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Second Quarter 2023 Investment Perspective

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

July 12, 2023

Investment Perspective

Bizarro Market

Fans of "Seinfeld" may remember "The Bizarro Jerry" episode of this iconic series. Modeled after "Bizarro Superman," in which everything was the opposite…the mirror image reversed. In that sense, 2023's first half performance stands as the "Bizarro Market" to 2022's first half.

Last year, stocks and bonds declined sharply during the first six months, and speculative asset classes were dismantled. This year, markets ripped higher in the first six months, with the S&P 500 Index experiencing its best first half since 2019. Gains were led by the Index's largest capitalization names and the combined weight of the five largest S&P 500 Index companies reached historical highs.

Source: Used with permission of Strategas Research Partners as of 7/3/2023. Please refer to pages 5-7 for important information.

The top ten largest weighted names accounted for 77% of the S&P 500 Index's advance, the second highest percentage contribution ever during positive performance years. This helps explain the large differential between the S&P 500 Index's 17% advance and the 7% gain in the equal weighted S&P 500 Index, the fourth largest differential on record. The Nasdaq 100 Index jumped 39% for its best first half *ever*.

The more momentum, go-go, orientation of the market is highlighted by the worst relative first-half performance for dividend-paying stocks versus nonpayers since 2009. Stocks in the S&P 500 Index that don't pay a dividend gained about 18%, while those that do increased roughly 4% during the first half. Signs of speculation also resurfaced around us: Bitcoin advanced 84% (its best start since 2019).

In this context, our concentrated quality, stable growing, dividend-paying, fortress balance sheet, valuation disciplined portfolios made solid absolute progress during 2023's first six months, but not at the pace of the S&P 500 Index, and nowhere near the more growthier asset classes. Not pleasing, but not entirely surprising either.

The Password is…AI

In part, some of this year's market advance likely reflected a rebound from depressed levels last year, and a drop in the ten-year bond yield — usually good for long duration price earnings multiples.

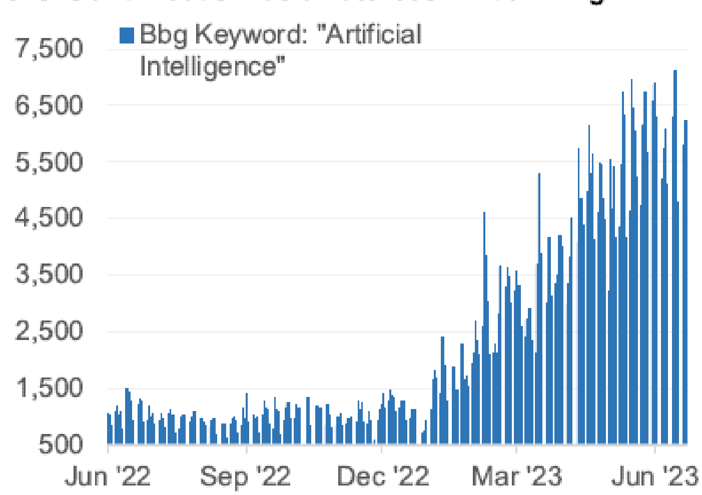
But the real fuel was the excitement around artificial intelligence (AI). The emergence of Chat GPT, Microsoft's "Co-Pilot" software initiatives, and Nvidia's robust AI chip sales ignited a veritable mania around AI and its promise.

AI represents a significant technology cycle, akin to the emergence of the P.C., the Internet, and the Mobile Revolution. In a June report, McKinsey & Company highlights generative AI's potential impact on productivity across customer operations, marketing and sales, software engineering, and R&D. They identified the biggest industry impacts across banking, high tech, and life sciences and expect broad changes across workflow, the workforce, and labor productivity from the new technology.

While AI is real, so is the hysteria around it, and in that vein mandates some caution. The July 3rd Barron's Up & Down Wall Street article references Gartner analyst Jackie Fenn's introduction in 1995 of the Hype Cycle tool for tracking a technology's progress. Fenn goes on to write "the majority of advanced technologies follow a predictable life cycle of hype, disillusionment, realism, and eventually, productivity."

Evercore ISI's Julian Emanuel's June 25th note, makes the point, "Everyone is talking about AI—not just Tech professionals and Wall Street analysts, but also politicians, celebrities, and even dog walkers (overheard first-hand). The omnipresence of the topic speaks to its transformative potential. But it also echoes past "Momentum Market Top" moments, well documented in the aftermath of history's Booms and Busts."

Figure 1: AI ... And You Thought Measuring Eyeballs, Clicks and Reads Was a Late '90s Kinda Thing!



