The S&P 500 generated a total return of 7.5% in the first quarter. Foreign stocks, as measured by the MSCI ACWI ex USA Index, appreciated 6.9%. The Morningstar U.S. Small-Mid Cap Index was up 4.0% for the quarter. Dividend stocks declined slightly, with the Dow Jones U.S. Select Dividend Index down 1.8%.

The U.S. equity market advanced in the first quarter, on the heels of the S&P 500 index’s worst annual calendar year performance since 2008. The market moved higher despite the economic uncertainty around inflation and interest rates — topics that appear to have carried over from last year into 2023.

Inflation, as measured by the Consumer Price Index (CPI), peaked in June 2022 with a 9.1% year-over-year increase. The latest available CPI reading at quarter-end was February’s 6.0% — so inflation continues to moderate but remains at elevated levels. On March 21, the U.S. Federal Reserve raised the benchmark federal funds rate by another 0.25 percentage points to between 4.75% and 5.0% — the highest level since 2007.

The Fed’s March rate hike may have been higher if not for the recent events in the regional bank industry. Earlier in the month, there was a bank run at Silicon Valley Bank, which, along with Signature Bank, was taken over by bank regulators. To alleviate fears of broader contagion about deposits and liquidity at other regional banks, the Federal Reserve increased lending options available to address liquidity concerns. It remains to be seen whether the bank industry gets tighter with lending to consumers and businesses, which could have implications for near-term economic growth.

Charlie Munger’s Wisdom

We are overdue in sharing wisdom from Charlie Munger in the Focus on Equities quarterly letter given our admiration for his rational and multidisciplinary approach to investing. Munger is the vice chairman of Berkshire Hathaway. He has served as Warren Buffett’s partner and sounding board for over five decades. In February, Munger hosted his annual Q&A session at Daily Journal’s annual shareholder meeting (where Munger serves as chairman), which was live streamed and recorded.
on CNBC.com. At age 99, we believe Munger is as mentally sharp as ever, as he offered his unique wisdom and insights for over two hours on a wide range of current topics.

Two answers caught our attention. First, here’s Munger’s response to a question about things that have surprised him the most and if he used those surprises to become a better learning machine.

Munger (abbreviated): “Some of the things that surprised me the most was how much dies. The business world is very much like the physical world, where all the animals die in the course of improving all the species, so they can live in niches and so forth. All the animals die and, eventually, all the species die. That’s the system. When I was young, I didn’t realize that that same system applied to what happens in capitalism to all the businesses. They’re all on their way to dying, is the answer, so other things can replace them and live. It causes some remarkable death… think of all the great department stores. Think how long they were the most important thing in their little community… It looked like they were eternal, and they’re basically all dying or dead. Once I understood that better, it made me a better investor.”

Munger’s answer resonates with us. Our Select Equity portfolios have a preference for investing in high-quality businesses, which we describe as possessing sustainable competitive advantages, strong balance sheets, and shareholder-friendly management teams that are focused on increasing intrinsic value on a per-share basis. Munger reminds us that most strong businesses don’t stay that way forever. This is a business reality given our capitalist system and the fact that the business environment is constantly evolving given technological advances.

Disruption risk is a common topic when our portfolio managers discuss current and potential holdings as a team. Charlie Munger is an advocate of continuous and cumulative learning, which is an approach we are aligned with. In our research and portfolio management process, our work is never done, as we constantly reassess our thesis and outlook for a company based on new information or financial results. We view analyzing a business as an ongoing process that we sometimes compare to seeking an accurate view of a picture without having all the puzzle pieces in place. Once all the puzzle pieces are in place and it’s obvious to everyone, the stock market has already priced it in.

Our Select Equity portfolios typically own between 20–40 stocks. We don’t think it makes sense to own our 81st best idea, and we believe most of the benefits of diversification can be achieved with our range of stock holdings. Also, owning a focused portfolio of our best ideas makes it easier and more achievable for portfolio managers to truly know what we own. Like all portfolio managers, we make our share of misjudgments about businesses, but we try to minimize these errors and strive to learn from our mistakes to become better investors.

An answer to a question about which quality has helped him most in life has broad applications beyond investing. Munger’s response: “That’s easy — rationality. If you’re just not crazy, you have a big advantage over 95% of the people. Most people have all
kinds of crazy patches. If you’re just consistently not crazy, you get a big advantage in life. If you’re patient and a gratification-deferrer, in addition to being not crazy, then it’s practically a cinch. If you’re exceptionally good at satisfying your commitments to other people, then you’ve just automatically improved your resources and your chances in life enormously. It’s so simple.”

The Select Equities team maintains a long-term investment horizon, so we are familiar with patience and deferring gratification. At times, we are willing to own an out-of-favor stock for several years when our investment thesis remains intact and the shares trade at prices well below our estimate of business value.

We certainly do our best to satisfy our commitments to the advisors and clients who invest in our portfolios. In terms of Munger’s advice on staying rational, we understand that it can be a challenge for clients to remain level-headed during times of stock market volatility and turmoil. That’s why consulting with your financial advisor is important to ensure that your asset-allocation plan is appropriate for your risk tolerance and on track to help you reach your long-term financial goals.

As always, we thank you for your business.