H S MANAGEMENT PARTNERS, LLC

# Year End 2022 Investment Perspective

*investment styles ebb and flow . . . fundamentals never go out of favor*

640 Fifth Avenue, 18th Floor
New York, NY 10019
212.888.0060
www.hsmanage.com

January 17, 2023

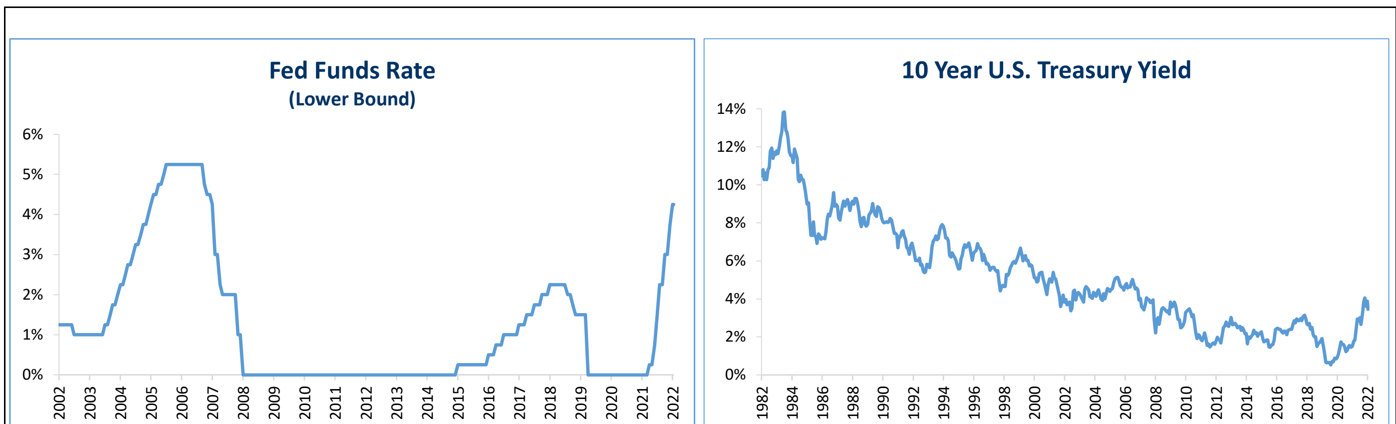
## Investment Perspective

**Money for Something**

In the summer of 1985, the British rock group, Dire Straits, released *Brothers in Arms*. The second track on what was their fifth album was entitled “Money for Nothing.” You may remember the song, with Sting singing the background chorus of “I want my MTV.”

In actuality, money cost something in the bygone days of 1985, three years after I started in the business, and one year before I got married. But over time, as inflation declined and interest rates dropped, money became ever less expensive. After the Pandemic hit in 2020, the world of ever-lower Fed Fund rates again hit 0% and was joined by additional easing in the form of QE2 (Quantitative Easing 2). The ten-year bond yield responded dropping to a mere 0.67% in 2020.

The Fed Funds rate stayed at 0% into 2022 and quantitative easing was still ongoing. But the combination of hyper-stimulative monetary policy joined by aggressive fiscal spending led to a sharp rise in inflation — not the transitory variety — but good old-fashioned wage inflation. Shakespeare would say: “there’s the rub;” Chairman Powell and the bond market said: “rates are going higher.”




*Note: Charts created with data from Bloomberg as of 01/13/23. Lower bound refers to the bottom of the Federal Funds target range. Please refer to pages 4-6 for important information.*

In my last correspondence, I noted that “every year makes its imprints on us in its own way, but this year is proving to be especially consequential on many fronts.” Amongst other developments, I cited the war in Ukraine, rapid inflation, the growing conflict with China, the U.K. financial crisis, and lingering Covid lockdowns. This led to a bear market across asset classes and volatility of notable proportions.

H S MANAGEMENT PARTNERS, LLC

But stepping back from it, I think what is most lasting from an investment perspective is what the Financial Times (FT) dubbed in their year-end editorial: “A new era: the end of cheap money.” The FT put it like this: “The era of ultra-low interest rates and quantitative easing died in 2022, with the arrival of high inflation. This transformation has, for now, upended prior assumptions about markets and the economy. Central banks will no longer come to the rescue of damaged markets…hawking speculative assets is no longer a sure road to riches. This is a new world.”

