

July 31, 2023

**BLUME CAPITAL MANAGEMENT**  
**Third Quarter Newsletter**

The stock market recovery from the bear market of 2022 continued in the second quarter. As in the first three months of the year, mega-cap technology companies led the S&P 500 as it rose 8.7%. The three “tech” dominated areas (technology, communications, and consumer discretionary) all gained over 30% in the first half of the year, while all other sectors underperformed or even declined. Furthermore, only 29% of S&P 500 stocks outperformed the index, the lowest percentage since 1998.

Foreign equity markets, as measured by the broader MSCI All-Country World Index Ex-U.S.<sup>1,2</sup>, gained 2.4%, but lagged U.S. shares because of a lower weighting to technology companies.

Bonds generated slight losses in the quarter as yields climbed (bond prices move inversely to yields). The 10-year Treasury yield rose from 3.47% to 3.84%, and U.S. bonds, as measured by the Bloomberg Barclays Intermediate U.S. Aggregate Index, lost 0.8%.

INDEX	Second Quarter <small>3/31/23 – 6/30/23</small>	Six Months - YTD <small>12/31/22 – 6/30/23</small>	Twelve Months <small>6/30/22 – 6/30/23</small>
S&P 500 Total Return <sup>1</sup>	8.7%	16.9%	19.6%
DJIA Total Return <sup>1</sup>	4.0%	4.9%	14.2%
MSCI All-Country World Index Ex-U.S. <sup>1,2</sup>	2.4%	9.1%	12.5%
Barclays U.S. Aggregate Bond Index	-0.8%	2.1%	-0.9%

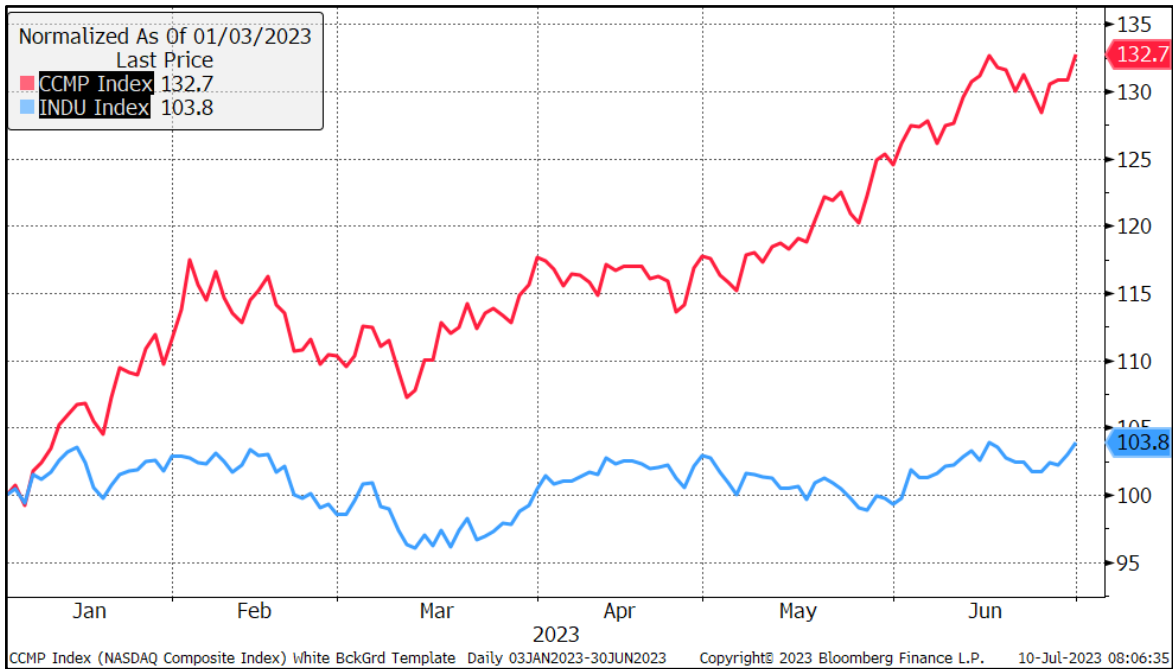
**Market Perspective/Recap**

As recession fears persisted and excitement over the prospects for artificial intelligence grew (more on this later), investors crowded into technology stocks in the first half of 2023. The chart that follows shows the year-to-date performance of the Nasdaq 100 (an index composed mostly of large tech companies) vs. the Dow Jones Industrial Average (which is heavily weighted towards more traditional businesses). The former is up 32.7%, while the latter gained only 3.8%, a striking divergence rarely seen in markets.

