 has never been this top-heavy, which is leading to gains in seven stocks driving the major average higher. (Goldman Sachs Global Investment Research)

What about 2024?

Looking at expectations for performance in 2024, while most investors seem optimistic, Wall Street strategists predict that the S&P 500 will have a down year, as shown in this recent Bloomberg chart.

We've spoken many times about the folly of trying to predict short-term movements in the market. Interestingly, most prognosticators were spectacularly wrong with their forecasts. At the end of 2022, The New York Times published an article titled "The Year the Long Stock Market Rally Ended" (LINK: SUBSCRIPTION REQUIRED), which demonstrates the recent track record of Wall Street's market predictions.

From the article:

> "A year ago, bank analysts responsible for projecting where stocks would end 2022 were somewhat optimistic... Even the most pessimistic prediction at that time thought that the S&P 500 would finish the year 10% higher than where it actually will. Now, the most optimistic strategist doesn't expect the S&P 500 to even make up that lost ground in 2023, while most expect the market to end roughly at where it's starting, after a dip early in the year."

As we can see, with the benefit of hindsight, the most pessimistic strategist wasn't pessimistic enough in 2022, and the most optimistic strategist wasn't optimistic enough in 2023. An extremely poor showing for the market "experts."

We are not surprised at the results, as market prognosticators are almost always wrong. Unsurprisingly, we don't believe market forecasts or timing needs to have any bearing on managing portfolios for long-term investors. As said before, these predictions do not affect how we invest for the long term. Trying to position portfolios based on forecasts introduces noise and additional decisions which are not only unnecessary but most often harmful to long term investment returns.

We manage portfolios using structural allocation between stocks, bonds, and cash, periodically rebalanced with alignment to one's ability and/or willingness to bear risk. While this philosophy seems less sophisticated than moving in and out of the market based on macro factors, it is much less prone to large, unforced errors.

It is our belief that the most important factor in determining the long-term success of the portfolio is the performance of the underlying businesses. Of course, purchasing them at reasonable prices is equally important. We narrow our focus to the task of finding great businesses to own over the long run and purchasing at a discount to what we determine to be their intrinsic value. We will leave the market prognosticators to their fun while we stay focused on the task at hand.

Top Contributors

Louis Foxwell, CFA
Portfolio Manager

Matthew Holman, CFA
Portfolio Manager

While 2023 was a tremendous year for U.S. stocks, it is notable that the four biggest performance detractors discussed in our 2022 annual letter are among the top winners in 2023 (MSFT, GOOG, AMZN, META). These names will likely sound familiar as they are not only some of the world's largest and most successful companies, but we have frequently lauded their virtues and business models as some of the best we have come across to date. This dichotomy between portfolio winners and losers over the last two years helps reinforce our long-term investing focus.

Let's dive into a few of these companies and discuss what made them outperform in 2023.

Fair Isaac's (FICO) stock price nearly doubled in 2023, making it one of our top performers for the second year in a row. It has been more than a year since the FHFA mandated both the FICO Score and VantageScore for mortgages sold to Fannie Mae and Freddie Mac. This mandate, in our view, gave FICO free rein to increase score prices without the risk of anti-trust scrutiny. Management has done just that, and reports indicate that pricing will substantially increase again in 2024. We believe FICO's pricing power remains strong, as the price of the FICO Score is still a small fraction of closing costs and total loan costs.

As a demonstration of FICO's economic moat, we should mention that the adoption of VantageScore in the mortgage market has proven to be more cumbersome than regulators anticipated. In June, a group of 17 housing organizations formally requested that the FHFA extend its implementation timeline. We have argued in the past that the inclusion of a second scoring model would be met with friction from market participants, and this appears to be happening as the costs of adoption seemingly outweigh the benefits. We think this bodes well for FICO in both auto and credit card scores as well since it reinforces our belief that stakeholders have little incentive to switch from the FICO Score.

In FICO's software segment, customer retention remains strong, and both the legacy business and the decision management platform have surpassed even our optimistic growth expectations. This has translated into margin expansion, which we believe will continue. We remain very pleased with management's strategic decisions regarding the platform, and we would not be surprised if they spin off the software business at some point in the next five years to unlock additional shareholder value.

