

January 30, 2024

BLUME CAPITAL MANAGEMENT
First Quarter Newsletter

Defying consensus calls for a recession and further market declines, stocks staged an impressive rally in 2023 with the S&P 500 returning 26.3%. In a reversal of 2022, mega-cap stocks led the gains as the technology sector rose 58% and the “Magnificent 7” (Apple, Microsoft, Alphabet (Google), Amazon, Meta (Facebook), Nvidia, and Tesla) accounted for more than 60% of the index return (more on this later). “Safety” stocks were notable underperformers as utilities lost 7% and consumer staples and healthcare were roughly flat. Energy also lagged, down 1%, after leading the market with stellar returns in each of the past two years.

International equities, as measured by the broader MSCI All-Country World Index Ex-U.S., returned 15.6% and, once again, underperformed their U.S. counterparts due to a lower weighting in technology stocks. Stocks of developed foreign markets rose 18.2%, while emerging markets only gained 9.8%, as Chinese equities declined.

Fixed income markets struggled for most of the year as the 10-year Treasury yield climbed from 3.9% in January to ~5.0% in October (bond prices move inversely to yields). After briefly touching that peak level, the 10-year yield quickly retreated in the final weeks of the year to finish roughly where it started, and the bond market index returned 5.5%.

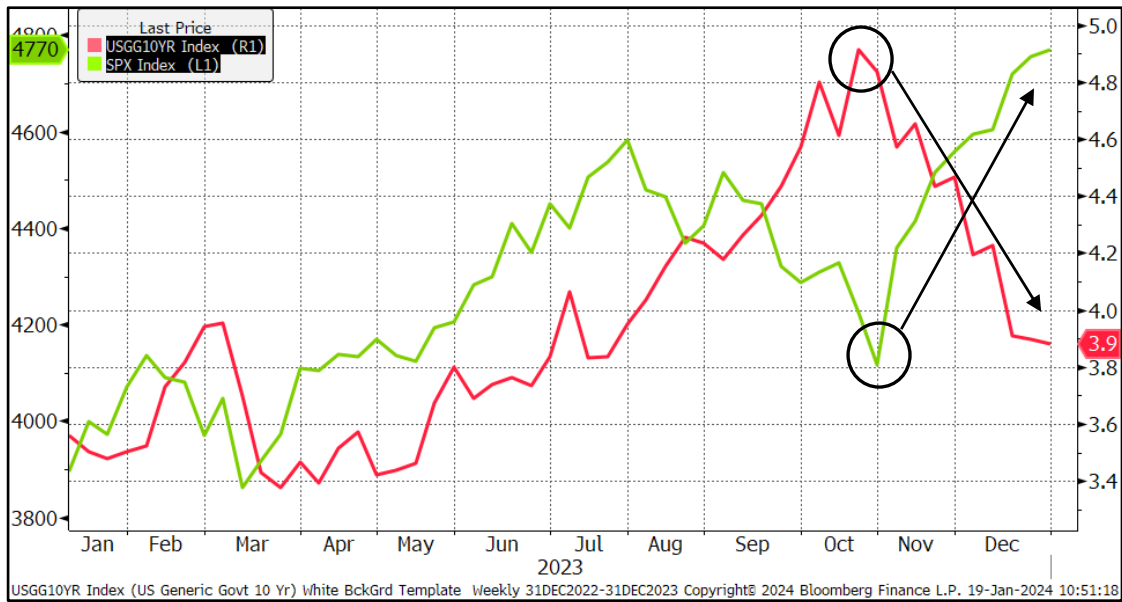
Index Returns	One Year <small>12/31/22-12/31/23</small>	Five Years <small>12/31/18-12/31/23</small>	Ten Years <small>12/31/13-12/31/23</small>
S&P 500 Total Return¹	26.3%	107.3%	211.6%
Dow Jones Industrial Average¹	16.2%	80.0%	185.8%
MSCI ACWI Ex US Index¹ (foreign stocks)	15.6%	41.5%	45.4%
Barclays U.S. Aggregate Bond Index	5.5%	5.6%	19.7%

MARKET RECAP

For the second consecutive year, interest rates (or yields) dominated the investing narrative. In the first half of the year, Treasury yields climbed gradually, and stocks managed to recover from the declines of 2022. However, as the Federal Reserve persisted in their fight against inflation and concerns over government deficits and borrowing grew, the 10-year Treasury yield spiked to 5% in a matter of weeks. All else equal, higher interest rates equal lower stock valuations, and equities declined 10% in response. Subsequently, as inflationary pressures continued to fade, yields peaked in October and dropped just as quickly as they had risen. As shown in the chart below, stocks moved in the opposite direction of yields and staged a powerful rally to finish the year.