We think the FT is spot-on. Prior to the market’s recent comeuppance, pockets of speculation ran wild from Crypto to SPACS to Meme stocks to asset managers touting the latest “disruptive” technology to this week’s new ETF flavor.

We were certainly not immune to the rise in rates in 2022 and the subsequent pullback in price/earnings multiples in the first nine months of last year. That said, we are not uncomfortable with a less speculative world. The world of ever-lower rates created “a rising tide lifts all boats” world and one that was self-reinforcing especially as passive assets grew in popularity. And it was a world that rewarded managers willing to take on more risk. More risk, meant more return, meant more assets.

A less speculative world has led to a significant impairment in asset values for more speculative asset classes and investment methodologies. We are mindful that the more one drops the more one needs to recover to get back to even. An 18% drop needs a 22% advance to get back to square one; a 36% decline requires a 56% gain.

The FT goes on: “higher interest rates will bring casualties, as debt becomes costlier. Given the uncertainty, market turmoil is also likely to continue. The combination is likely to shake out overbought assets and increase defaults…. expensive money will at least do the needed job of reminding everybody that leverage is never a one-way bet.”

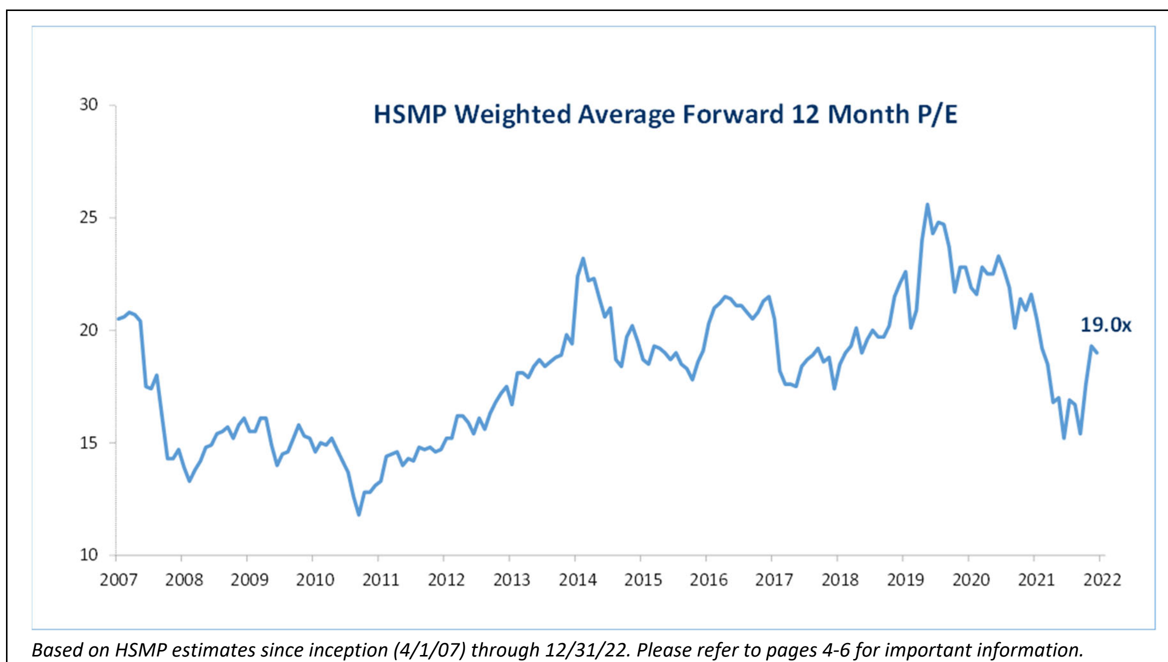
We agree and, in many ways, this plays to our strength which is to focus on businesses with first-rate balance sheets and strong cash flows. If anything, many portfolio companies have had to withstand competition from companies that were able to participate in the marketplace only because of the existence of cheap money.

