April 12, 2023

Dear Valued Client,

As we reflect on the first quarter of 2023, we are pleased to provide you with an insightful update on the financial markets and our strategic outlook. The beginning of the year has been marked by a complex investment landscape, characterized by a dynamic global economic recovery, shifting monetary policies, and evolving market trends. At Douglass Winthrop Advisors, we remain committed to helping you navigate these challenges and capitalize on opportunities as we work together towards achieving your long-term financial objectives.

The paragraph above was written by **ChatGPT** in a matter of seconds after we typed in the simple prompt: "Write the introductory paragraph to the Douglass Winthrop Advisors first quarter letter." For those who have not yet heard of or tried it, ChatGPT is a conversational artificial intelligence (AI) model that can answer questions, generate text, provide summaries, and engage in conversation with users on a wide range of topics. It was developed by **OpenAI**, a San Francisco-based research laboratory with the declared intention of creating a friendly artificial intelligence.

Artificial intelligence and advanced natural language processing systems like ChatGPT are likely the most widely discussed subjects in technology investment circles this year. Microsoft co-founder Bill Gates recently called the development of AI "as fundamental as the creation of the microprocessor, the personal computer, the internet, and the mobile phone."[1] Goldman Sachs believes natural language processing could lift global GDP by 7% and grow productivity by 1.5% over the next 10 years.[2] Many other thought leaders are concerned about the implications of technologies that mimic human language. While it is unsettling to read an AI generated paragraph that is eerily similar to those we have written in our past letters, we believe AI is the type of technology advancement that long-term investors should cheer rather than fear.

Investors are lining up their bets on AI's side…

Buoyed by its very public investments in AI, including its large stake in OpenAI, **Microsoft's** share price is up over 13% from November 30, 2022, the date when ChatGPT was launched, to March 31st, 2023. Meanwhile the stock price of **Alphabet**, the parent company of Google, was only up 2.5% over the same strong period for tech stocks.[3] Investors may be speculating that Google's near monopoly on internet search will cede ground to AI-powered search engines, including Microsoft's Bing. Alphabet has included certain AI functionality into its products for some time and is expected to launch its own AI-powered natural language processing suite of products soon.
Depending on how they are received, a reversal of fortunes could be ahead. ChatGPT may generate responses that are factually incorrect or misleading, as it relies on patterns in the data and not a ground truth. It can be difficult to verify the accuracy of its responses without additional research. As a result, we think Google's current flagship search engine which points users to source websites and documents is as important as ever. Both businesses have been cutting costs in other areas and look fairly valued relative to other mega cap technology companies.

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[1] https://www.gatesnotes.com/The-Age-of-AI-Has-Begun
[2] https://www.goldmansachs.com/insights/pages/generative-ai-could-raise-global-gdp-by-7-percent.html
[3] Bloomberg, L.P

…But beware of boom-and-bust technology cycles.

New technologies that generate this type of excitement tend to result in overinvestment, followed by painful stock market corrections like the Dotcom Bust of early 2000. We believe the best way to take advantage of innovation without falling prey to boom and bust cycles is to take a long-term approach and invest in high quality companies led by managers that have histories of implementing technology to drive efficiencies.

There are many companies that stand to gain from AI, not just those that are developing it. Businesses with large customer service requirements including cable network operator **Charter Communications** and healthcare provider **United Health** are already using AI to serve customers more efficiently. We expect the benefits to accelerate as improved technology becomes available. As demand rises for more AI applications, so will the infrastructure needed to meet it. AI applications use tremendous processing power and large amounts of data, so we expect steady growth in demand for cloud computing leaders **Alphabet, Microsoft and Amazon**. Broadband infrastructure provider **Charter Communications** and chip manufacturer **Texas Instruments** should also benefit from the proliferation of AI applications.

Stocks and bonds gain in volatile start to 2023.