Source: Bloomberg, Evercore ISI Research

Source: Evercore ISI as of 6/25/23. *Please refer to pages 6-7 for important information.*

In sum, we think Microsoft's CFO Amy Hood put it well during a recent investment community call on AI when she said, "A hallmark of any big technology shift is you both have technical transformation, platform transformation, and business model innovation". It is in that context that we will evaluate the impact of AI on all portfolio candidates with an eye towards fundamentals, earnings and cash flow growth, and valuation.

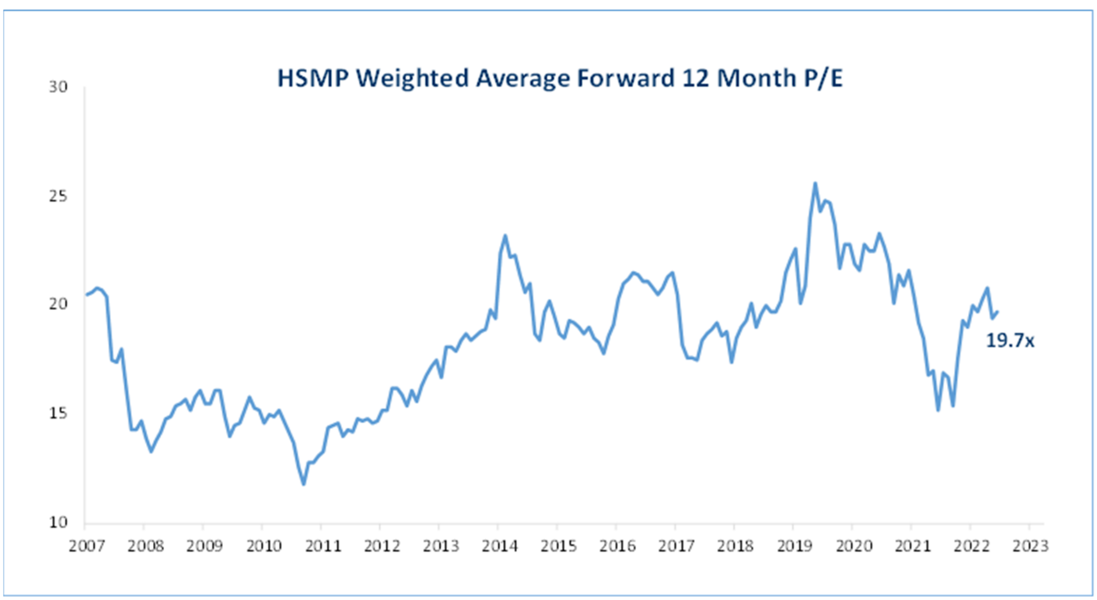
Investment Outlook

Our big picture view going into this year was that 2022 marked the end of the era of easy money. Fed tightening — aimed at curbing inflation – was likely to slow the economy down and it would ultimately be critical to navigate this period with a resilient earnings stream and robust balance sheets.

Notwithstanding the first half fireworks, we still believe this to be the case. Evercore ISI's Ed Hyman reminds us that monetary tightening works with long and variable lags. He notes in his July 2nd, 2023, Weekly Economic Report that "because of the combination of the yield curve inversion, M2 contraction, the surge in fed funds, and ongoing QT, we're convinced that a recession is coming." In sum, expansion now, recession later.

Whether it proves to be a slowdown or full-blown recession, we believe that our earnings stream — while not immune from economic weakness — is resilient by the nature of the business models, leading market positions, and cash flow characteristics of the companies we own.

All told, we believe our portfolio earnings stream may advance at a 10% or so pace this year and next. The portfolio also currently sells for about 20X estimated forward 12-month earnings and sports a 2.0% dividend yield. Ultimately, we look to the growing earnings and cash flow power to drive potential appreciation over time with dividends adding to cumulative returns.



Based on HSMP estimates since inception (4/1/07) through 6/30/23. Please refer to pages 5-7 for important information.

Short-term treasury and money market yields of over 5% stand as competition for equities, but more so for cash balances sitting in lower return bank accounts (as referenced earlier). Treasury money market yields were running at 0.08% as recently as April of 2022 (that was not that long ago!).

Ultimately, valuations are influenced by the level and direction of longer-term rates, specifically the ten-year U.S. Treasury yield. The 10-year yield sat at 3.8% on June 30th, 2023—down from year-end—but on an upward trajectory from rock bottom levels of less than 1.0% in 2020 and as low as 1.5% as recently at year end 2021.

Today, we have a steeply inverted yield curve (short rates are higher than long rates), and as Ed Hyman points out, this is a sure-fire recession predictor, although it can take a fair while after the curve inverts before a recession occurs (it was 18 months after the curve inverted in 2006 before the Great Recession hit in 2008).

Our sense is that over time we will see lower short-term rates (The Fed will respond if things do materially slow), but we are mindful that there is room for long-term rates to move up. The latter will depend on success at taming inflation and what real returns bond investors demand. That said, we do not feel extended from a valuation perspective and believe our absolute multiple is reasonable and our relative valuation next to bond yields can withstand some move higher in long-term rates.