Looking forward, the Fed’s determination to curb inflation will slow economic growth. Portfolio profits will decelerate in 2023 but we do believe that our focus on resilient business models that are less capital intensive and cyclical in nature makes it more likely that the portfolio earnings stream continues to advance.

The end of easy money has also forced a reappraisal of valuations and we saw our portfolio price/earnings ratio drop in 2022. We believe our forward 12-month price/earnings ratio of 19x is reasonable, even in the face of higher interest rates. The earnings yield on the portfolio of 5.3% is still attractive, in our view, in a world of mid-single-digit ten-year bond yields. Having a valuation discipline may put the brakes on returns during go-go periods such as what we have experienced over the past five to ten years, but it is good to know that the valuation brakes work as we head around perilous curves. Receiving a dividend yield of almost 2% is also supportive of portfolio values.



*See pages 4 - 6 for important information & disclosures.*



*Based on HSMP estimates since inception (4/1/07) through 12/31/22. Please refer to pages 4-6 for important information.*

Active management and making hard choices remain central to our investment methodology. In our view, we upgraded the quality of the portfolio in the process with an eye toward earnings resiliency, and balance sheet strength while staying mindful of valuation.

The FT summed up its editorial by stating that: "Higher interest rates will bring casualties but also opportunity." We share that view. Undoubtedly, we will face challenges in times ahead, but believe this is a different time, a new era. A passive approach was rewarded in "a high tide lifts all boats world". But as Warren Buffett warned: "Only when the tide goes out do you discover who's been swimming naked."

We believe active management adds value and our steadfast focus on quality growth shares will be the key to unlocking opportunities in the years ahead. Much as the mantra in real estate is "location, location, location," we think for an equity portfolio that mantra will be "quality, quality, quality."

Before signing off, please indulge me with a note of personal importance. As some of you may know, my father, Spiros "Sig" Segalas, the co-founder of Jennison Associates just passed away at age 89. I have learned from many people over the years, but I learned more from my father than anyone else. My father was going strong as a portfolio manager as he approached his 90th birthday — there's my career plan — and he was a force in life and a positive influence on so many. While we are all saddened and will miss him, my family has an enormous sense of pride for what he was able to accomplish and more so for who he was.

Thanks as always for your belief in us and I wish all a healthy, happy and prosperous 2023.

