July 11, 2024

Dear Clients, Partners and Friends,

For several decades distressed debt investor Howard Marks, through his books and numerous memos, has been educating the investment community on the importance of risk management and on the psychology of liquid markets. A luminary in the value investing community, he is also co-chairman of the world's largest distressed debt manager, which happens to be majority owned by one of our holdings, **Brookfield Asset Management (BAM)**. Marks once described a dinner he had with the manager of a large pension fund. As told by Marks, the fund manager never finished a year worse than the top 50th percentile or better than the top 25th percentile compared to his peer group. While that might sound like middling performance, avoiding big mistakes in any one year resulted in his fund being in the top 4th percentile over his 14 years of managing the fund. This shows the unparalleled importance of managing risk and avoiding major losses.

We embrace that idea by refusing to invest in a business unless it is a top tier franchise with unyielding command of its market position. For it to meet the criteria of capital preservation, its shares must also be offered at a reasonable market value relative to what the business would sell for in the private market. That's where many popular stocks fail our underwriting process. This dynamic has been on full display recently as the stock market has been increasingly defined by narrow leadership. Signs of a broadening market in the first quarter retreated in the second quarter, in which the S&P 500 Index (weighted by market capitalization which emphasizes the importance of the largest companies) gained 4.3% while the S&P 500 Equal Weight Index declined 2.6%. Year-to-date, the S&P 500 is up 15.3% driven by the Magnificent Seven group of stocks: Nvidia, Meta, Microsoft, Apple, Alphabet, Amazon, and Tesla. Returns outside of those stocks have been muted. The S&P 500 Equal Weight is up 5.1% for the year, international stocks (MSCI ex-US) are up 5.0%, small caps (Russell 2000) are up 1.7%, and returns for most bonds and REITs are negative.

The Magnificent Seven now account for one-third of the S&P 500 weighting. The stock market has not been this top heavy since the late '90s dotcom bubble. This group has turbocharged the S&P 500 since the end of 2019 with a 43.9% average annual return. On the heels of that incredible run, the group now trades at an alarming 12.9x ratio of trailing Enterprise Value / *Revenue*.

In our view, the extended valuations for these stocks translates into an increased risk profile, and our exposure to them is accordingly limited. We have owned Microsoft, Amazon and Alphabet for a number of years and we continue to be comfortable with their respective business outlooks and market valuations. Still, it is worth noting that the top ten market leaders in one decade are rarely the same in the next. On average since 1991, returns for the ten largest stocks have underperformed the market over the subsequent ten years.[1] In addition to our concerns about stretched valuations, we are especially mindful that technology companies are vulnerable to new innovations from competitors that can quickly overrun what had previously appeared to be unassailable moats.

While pockets of the market seem overly optimistic, the macro-economic environment in the US appears largely benign with low unemployment and solid wage growth. Core inflation of 3.4% is still above the Federal Reserve's 2% target, but much progress has been made since the gauge peaked two years ago at 9.1%. What implications

[1] Source: Plante Moran. Data from 12/31/91 to 12/31/23.

does this have for the stock market? We are realistic about the unpredictable nature of that outcome, and that underscores our strategy to only invest in resilient companies.

We see opportunity

In 2017 we began tracking our internal return projections for our portfolio holdings. While estimates generated by any such exercise are inherently imprecise, ours have been directionally correct. Currently, the estimated excess returns for our portfolio relative to the S&P 500 is nearly as high as it has been since we began tracking.[2] We believe this presents a compelling opportunity for our clients. Themes such as artificial intelligence and GLP-1 (weight loss) drugs are capturing investors' imaginations and driving capital away from less glamorous parts of the market. The upshot is there are plenty of quality stocks available at valuations far less demanding than those for the widely-owned mega cap AI stocks but with better-than-market growth potential, in our view.

One such example is **Aon (AON)**, a global risk consultant and insurance broker. Regulatory regimes continue to get more complex. Business risks are getting ever-more complicated and expensive to insure due to increasingly sophisticated cyber-attacks, erratic weather events, and the effects of geopolitical risk on global supply chains, among many other factors. Intangible assets represent a far higher share of corporate balance sheets than a generation ago, and banks won't lend against intangibles unless they are valued and insured. All of this plays to the strengths of Aon. These risks are all bespoke, which elevates the importance of the insurance broker in educating insurers. This is also a business that is detached from the economic cycle; Aon's business has historically been resilient during recessions because insurance is always necessary. Importantly, Aon bears no insurance risk, providing additional ballast to the business. Consistent cash flows have enabled management to return to shareholders nearly 5% of the share price annually, mostly through share repurchases. We expect nearly 12% annual per-share earnings growth over the next five years, considerably higher than typical earnings growth for the S&P 500. Yet Aon's shares trade for 17.5x forward earnings compared to 21.5x for the S&P 500.

Eschewing the grocery cart portfolio approach

Our strategy of owning a portfolio of some of the world's strongest businesses, like Aon, allows us to allocate a higher percentage of client assets to equities. Our heavy allocation to equities is buttressed by our **Five-Filter research process**, through which we assess prospective investments on the merits of the competitive strength of their business, opportunities to reinvest capital internally for organic growth, balance sheet strength, quality of management, and whether market value offers a discount to intrinsic value. Throughout our history, our conservative approach to selecting companies (and stocks) capable of sustainable growth, combined with our commitment to staying invested, has been an effective formula. This approach has historically performed better than alternative strategies promoted by the many consultants, investment advisors and bulge-bracket firms that fill portfolios with an overly diversified grocery cart of investment products that dilute returns and add costs, often poorly disclosed as management fees or sales charges embedded in pooled vehicles. Past performance is no guarantee of future results.

In stark contrast to this grocery cart approach, we subscribe to a method of investing borne out of our founding mission to protect and grow client wealth through patient, long-term compounding of returns. We pair our fiduciary

[2] Based on our internal return projections for each company we own, and our expectation of mean-reverting returns for the S&P 500 over the next five years.

mindset and disciplined value investing approach with our trust and estate advisory services, which are hugely impactful for tax efficient generational wealth transfer. Buttressing these capabilities are the substantial investments we have made in our technology, compliance, and client service teams with the goal of delivering a comprehensive client experience. In an era of mega banks and continued consolidation in the RIA space, we believe our boutique size, high-quality team, and simple investment strategy stand out today more than ever.

Firm Update

In our 25th year we are laser focused on developing our cohort of younger professionals so that we can continue to serve multigenerational families. Our exceptionally low personnel attrition fosters continuity and consistent execution for our clients. We also continue to recruit outside talent. Our latest addition is Tyler Mixter, who joins us as a Managing Director in our NYC office. Tyler was most recently a senior research analyst and partner at Cramer Rosenthal McGlynn where he was responsible for the firm's investments in the technology, media, telecom, energy, and utility sectors. Previously, he worked at Credit Suisse in investment banking. Tyler is a graduate of Amherst College and NYU's Leonard N. Stern School of Business.

We hope you have a wonderful summer, and we look forward to seeing you soon at the office or at one of our events in New York, Washington, or West Palm Beach. Thank you for your continued support.

Sincerely,

Douglass Winthrop Advisors LLC

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