<sup>1</sup> Includes dividends in addition to index price appreciation

<sup>2</sup> The MSCI AC World Ex-U.S. index measures equity market performance in foreign developed and emerging markets excluding U.S.

### Nasdaq 100 (red) vs. Dow Jones Industrial Average (blue) Year-to-Date Performance:



Source: Bloomberg

Furthermore, the stocks of the seven most valuable companies, which account for more than one-quarter of the S&P 500, generated a median return of 54%. Unfortunately, barring a major change in fundamentals, the consequence of sizable price gains is higher valuations, and, therefore, lower prospective returns. As clients know, we own substantial positions in several of the largest technology companies, and, consistent with our discipline, we trimmed positions in the second quarter. In general, these are fabulous businesses, but the risk-reward is now less compelling.

On the other hand, we continue to see attractive opportunities throughout other segments of the stock market. Excluding our largest “technology” holdings, we estimate our U.S. equity portfolio trades at more than a 30% price-earnings multiple discount to the S&P 500.

### Outlook

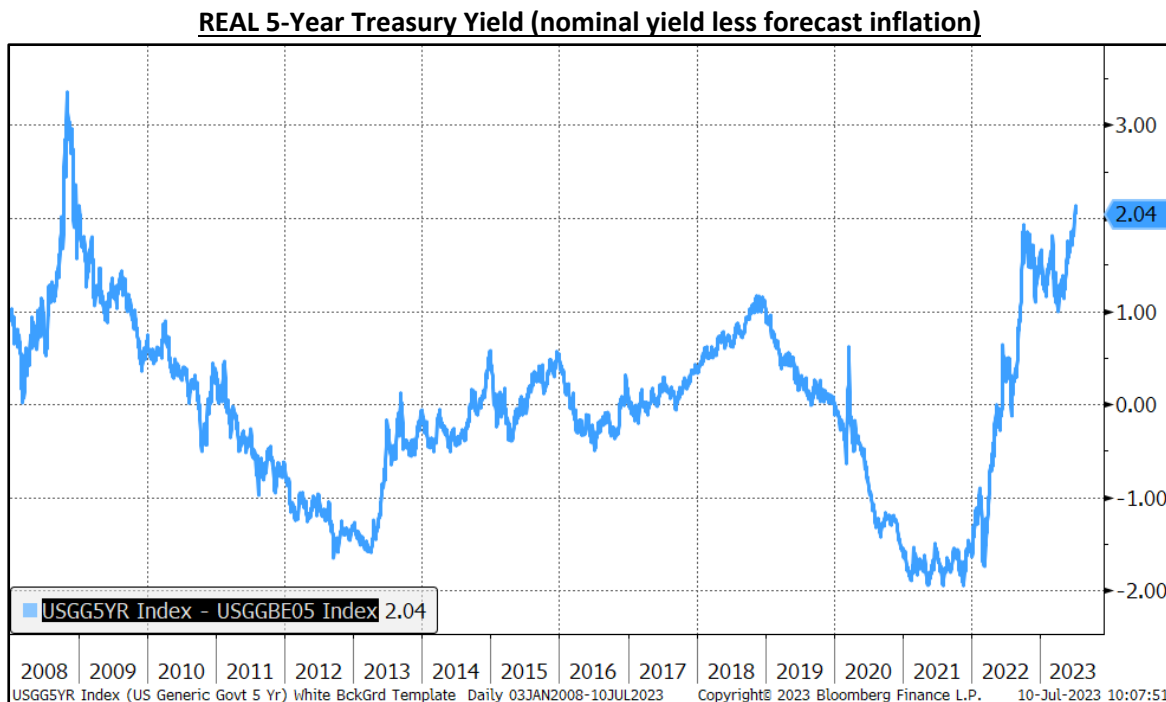
The outlook commentary in our last several newsletters focused on the risk of recession. After worrying for so long about an event that has not yet come to pass, the recent stock market rally suggests many investors may have developed “recession fatigue” and, akin to the frog in boiling water, grown numb to the risks. However, given the massive tightening in monetary policy (higher interest rates) that operates with substantial time lags, we believe the risk of a downturn remains elevated.