Sincerely,

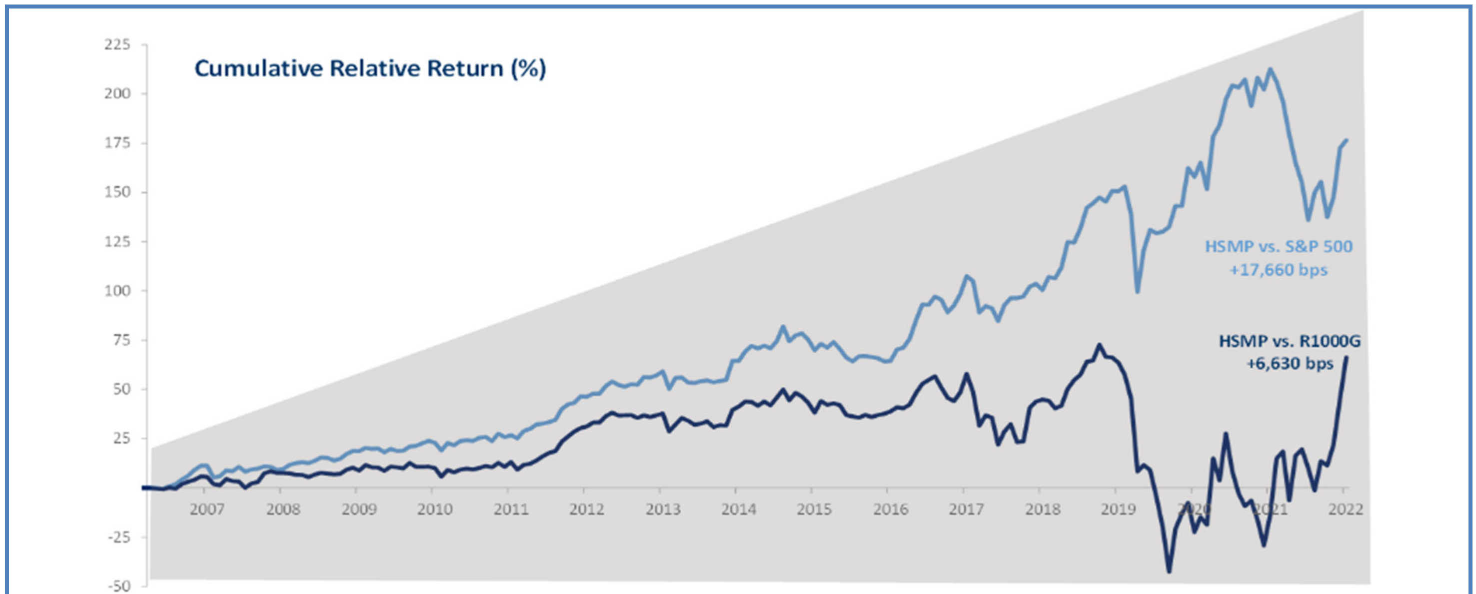
Harry W. Segalas

## *Portfolio Profile (12/31/22)*

**HSMP Composite Performance as of 12/31/22**

| | 4Q22 | 2022 1 Year | 3 Years *Annualized* | 5 Years *Annualized* | 10 Years *Annualized* | *Since Inception 4/1/07 Annualized* | *Since Inception 4/1/07 Cumulative* |
|---|---|---|---|---|---|---|---|
| HSMP Composite (Net) | 13.5% | -17.7% | 6.9% | 9.7% | 13.1% | 11.4% | 448.3% |
| S&P 500® Index | 7.6% | -18.1% | 7.7% | 9.4% | 12.6% | 8.7% | 271.7% |
| Russell 1000® Growth Index | 2.2% | -29.1% | 7.8% | 11.0% | 14.1% | 10.5% | 382.0% |

*Performance results are net of fees and include the reinvestment of dividends and other earnings. Past performance is not indicative of future results. Please refer to pages 5-6 for important information.*




*Composite monthly performance (net-of-fees) since inception (4/01/07) through 12/31/22. Performance results include the reinvestment of dividends and other earnings. Past performance is not indicative of future results. Please refer to pages 5-6 for important information.*

H S

## IMPORTANT DISCLOSURES

This piece represents our opinion as of 12/31/2022 based on our understanding of market conditions and publicly available information. This piece is written from the perspective of our investment philosophy and strategy, Composite holdings, performance, and estimated outlook and metrics, and it does not refer to any specific client account (client accounts can have higher or lower performance than that shown here and can have some but not all of the holdings shown here). When we use *Composite*, we mean our HS Management Partners Concentrated Quality Growth Composite. Composite performance is presented net-of-fees (net of actual investment advisory fees and trading costs) and includes dividends, interest, and other earnings. The performance shown here should not be taken as an indication of how the Composite or a client account will perform in the future; past performance is not indicative of and does not guarantee future results. Some charts were obtained from third-party sources which we believe reliable, but we did not verify, nor do we guarantee the accuracy of this information.

This document may contain forward-looking statements relating to the objectives, opportunities, and the future performance of the U.S. market generally. Forward-looking statements may be identified by the use of such words as; "believe,", "anticipate," "estimated," and other similar terms. Examples of forward-looking statements include, but are not limited to, estimates with respect to financial condition, results of operations, and success or lack of success of any particular investment strategy. All are subject to various factors, including, but not limited to general and local economic conditions, changing levels of competition within certain industries and markets, changes in interest rates, changes in legislation or regulation, and other economic, competitive, governmental, regulatory and technological factors affecting a portfolio's operations that could cause actual results to differ materially from projected results. Such statements are forward-looking in nature and involve a number of known and unknown risks, uncertainties and other factors, and accordingly, actual results may differ materially from those reflected or contemplated in such forward-looking statements. Prospective investors are cautioned not to place undue reliance on any forward-looking statements or examples. None of HSMP, its affiliates, principals nor any other individual or entity assumes any obligation to update any forward-looking statements as a result of new information, subsequent events or any other circumstances. All statements made herein speak only as of the date that they were made. Investing in securities involves significant risks, including the risk of loss of the original amount invested.