So, in sum:

1. Bizarro first half market performance, the complete opposite of the first half 2022,
2. Your portfolios made progress, and we are the tortoise in this long race,
3. We continue to find attractive new names and try to learn from our mistakes,
4. We think resilience will be required and prized as economic activity slows,
5. Our portfolio valuation seems reasonable, and dividends will matter again.

Rest assured that we are working hard on your behalf. Know that we manage considerable funds of our own alongside yours…we eat our own cooking. Thanks for your confidence in us and we wish you all a happy and healthy summer.

Sincerely,

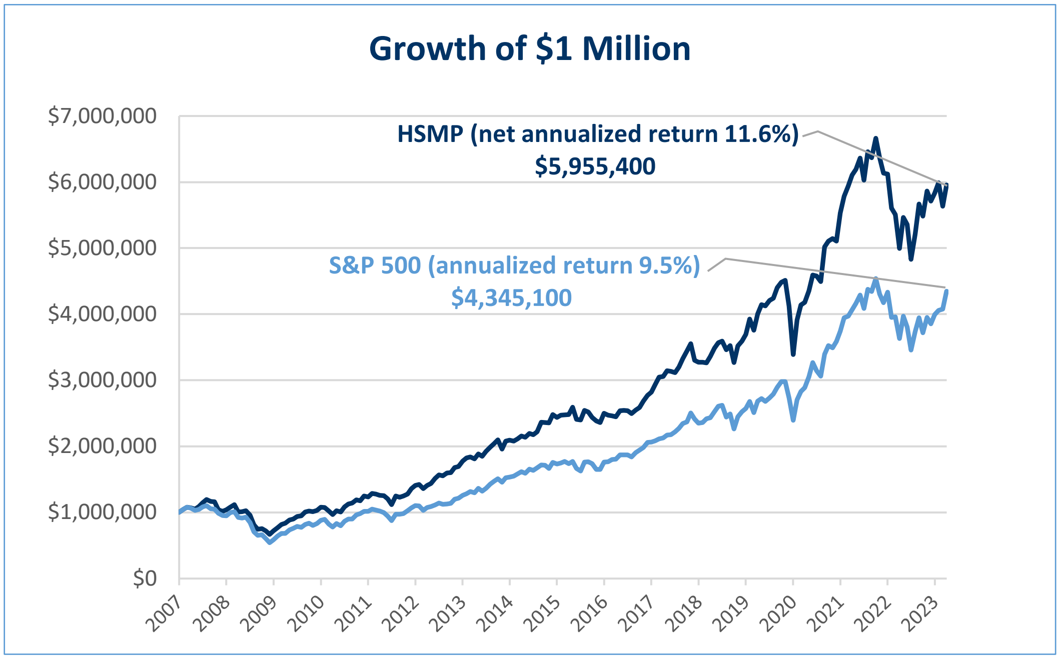
Harry W. Segalas

Portfolio Profile (6/30/23)

HSMP Composite Performance as of 6/30/23

	2Q23	YTD	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)	2.2%	8.6%	19.3%	12.5%	12.1%	12.7%	11.6%	495.5%
S&P 500® Index	8.7%	16.9%	19.6%	14.6%	12.3%	12.9%	9.5%	334.5%

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 6-7 for important information.



For illustration/discussion only, based on HSMP Composite annual returns (net-of-fees). There is no assurance that the indicated return was attained by any client account or could be attained in the future. Annual performance for 2007 is since inception (4/1/07) through 12/31/07, and 2023 is 1/1/2023 through 6/30/2023. Performance results include the reinvestment of dividends and other earnings. Past performance is not indicative of future results. Please refer to pages 6-7 for important information.

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IMPORTANT DISCLOSURES

This piece represents our opinion as of 07/12/23 based on our understanding of market conditions and publicly available information and is intended for Institutional and High-Net-Worth investors only. 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). When we use *Composite*, we mean our HS Management Partners Concentrated Quality Growth Composite. Composite performance is presented net-of-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, a representative fee of 0.90% annually was applied to the individual accounts in the Composite 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 S&P 500® Index as a benchmark for market context only. The S&P 500® Index is an unmanaged market capitalization-weighted index of 500 stocks 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 the S&P 500 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 the S&P 500 Index and is much more concentrated than the S&P 500 Index in terms of companies and sectors; the average market capitalization of companies in the Composite will likely differ from the S&P500 Index; and market or economic conditions can affect positively/negatively the Composite's performance but not the S&P 500 Index to the same extent). In addition, the S&P 500 Index does not bear fees and expenses and investors cannot invest directly in the S&P 500 Index. 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).

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