Despite increasing geopolitical tensions and pervasive negative sentiments, major stock and bond indexes were up in the first quarter. The **S&P 500** continued to build on its momentum from late 2022, notching a 7% gain. The **Nasdaq Composite** experienced a notable increase of 17% as investors snatched up 2022's beaten down technology shares. Meanwhile, the **Dow Jones Industrial Average** which performed better than those indexes last year, rose by less than 1%, eking out a small gain thanks to a late March rally.[4]

Investors have been closely watching the Federal Reserve's attempt to tame inflation by rapidly increasing interest rates and allowing the bonds it holds to mature without making new purchases to replace them. Their efforts to take excess liquidity out of the financial system seem to be working. One measure of liquidity, M2 money supply, contracted for the first time since 1960 and the rate of inflation has cooled from last year's torrid pace. Mortgage rates have climbed to 7%, up from 4% a year earlier. Increased borrowing costs are already putting a dent in home prices even though the inventory of homes for sale remains low. [5]

We are cautious about bonds as a long-term safe haven.

The U.S. bond market also recovered this quarter after its worst year ever in 2022. At the beginning of the year, the yield on **10-year U.S. Treasury bonds** was 3.9%, eventually closing the quarter at 3.5%. (Bond prices and interest rates move in opposite directions.) The Bloomberg U.S. Aggregate Bond Index saw an increase of 2.5%. Short-term interest rates have risen so rapidly that bonds and money market funds may appear more attractive for short-term deposits. We note, however, that it will likely take some time before inflation settles back to the Federal Reserve's stated target of 2%. In the meantime, after-tax returns on treasuries and money market funds are not keeping up with the current pace of inflation.[6] The stocks of high-quality companies with sustainable competitive advantages and pricing power, like those we purchase for our clients, offer a better inflation hedge over the long term.

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[4] Bloomberg, L.P

[5] https://www.barrons.com/articles/m2-money-supply-recession-51674569554

[6] Bloomberg, L.P

Rapid rate increases put banks in the crosshairs.

The Federal Reserve may have already reached the limit of what it can do to rein in inflation without sending the economy into recession or inflicting grave harm on the banking system. On March 10th, the quick pace of rate hikes combined with loose risk management practices at **Silicon Valley Bank** (SVB) led to the largest bank failure since 2008. Rising interest rates caused a steep drop in the value of the bank's bond portfolio as the bank's depositors, including many unprofitable technology companies, pulled funds to meet expenses or seek higher deposit rates elsewhere. New York-based **Signature Bank** failed two days later. **First Republic Bank, Wells Fargo** and others were caught in the contagion and saw their share prices fall precipitously as investors wondered if they might follow SVB and Signature into insolvency. In Europe **UBS Group AG** stepped in to buy **Credit Suisse AG** as it teetered on the edge of collapse due to a string of scandals and poor risk management.

We believe the worst of this crisis is behind us but the fallout for the banking industry will remain. When banks fail and the government steps in to support them, calls for tighter banking regulation ring out from across the political spectrum. More stringent regulatory regimes stifle innovation and make it harder for well-run banks to distinguish themselves. While larger banks may enjoy a short-term bounce as worries pass, we believe the banking sector will offer unappealing returns over the longer term.

Artificial Intelligence is here to stay, even at Douglass Winthrop.

Like email and mobile phones, AI is only going to become more pervasive in our lives. Businesses across all industries, including financial services, will be measured by how they implement AI for the benefit of their customers and shareholders. AI applications will be powerful tools when used thoughtfully and Douglass Winthrop Advisors will inevitably use AI-powered software to improve our own operations as it becomes available. As we do so, you can rest assured that our clients will always have very real partner-level contacts to advise you while understanding your specific needs and that we only implement new technology when we feel it is in our clients' best interests.

We look forward to navigating the peaks and valleys of this brave new world of AI with you, and hope you enjoy a healthy and happy spring.

Sincerely,

Douglass Winthrop Advisors