At the same time, we would note that recent economic strength has been fueled by the consumer and services sectors, which may have masked corrections that were already occurring in other cyclical segments. We commented on this possibility in last quarter’s letter:

*Investors agonize over the risk of recession due to the adverse impact to corporate profits and cash flow that have historically accompanied that scenario. Nevertheless, if a downturn does come to pass, a possibly important difference is that many large, economically sensitive sectors have already endured their own rolling recessions, and the inexpensive valuations of others likely account for future economic weakness...Certainly, a broad-based recession would affect many sectors to some degree, but economically speaking, the areas we worry about most are the ones that relied on leverage (or excessive borrowing) and the low-cost funding that were available in recent years.*

While painful, recessions are a necessary part of the economic cycle that correct imbalances, reallocate capital towards more productive uses, and improve the long-term growth potential of the economy.

While higher interest rates create risks for the economy, they also present opportunities for investors. As shown in the chart below, the real (after inflation) yield available in 5-Year Treasury bonds is now at the highest level in 15 years.



Source: Bloomberg

Even more importantly from an asset allocation perspective, the incremental return offered by equities in terms of earnings yield (current earnings divided by stock price) less the 5-year Treasury rate is now at the lowest level in 20 years. In other words, at least relative to recent history, U.S. equity investors are not being adequately compensated for the incremental risk of stocks.

### S&P 500 Earnings Yield less 5-Year Treasury Yield



Source: Bloomberg

Following the increase in yields, we have been adding to our bond exposure for the last several months, but, given the relative shift in risk-reward between asset classes, we are now also in the process of adjusting our asset class models for the first time in over a decade. Across all balanced portfolios, clients should expect to see increasing bond allocations and reduced equity exposure in coming months. Importantly, we would note that this is a portfolio level, valuation judgment and not a call to sell all stocks. As we noted earlier in this letter, many of our equities continue to trade at highly attractive valuations and offer return potential that we view as superior to bonds. (If you would like to discuss your asset allocation model, please reach out at any time.)

### **Closing Thoughts**

With recent advances in artificial intelligence, the advent of the next world changing technology investment cycle may be upon us and likely to play out over the next decade and beyond. We anticipate that we will witness many exciting (and also potentially frightening) developments as well as eye-popping returns in select stocks. However, history would suggest that we will see even more losers, as evidenced by the money lost at the forefront of technological revolution in railroads, cars, telecommunications, the internet, and others. Warren Buffett's observation on the failure of thousands of automobile businesses despite the ultimate success of the broader auto industry is a good reminder of the potential risks involved.

*What you really should have done in 1905 or so, when you saw what was going to happen with the auto is you should have gone short horses. There were 20 million horses in 1900 and there's about 4 million now. So, it's easy to figure out the losers, the loser is the horse. But the winner is the auto overall. 2000 companies (carmakers) just about failed.*

As clients know, we are not top-down thematic investors that target the most exciting growth sectors to allocate capital, with little regard for price. We have purchased and own many of the best growth companies of this generation (Apple, Google, Amazon, Microsoft, etc.), but we waited for them to come to us and bought when the price was right.

Several of our portfolio companies already have direct exposure and substantial opportunities in artificial intelligence, and others will deploy the technology to enhance productivity and increase profits. We will be following developments in this area closely but will only deploy incremental capital when we see the right balance of risk and reward.

As always, please don't hesitate to reach out with any questions or concerns. We hope everyone is enjoying a wonderful summer.

Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire

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