Booking (BKNG) represents an excellent example of why fundamental analysis is important in the portfolio management process. When the global pandemic created unprecedented travel restrictions, we did not know how long it would take for travel demand to recover. When Russia invaded Ukraine, we did not know the impact it would have on the European travel market. However, in the midst of these unknowns, there were a few things in which we did have confidence. We believed that Booking possessed (1) a flexible cost structure, (2) a favorable market position in an industry with long-term tailwinds, (3) good capital allocators at the helm, and (4) excellent unit economics. As travel has recovered, Booking has taken market share and is now generating record levels of gross bookings, revenue, and cash flow due to these traits. As the saying goes, time is the friend of the wonderful business. If we had focused on macroeconomic predictions instead of bottom-up analysis over the past three years, we likely would have missed out on these excellent results.

We think Booking is primed to capture additional market share in alternative accommodations, U.S. hotels, and ancillary services like flights and rental cars. Given Booking's global scale, offerings across multiple hospitality services, and relationships with independent hotels, we are confident that it is well positioned to offer a single platform for all travel needs – what management calls "The Connected Trip." In addition to reinvestment into this platform, we anticipate additional share repurchases with excess cash flow. Given that management is highly aligned with shareholders and has an excellent track record of both M&A and opportunistic share repurchases, we are confident that they will optimally strike a balance between the two.

In our Q3 2023 Company Spotlight, we explained how **Meta (META)** has undergone multiple moat tests and why we believe it is an antifragile business. We recommend revisiting that piece, as it summarizes our thesis on the company. Meta had a tremendous 2023, exceeding earnings expectations, creating a leaner organizational cost structure, scaling Reels as a viable competitor to TikTok, and navigating Apple's IDFA deprecation to regain ad targeting and attribution efficiency. As a result, META was one of the top performers among the companies we follow.

We are encouraged by META's ability to grow operating earnings while ramping up investments in A.I., infrastructure, and Reality Labs. The company's sticky advertising customer base and end-user lock-in, in our view, enables it to adapt to rapidly evolving regulatory and commercial landscapes. We think management's capital allocation philosophy is long-term focused and aligns well with our own investment horizon. Meta CEO Mark Zuckerberg will likely continue to make decisions that sacrifice short-term profits for long-term value creation, and there may be brief periods where the market dislikes that. However, unless the core value proposition or the economics of the business change, we will remain patient as the long-term thesis plays out.

Amazon (AMZN) delivered a stellar 2023, and it rewarded patient and disciplined investors for recognizing the enduring strength of its underlying business and its true value. While 2023 was a strong year, Amazon's investment performance has been a tale of three stories over the past few years.

2020 was an equally stellar year for Amazon as the pandemic accelerated secular trends like online commerce, digital advertising , and business migration to the cloud. Amazon was able to flex its muscle during this time and acquire market share while these emerging industries grew.

In the subsequent two years, the business's growth slowed, especially its retail business, making it difficult to compete with its own recent success. Also, the market was becoming increasingly nervous about a looming recession and fixated on economic headwinds, the Fed's rate hiking schedule, and combatting stubborn inflation. The market thus shifted its interest, and Amazon's share price stalled and ultimately fell in 2022, landing the company on our 2022 detractors list.

A market rotation in 2023 helped renew investors' admiration of Amazon's core businesses and economic moat. Investing in Amazon during the past four years demonstrates the value of sifting through the short-term noise and remaining focused on the core business and long-term. In fact, the investment thesis for Amazon has not changed much in the past four years, nor have the business's underlying fundamentals. But long-term investors had to endure two exceptional years of performance with two subpar years sandwiched between them. However, this volatile four-year span would have rewarded investors with a market-beating gain if they had done nothing.

Microsoft (MSFT) has been one of our best-performing stocks since we first started buying it, and 2023 was no exception. Despite a brief appearance on our portfolio detractors list in 2022, Microsoft remains very well-positioned in 2023, and we continue to be excited about the company's long-term prospects.

2022 was fraught with economic uncertainty. Many investors were convinced a recession was coming; it was just a matter of when. It is possible that this uncertainty led to a lot of resistance and hesitation in the broader markets. However, after thinking this way for more than a year, the market appeared to shift in 2023 and moved capital into the highest-quality household names in a "Flight to Quality" rotation. As long-term investors in the company, we view Microsoft as one of the highest-quality businesses in our portfolios, and we were not surprised by its inclusion in this thematic rotation. The appeal of these higher-quality companies in an uncertain environment is their dominant and durable market positions combined with more predictable cash flow streams, which is where Microsoft shines. We recently wrote about the strengths of Microsoft's business in our Q2 2023 Company Spotlight if you want a deeper look into why we like the company so much.