The following is a summary of some material risks, not all risks, applicable to our investment strategy and advisory business, listed alphabetically.

- Concentration Risk. Our investment strategy involves a high concentration in certain market sectors, industries, geographic regions, and number of issuers. A concentrated portfolio is subject to greater risk of loss and market impact than a more diversified account.
- Consumer Discretionary, Consumer Staples and Technology Sectors Risk. Our portfolios are concentrated in these sectors, which are highly sensitive to rising inflation, increased interest rates, pandemics, wars, and other events that impact consumer confidence and behavior. The consumer discretionary and the technology sectors are especially tied to the strength of the economy. The technology industry is sensitive to rapid and unforeseeable innovation and product obsolescence.
- Equity Securities Risk. We invest in equity securities, which involves several risks. Their value can decrease, potentially dramatically, in response to many factors (including general economic conditions, inflation, changes in interest rates, fluctuations in foreign currencies, and national or international political, social, governmental, tax, legal, regulatory and economic events, as well as natural disasters, environmental calamities, terrorist attacks, wars, and health crises such as epidemics or pandemics) that can negatively impact the economy in general or a particular company's financial situation, result in poor performance of some companies in certain geographical regions or economic sectors or industries, and/or adversely affect the stock market in general or overall market sentiment. Even under favorable market and industry conditions, a company's performance can be negatively impacted by internal factors, such as poor execution by company management, a cybersecurity attack or data breach, and a change in the demand for its products or services.
- Foreign Security Risk. Our discretionary client portfolios generally include foreign companies. Investing in foreign companies exposes clients to political, social, economic, legal and currency factors or other issues relevant to the corresponding foreign countries or regions.
- General Economic and Market Conditions Risk. The success of the companies in which we invest will be affected by general economic and market conditions, such as inflation, interest rate fluctuations, a recession, the availability of credit, economic uncertainty, changes in laws, supply chain issues, labor shortages, trade barriers, currency exchange controls, energy and commodity prices, national and international political circumstances, natural disasters such as environmental calamities, and regional, national and global health crises.
- Reliance on Key Personnel Risk. Our CIO and sole Portfolio Manager is considered a key person with respect to our investment strategy. Although other experienced Firm-partner members of the investment team can make investment decisions, the unforeseen absence of our CIO can impair our ability to successfully implement our investment strategy.

Refer to our Firm Brochure (at http://www.hsmanage.com/documents/ or upon request at 212-888-0060) for material risks applicable to our strategy and information regarding our Firm. The information here is solely for illustration or discussion, is subject to change without notice, should not be construed as a recommendation to buy or sell any particular security, and should not be used as basis for making investment decisions.

HSMP claims compliance with the Global Investment Performance Standards (GIPS®). HS Management Partners, LLC is an independent SEC registered investment adviser (SEC registration does not imply any certain level of skill or training). The HS Management Partners Concentrated Quality Growth Composite includes all fully discretionary, actively managed, investment advisory fee-paying accounts (even if they pay zero trading commissions), which employ our style of investing in 20-25 quality growth businesses. These accounts must have a market value exceeding $500,000 at the time of initial inclusion in the Composite and have a market value exceeding $300,000 to maintain inclusion. Results are based on fully discretionary accounts under management that meet our Composite's inclusion criteria, including those accounts no longer with HSMP. Results reflect accounts managed at another entity: prior to January 1, 2008, the accounts in the Composite were non-fee paying (non-investment-advisory fee-paying) individual accounts managed by Harry Segalas in accordance with HSMP's investment policies, becoming HSMP's accounts in December 2007. The U.S. Dollar is the currency used to express performance. For more information or for a copy of our fully compliant GIPS® Report and/or list of composite descriptions, please contact us at 212-888-0060.