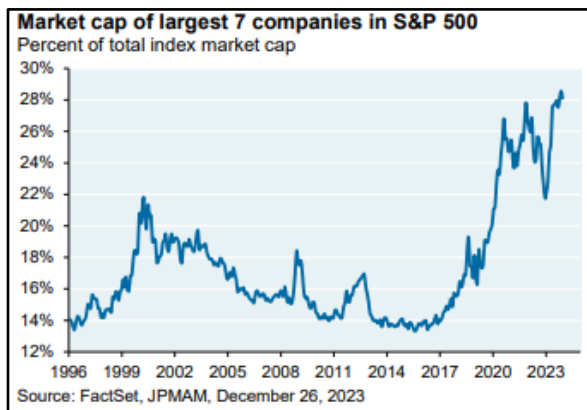
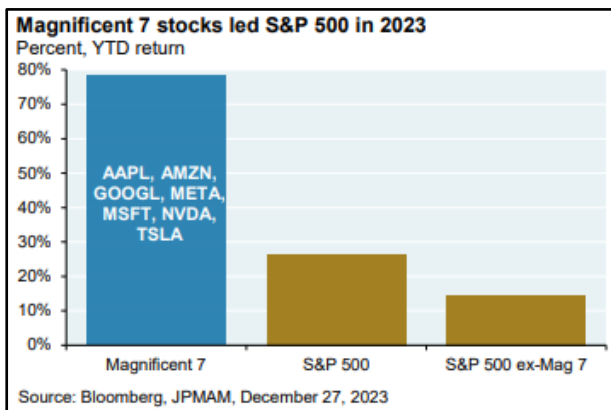
¹Includes dividends in addition to index price appreciation.

2023: 10-Year Treasury Yield (red) vs. S&P 500 (green)



Source: Bloomberg

While it was a stellar year for the S&P 500, the gains were not uniform. “Growth” stocks led the market, and, the previously referenced “Magnificent 7” returned ~80% on average (see left chart below). The remaining 493 stocks generated less than half the return of the S&P, and a record 72% of stocks underperformed the index. Moreover, those same seven stocks now account for almost 30% of the S&P 500, a record level (see right chart below). Given the premium valuations now afforded to those names, even if they are often justified by the strength and quality of their businesses, we believe better opportunities lie ahead for the remaining 493.



PORTFOLIO REVIEW

Blume Capital client portfolios delivered a strong performance in 2023. On average, clients' domestic stock portfolios outperformed the S&P 500 by 3-4%. On the positive side, we were highly active in adding to our technology holdings as the sector endured a deep selloff in 2022. These buys were all significant contributors to client returns in 2023, and sizable holdings in Federal Express and Comcast were also strong performers. On the other hand, several financial stocks and health care names experienced declines or trailed the broader market. As is often the case with our underperformers, we would note that valuations for these names are now highly attractive, and we took advantage of the price weakness to add to positions in 2023.

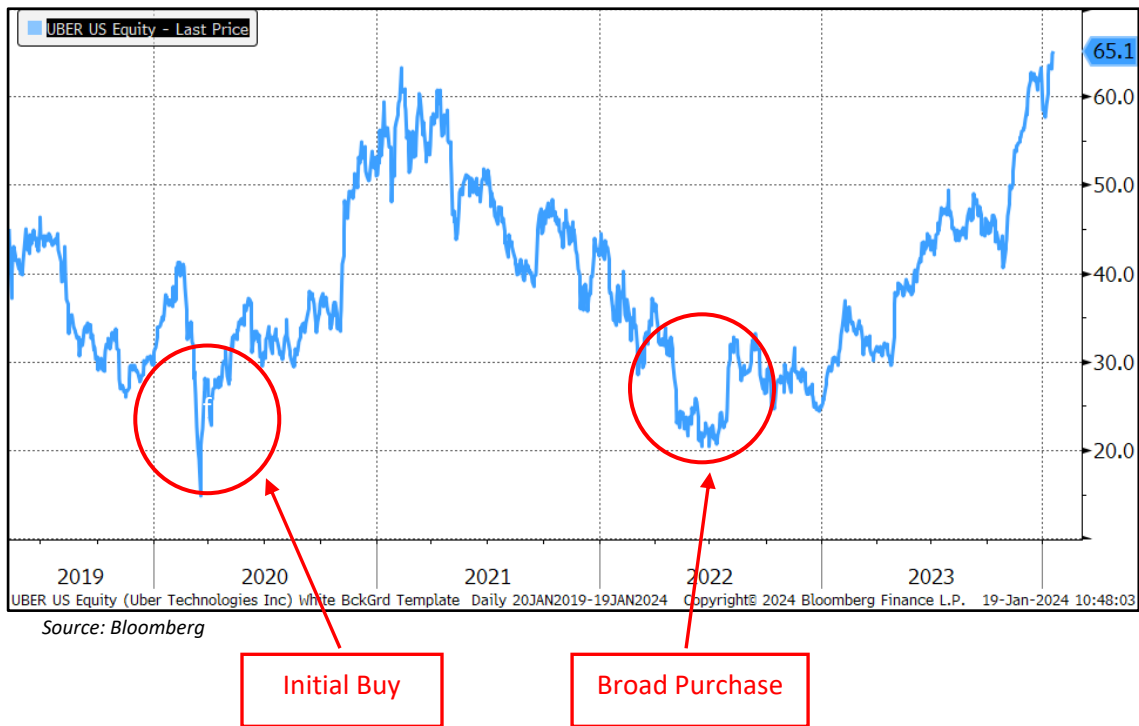
Six Largest Stock Holdings	2023 Performance
Apple	49.0%
Energy Sector ETFs	-0.6%
Alphabet (Google)	58.8%
Federal Express	49.1%
Charles Schwab	-16.0%
Uber	149.0%
S&P 500 TR	26.3%

