Focus on Equities
Q4 2023

All data and information as of September 30, 2023.
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Market Update – The Facts

The S&P 500 generated a total return of negative 3.3% in the third quarter. Foreign stocks, as measured by the MSCI ACWI ex USA Index, declined 3.8%. Small- and mid-cap U.S. stocks traded lower, with the Morningstar US Small-Mid Cap Index down 4.9% for the quarter. Dividend stocks also declined, with the Dow Jones US Select Dividend Index down 3.7%.

The S&P 500 index traded lower in the third quarter, bringing the year-to-date total return to 13.1%. Often-cited issues facing the stock market today include inflation, higher interest rates, and geopolitical uncertainty. Inflation, as measured by the Consumer Price Index (CPI), increased 3.7% year over year in August.

The U.S. Federal Reserve increased the federal-funds rate at its July meeting by 25 basis points to a range of 5.25%-5.5%. In September, Fed Chair Jerome Powell indicated that future interest-rate hikes will remain paused until Federal Reserve officials review economic data over the next several months. The phrase "higher for longer" is now getting used by some market participants in reference to the level of interest rates.

The bond market continues to respond to the Fed’s actions. The two-year U.S. Treasury yield at quarter-end now stands at 5.0%. The 10-year Treasury note yielded 4.6% at quarter-end, up from 3.8% at the end of June. Short-term rates are generally aligned to the fed-funds rate set by the Federal Reserve, while long-term rates are priced by fixed-income market participants. We suspect the modest selloff in the U.S. equity market that occurred during the third quarter was due, in part, to the higher yield on the 10-year Treasury note. At quarter-end, the yield was approaching a 16-year high that goes back to August 2007.

Our Approach to Economic Change

The Select Equity portfolio managers do not attempt to predict the future level of inflation or interest rates. Economic conditions are subject to change and hard to predict. Our team is better equipped in responding to whatever the stock market serves up than in trying to predict what the stock market will do over the next year.

We don’t consider our portfolios too heavily weighted for any one specific
macroeconomic scenario, as our goal is to balance risk and reward by considering a wide range of outcomes. When assessing individual businesses, our aim is to strike a balance between not overreacting to short-term events while incorporating new information about businesses. We are watching for changes to long-term competitive positioning (both higher and lower) and cash flow generation as our primary motivation.

**Timeless Principles from a Classic Investment Book**

*Security Analysis* was a book written by Benjamin Graham and David Dodd in 1934. Graham was a professor at Columbia University and is often labeled as the “father of value investing.” He had a great influence on Warren Buffett as a student. Buffett also worked for Graham’s investment firm for several years before starting his own partnership.

The 7th edition of Security Analysis was released earlier this year, with many well-respected investors such as Seth Klarman, Howard Marks, and others contributing well-placed new additions and chapter introductions. For valuation-driven equity investors, it’s not an exaggeration to say that Security Analysis is considered the bible for value investing. Howard Marks, a renowned fixed-income investor, stated as much in his section of the 7th edition: "The 1940 edition of Security Analysis contains wisdom for the ages, applicable at the time it was written as well as today and tomorrow. Importantly it shows the reader how to think about investing, which is more valuable than what to think. I’m sure it will remain a bible of investing for years to come."

Todd Combs, investment manager at Berkshire Hathaway and president & CEO of GEICO wrote the introduction to the chapter about common stock investments.

We loved that he included the following, “I break my process into three buckets—find a good business, with good management, at a good valuation. You don’t need or expect to find all three of these to the same degree in every investment; there can be a sliding scale with puts and takes.”

We've shared similar stock selection criteria to describe how we manage the Select Equity Portfolios in past Focus on Equities letters. We like how Combs added the nuance of how he can accept different levels within his stated criteria.

We aim to own undervalued stocks, but we’re willing to accept less of a discount under the right circumstances. This happens if the company has a wide economic moat and/or a shareholder-friendly management team with a strong record with capital allocation.

The following passage from Seth Klarman is a nice summary: "A successful investment philosophy, such as value investing, must address the challenges in navigating change, remaining flexible in approach and tactics, which are grounded in basic, unwavering principles. The alternative—a strategy that blows with the wind—almost ensures being perpetually whipsawed by volatile markets and burdened with frenetic trading."
Klarman’s thoughts are applicable to how we manage the Select Equity Portfolios. We also think clients can take this message to heart, especially as the financial markets can be volatile during certain periods. Keeping short-term investment results in the proper perspective is important. Your financial advisor can help you make sure your current 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.

The S&P500 is a market-capitalization weighted index of 500 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrials, financial, utility and transportation companies.