In some instances, Composite performance is presented by itself on an absolute basis (without comparing it to an index or benchmark) and in other instances, the Composite is compared to the Russell 1000® Growth Index and the S&P 500® Index as benchmarks for market context only. The Russell 1000 Growth Index is an unmanaged index that measures the performance of those Russell 1000® Index companies (largest 1,000 U.S. companies based on market capitalization) with higher price-to-book ratios and higher forecasted growth values. The S&P 500® Index is an unmanaged market capitalization-weighted index designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. There are meaningful differences between the Composite and each index that should be considered when comparing performance, such as in terms of composition, concentration and volatility (e.g., the Composite contains securities not represented in either or both indices and is much more concentrated than either index in terms of companies and sectors; the average market capitalization of companies in the Composite will likely differ from that of either index; and market or economic conditions can affect positively/negatively the Composite's performance but not the indices to the same extent). In addition, neither index bears fees and expenses and investors cannot invest directly in either of them. Furthermore, we do not seek to mimic any market index in our investment approach and do not maintain limits on industry or sector weightings. For these and other reasons the Composite does not directly relate to an index. Although most discretionary client accounts are included in the Composite and dispersion is typically low over time, not all client accounts are in the Composite, and even for those in the Composite, there can be dispersion, particularly for small client accounts and also when viewed over narrow time periods. Small accounts generally experience higher dispersion from our Composite than large accounts primarily because they do not participate in trading, allocations, and aggregations to the same extent as large accounts given their size and that actual participation in trade orders depends, among other factors, on cash available in an account and on our imposed per-order share minimums, which typically range anywhere from 5 to 100 shares depending on the stock price. While the investment merits of a given security drive our investment decisions, we use trading groups to facilitate trading and not all groups trade to the same extent. Client account holdings and performance can deviate from our Composite and/or from other client accounts, and also from the representative portfolio, for several reasons, such as: client restrictions, account type and size, timing and market conditions at an account's inception and contributions/withdrawals, timing and terms of trades, actual client investment advisory fees (or the lack thereof), and client directed brokerage/commission recapture instructions.

We typically build a concentrated portfolio with a hard cap on company names and with an aim to keeping clients' capital nearly fully invested. Our investment advice is limited to domestic and foreign equity securities of publicly traded companies. Client accounts generally hold 20-25 companies, although in some cases they may hold more or less names. We do not maintain limits on industry or sector weightings, and while we do limit portfolio positions by company, clients' portfolios are likely to be significantly concentrated by sector, industry and/or geography, among other factors (client accounts can typically have over 50% exposure to the consumer discretionary, consumer staples and/or technology sectors). Cash is not a major component of our investment strategy, and we tend to keep client accounts almost fully invested with less than 1% residual cash position after a trading day. Our portfolio has typically been invested in what are generally considered more established, large cap names (over traditionally growth companies and mid-small cap companies).

The price-earnings (P/E) ratio and earnings yield are weighted averages of the Composite holdings and are based on our estimates on a 12-month forward projected basis as of the indicated reporting date (our estimates can be inaccurate; actual results and future events can differ, even materially, from our assumptions). The dividend yield is a weighted average of the Composite holdings based on the most recently announced company gross dividend (annualized) divided by the last stock price as of the indicated reporting date.

This document includes general information and has not been tailored for any specific recipient or recipients. Accordingly, the information here is not intended to cause HSMP to become a fiduciary within the meaning of Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974, as amended, or Section 4975(e)(3)(B) of the Internal Revenue Code of 1986, as amended.

Russell Investment Group is the source and owner of the trademarks, service marks, and copyrights related to the Russell 1000® Growth Index. Russell® is a trademark of Russell Investment Group. S&P 500® Index is a registered trademark of Standard and Poor's Financial Services LLC, a division of the McGraw-Hill Companies, Inc. Standard & Poor's is the owner of the trademarks, service marks, and copyrights related to its indexes. GIPS® is a registered trademark of the CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Neither Standard and Poor's nor Russell Investment Group endorses, promotes, or sponsors HSMP. The marks, trade names, or copyrighted work included in this document are mentioned for identification purposes only and are the property of their respective owners.

HS Management Partners, LLC ("HSMP", "HS Management Partners", or the "Firm"). For information or questions please contact us at 212-888-0060.
© Copyright 2023 HS Management Partners, LLC. All rights reserved. Any reproduction or distribution of this material, as a whole or in part, or the disclosure of the contents hereof, without the prior consent of HSMP, is prohibited.