While this rotation is nice for short-term investment gains, we would prefer a more modest pace so the company can repurchase more of its own shares at better prices, and so we can accumulate more shares in client portfolios when it trades below our estimate of intrinsic value. This would greatly increase the long-term potential for investment gains for patient shareholders, but the secret has long been out on Microsoft, and it is rare to see its shares go on sale.

Top Detractors

Stocks can sell off for many reasons, and it is important to distinguish between their fundamentals and the market sentiment surrounding their share prices. If something structurally changes in the underlying business, this may cause us to re-evaluate our thesis and potentially change our investment strategy or exit the position altogether. However, market sentiment is complex and an aggregation of every investor's thesis. Market sentiment is driven by each investor's:

- Perception about the business and its future
- Economic outlook
- Time horizon
- Need to raise or invest capital

Thus, there are several reasons a stock can sell off other than changes in its underlying fundamentals or intrinsic value. If we find that a company's share price is falling for one of the reasons above, this could be a short-term dislocation between price and value and present an attractive investment opportunity.

Etsy's (ETSY) business model performs best in a strong economy, and 2023 was not the most favorable year for discretionary spending. Concerns about a possible recession, combined with rising price levels, caused some to tighten their household budgets and curtail spending in certain pockets of the market – many of which Etsy participates in. That said, most of these sales that Etsy "missed" in a weak 2023 economy were *pulled forward* during the pandemic when it more than doubled its sales in a single year. Further, the business has retained those pandemic gains and continues to grow despite this muted economic backdrop.

Let's put some numbers behind this. Since the start of the pandemic:

1. Users selling on Etsy more than tripled
2. Unique active buyers more than doubled
3. Marketplace transaction volume nearly tripled
4. Average take rate significantly improved, meaning Etsy's revenue grew faster (3.3x) than its transaction volume

In other words, we think Etsy's market position is at least three times as strong as in 2019 before the pandemic -- yet the stock still trades where it did in 2019.

We believe the disconnect here is primarily market sentiment-driven. Specifically, we attribute a tepid economic outlook and a higher interest rate environment as the primary drivers of Etsy's share price decline. For more details on this topic, see our white paper on How Interest Rates Impact Stock Prices. Both are temporary in nature, and neither suggests any structural concerns to Etsy's core business. Because of its improved ability to monetize its vastly larger business, we believe Etsy is well-positioned for an economic recovery, and we are still bullish about its long-term prospects.

Vail Resorts (MTN) has faced numerous headwinds since the start of the pandemic, and 2023 brought mixed results. While we were pleased with the growth of the Epic Pass product, margins and revenue growth came in lower than expected. Skiing conditions have been subpar in key markets, as weather has been unpredictable and restrictive. While the Epic Pass insulates the company from some of this risk, operating results still suffer under these conditions. The market wants to see more growth and improved profitability, and we expect Vail to deliver on that in the coming years as it continues to scale.

Despite the recent negatives, we think our long-term thesis is intact. Given the stability of the passholder base and the value proposition of the pass product relative to the competition, we are confident that Vail can find additional ways to monetize the Epic Pass asset.

Additionally, the company acquired its second European ski resort in 2023, laying the groundwork for a pass network in Europe. While this expands the value of the Epic Pass, it also presents a new reinvestment opportunity. Europe is a significantly larger ski market than the U.S., and Vail is seemingly prepared to follow the playbook that made it so successful back home.

PayPal's (PYPL) performance is highly correlated to the strength of the global economy. Its revenue is dependent on the volume transacted on its platform, which is strongest with the benefit of a favorable economic landscape. Like Etsy, we consider PayPal a longer-duration stock, given its remaining runway and opportunity to reinvest in growing pockets of the payment processing industry. As such, it is more sensitive to interest changes, and thus, its investment performance since 2022 resembles other long-duration stocks.

But PayPal has also been navigating some more idiosyncratic changes, which may be keeping its shares from reaccelerating. First, the business completed its separation from eBay, where PayPal formerly served as the primary payment processor. While this means PayPal will no longer process the bulk of eBay's transactions, its branded "PayPal button" is still offered as a primary payment option. More importantly, this now allows PayPal to serve other large retailers as their primary processor.

Second, former PayPal CEO Dan Schulman announced his retirement, with Alex Chriss, formerly from Intuit, taking his place. We believe this new team's background and strengths better align with the current state of the payments industry. We are encouraged by their focus on the company's core products, cost efficiencies, and better allocation of resources towards innovation.