We expanded what is normally our list of top five holdings to include a sixth name this year, Uber. Of course, it is always enjoyable to highlight a winner, but more importantly for our clients, we believe Uber is a good example of how we invest capital.

We initially only purchased Uber stock for our most risk-tolerant portfolios during Covid, when their primary ride-share business was severely impacted. The company was not yet profitable (and therefore more speculative than most client stocks) but had ample cash reserves, a massive market opportunity and a lean business after cutting costs to weather the pandemic. As the world reopened, the stock nearly tripled off its lows.

As interest rates rose in 2022, all "growth" stocks came under pressure. Uber was lumped into this group and its stock price once again declined towards pandemic lows (see chart below), in contrast to their thriving business. Revenues were now growing rapidly, the more efficient business was quickly approaching profitability and the valuation was highly attractive on many metrics. Accordingly, we opened a position across client portfolios. Given the gains in the stock since that time, our Uber holdings have grown into a top position for clients. We continue to like Uber's long-term prospects today, even if the upside potential is not what it was a year ago.

UBER Stock Price (2019 IPO – 12/31/2023)



Clients' international equities modestly trailed the benchmark. Our relative overweight to underperforming emerging markets was a drag on returns and one mutual fund, which we no longer own, delivered a disappointing year.

Fixed income portfolios outperformed the broader U.S. bond market by ~1.5% and did so while taking limited credit risk (getting paid a higher yield in exchange for risk of default or nonpayment.) We entered the year underweight bonds and duration (owned shorter-term bonds) to protect against the risk of rising interest rates, which allowed us to minimize losses in the first three quarters of the year. As interest rates climbed towards 5%, we sold most of our shorter-term bonds and filled out client fixed income allocations to lock in higher yields.

Lastly, our allocation to alternative investments in client portfolios served their purpose in diversifying portfolios and generating solid absolute returns. Positions in timber, infrastructure, copper and real estate all outperformed our alternatives index, while investments in utilities and other commodities lagged.

Stepping back, the last five years has brought one of the most tumultuous investing environments we can recall including a pandemic shutdown and recession, zero and even negative interest rates, an inflationary boom, rapidly rising interest rates and the worst bond "bear market" in history, historical "growth" stock outperformance and numerous geopolitical "threats". Our goal is that our flexible, value-oriented approach to active management can mitigate risk and capitalize on the opportunities provided by such volatility. We are happy to report that client portfolios have outperformed across all asset classes during this five-year period. In addition, our decisions to underweight/overweight asset classes also benefited client bottom line returns.

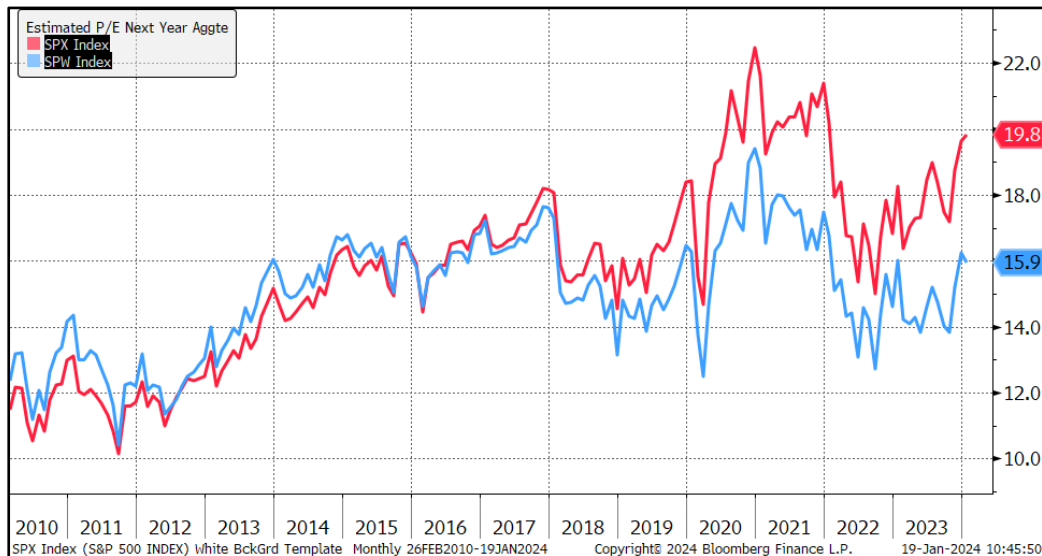
Looking ahead, in today's market we continue to see significant opportunities to add value to portfolios and outperform over the long-term. As one basic example, we believe many investors are unaware of the "passive" index fund portfolio concentration to recent mega-cap tech winners, which now mostly trade at elevated valuations. While we also own several of these stocks, we have trimmed them to right-size positions and/or free up cash to invest into other areas or names where we see a superior risk-reward.

OUTLOOK

We believe the risk of a recession remains elevated as the lagged effects of tightened monetary policy have not been fully realized. However, history would also suggest there are numerous reasons to be constructive on the market outlook for 2024. Inflation data and expectations have largely retreated. The Federal Reserve has signaled their tightening cycle is done and that they are likely to cut rates in coming months. Longer-term Interest rates have declined. The U.S. economy continues to expand at a solid pace, and there are no major imbalances, particularly within the corporate segment of the economy, that often precede a deeper or prolonged downturn. Lastly, growth in the rest of the world looks poised to improve.

Nevertheless, with equities having realized sizable gains in recent months and trading at all-time highs, those constructive developments may already be reflected in the broader U.S. stock market. In our view though, the good news is not priced into all stocks, and many companies offer a risk-reward that compensates investors for some risk of an economic downturn. As shown in the chart below, the traditional market-cap weighted S&P 500 trades at an elevated ~19.8x forward earnings multiple, but the "Equal Weighted" or median valuation is 15.9x, a modest discount relative to history.

Price to Earnings Multiple of S&P 500 Index (red) vs. S&P 500 Equal Weight Index (blue)



Source: Bloomberg

We see the same dynamic at play within our client portfolios. While the S&P 500 is at roughly the same level it was to start 2022 (the last time we were at new highs), given the opportunity provided by the divergence in valuations, client equity portfolios trade at twice the discount to our estimate of fair value versus two years ago. Over the medium to long-term, that discount should translate into higher returns, or perhaps less downside in a correction.

If the economy does endure a downturn in 2024, we believe the sectors most at risk are those with higher leverage including smaller companies, certain consumer segments, some private investments and real estate, and possibly even government spending given the current level of debt and deficits. We are already seeing early signs of credit stress in terms of higher consumer delinquencies and corporate bankruptcies, and, if interest rates remain near current levels, there is likely still pain to come.

Lastly, we will almost certainly endure heightened geopolitical uncertainty for the remainder of 2024. With a presidential election cycle underway, Congress struggling to approve a budget, and multiple active conflicts overseas, we expect bouts of higher volatility. Come what may, given the high level of current interest rates, the Fed has ample room to ease monetary policy to support the economy and markets. In addition, for the first time in nearly 15 years, client bond portfolios should also serve as ballast and counterweight to equity losses, assuming interest rates follow their historical pattern and decline in response to market fears.

DESCRIPTION OF ENCLOSED REPORTS

Two of the enclosed reports, the Portfolio Statement and the Billing Statement, you receive quarterly. At year end, we provide two additional reports: the Asset Class Performance Summary report, which compares your portfolio's performance by asset class, vis-à-vis the standard indices over one year, five years and since inception; and, the Portfolio Value vs. Cumulative Net Investment report, which displays the two components of your portfolio's growth – investment gain (net of fees) and your own contributions.

As always, please reach out with any questions, concerns, or just to catch up. We appreciate your continued trust.

Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire

Important Disclosure Information

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