Lastly, the payment industry is constantly evolving, and some bearish investors cite threats such as competition, disruption, or disintermediation. We acknowledge these but recognize that these threats are not new and have existed since its inception. The fact that PayPal has endured more than two decades of these and still retains its dominant market position is a testament to its moat.

In summary, the market appears too focused on the short term and is overly discounting the long-term opportunity. We think PayPal's core assets, brand equity, and dominant market position are stronger than the market currently values, and thus, we believe shares are cheap at these levels with a longer-term time horizon.

In our opinion, the factors at **Starbucks (SBUX)** that led to subpar stock performance in 2023 are short-term in nature and sentiment-related. The company appointed a new CEO in March, and the market is seemingly in "wait and see" mode when it comes to management's updated revenue and earnings growth targets.

Management has highlighted the opportunity to take costs out of the business through improvements in the supply chain, beverage-making equipment, and tech stack. It appears to us that investors are not fully appreciating these opportunities and their potential to improve the long-term margin profile of the business. We think the brand asset remains very strong, and we believe revenue in mature markets has increasingly become more recurring in nature as customers have made Starbucks part of their daily routine. Beverage customization has improved along with the prevalence of cold drinks, which also improves the pricing and margin outlook. Additionally, prepaid customers continue to grow as a percentage of total customers, which increases float and gives more visibility into future revenue.

China remains a key point of debate, as some investors are hoping for a shift from an ownership model to a licensed store model. We see the benefits and shortfalls of both, and we trust that management will make the right decision for shareholders. In terms of capital allocation, we support management's unit growth plans in high-ROI markets, as well as the return of excess capital to us through share repurchases and dividends. We expect double-digit earnings per share growth in the foreseeable future, and we believe the market will eventually appreciate that value creation.

Financial Planning Corner

What important planning issues should you consider in 2024?

Dani Ryan, CFP®, CDFA®
Senior Wealth Advisor

The SECURE ACT 2.0, a proposed follow-up to the original Setting Every Community Up for Retirement Act, aims to enhance retirement savings and security for individuals further. In 2024, the SECURE Act 2.0 brings a suite of new provisions set to take effect. These changes not only aim to enhance retirement savings but also strive to provide greater flexibility and opportunities for individuals navigating the complexities of preparing for retirement.

PLANNING ISSUES – EFFECTIVE 2024

Do you (or will you) have unused funds in a 529 plan?	Unused 529 fund assets may be rolled over directly to a Roth IRA for 529 plan beneficiaries up to the lifetime limit of $35,000 and subject to certain conditions.
Do you have a Roth Defined Contribution Plan (401(k), 403(b), etc.)?	Consider how the elimination of Required Minimum Distributions (RMDs) affects your plan.
Are you planning on making Qualified Charitable Distributions?	The annual QCD limit will be $105,000 in 2024 and indexed for inflation moving forward. The eligible age for making a QCD will remain at 70 ½.
Do you have an emergency savings account?	Defined Contribution Plan participants may contribute up to $2,500 after-tax to a pension-linked emergency savings account (PLESA), allowing tax and penalty-free withdrawals.
Are you planning on making an IRA catch-up contribution?	IRA catch-up limits will be indexed for inflation. For 2024, if you are age 50 or older, you can add an extra $1,000 per year in "catch-up contributions, bringing the total contribution to $8,000.
Do you have student loans?	Employers can make matching contributions to employees' qualified retirement accounts equal to employees' student loan payments.

As the SECURE Act 2.0 unfolds in 2024, it presents a pivotal moment for individuals and businesses to re-evaluate their retirement strategies. Talk with your financial advisor about how these changes may impact you directly.

Hunt Valley Wealth: Upcoming Webinar

Join us as we look back at 2023, share updates shaping 2024, and provide invaluable tips to brush up on your financial planning.

Navigating 2024: Key Updates, Market Insights & Assessing Your Financial Wellness

When: Wednesday, January 24, 2024 at 2:00 pm - 2:45 pm E.T.

Throughout this discussion, we'll explore three key areas:

1. **2024 Planning Updates** - Covering critical developments in Tax Planning, Social Security and Medicare, Education Planning, and more. Stay ahead of the curve by understanding the implications of these updates.

2. **2023 Market Review and 2024 Outlook** - The folly of market forecasts was proven once again. What happened last year, and what is on tap for the new year.

3. **Assessing Your Financial Wellness** - Adopting a holistic approach to wealth management, we'll equip you with the knowledge and tools needed to review your plan and make informed decisions.

Register for our interactive webinar to initiate the evaluation of your financial well-being today.

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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