Executive Summary

Performance in the 1st quarter was behind the OS's benchmark and behind the S&P 500. Conservative positioning and some underperforming securities made it difficult to keep pace. The S&P 500 continues to push higher. AI is still a huge part of stock market advances. Optimism that the economy will absorb the 500 basis points of Fed rate increases without falling into a recession led to a broadening of upward stock moves. Recent economic strength is pushing back the timeline for the Fed to begin rate cuts. While the economy is holding up okay at the outset of 2024, there are numerous reasons why a concentrated S&P 500 focused investing strategy is misguided.

The Opportunistic Strategy returned 6.0% in the first quarter of 2024, behind its benchmark and behind the S&P 500. While overall returns were solid for most equity indices, diversified equity investing lagged the S&P 500 once again. US small cap value stocks only managed a 2.9% return. Emerging Market stocks only managed a 2.1% advance. And EAFE stocks returned 5.8%, very respectable but not like the S&P 500.

As of 3/31/2024	QTD	YTD	1 year	3 year	5 year	Since Inception
Opportunistic Strategy	6.0%	6.0%	16.6%	7.2%	13.7%	15.8%
Benchmark	7.4%	7.4%	18.2%	6.1%	9.1%	8.9%
SPX	10.6%	10.6%	29.9%	11.5%	15.0%	14.4%

Inception: 9/1/2016

When optimism over domestic economic conditions improves, small-cap stocks tend to outperform. However, momentum continues to drive this stock market. Various momentum factor-based ETF's were up around 20% in the 1st quarter. Momentum is a strategy of investing in yesterday's winners assuming further outperformance. It is close to the opposite of contrarian investing, which looks for underperforming stocks that might be at a positive inflection point. The OS mostly follows a contrarian investment style.

The OS has a little higher than historical bond allocation, a modest cash position and an allocation to a few funds that should help dampen some volatility but nevertheless it will continue to be a volatile strategy. Contrarian investing can be volatile. The strategy for the past 7.5 years has been a good complement to the S&P 500 and I expect that to continue. I am optimistic the OS will generate a better return in upcoming years than the S&P 500. While growth prospects for OS stocks might not be as high as S&P 500 companies, the valuation gap is very large which means S&P 500 companies are going to have to grow earnings at a significantly better rate to provide a superior return. I am skeptical. Here are some reasons why.

Historically, about 1/3 of the S&P 500 return has come from dividends. A dividend yield a little over 3% with EPS growth close to 7% can produce a 10% return, about what the S&P 500 has been able to do historically. The current dividend yield is about 1.4%, close to historic lows, only lower during the dotcom boom. Therefore, to get close to that 10% return the S&P 500 has historically been able to provide, earnings per share growth needs to improve from historical trend. That is going to be challenging. The S&P 500 is trading at 25x 2023 diluted earnings from continuing operations and 23x 2023 adjusted earnings. Price to free cash flow is even greater. EPS has been able to historically grow high single digits partly because of the ability to buy back shares. The ability to pay a dividend and still retire a meaningful percentage of shares outstanding when your stock price is trading at a very large multiple to free cash flow is challenging. Leveraging up to do so in a higher interest rate environment is not appropriate or even possible for many companies. Therefore, eps growth needs to come almost entirely from business performance.

Business earnings before per share adjustments need to grow above GDP growth consistently for a long period of time. Can S&P 500 companies continue to garner more sales at the expense of smaller or private companies? Or maybe take share in international markets. Perhaps, but government scrutiny of large companies will not help and the trend toward protectionism in the global economy will not help either. The wealth and income gap in the United States is already large enough to create meaningful discontent among individuals, it needs to grow larger to justify stock prices.

It is difficult for companies to grow earnings in an economic slowdown and ruling out a recession is a mistake. Discontent among individuals is an economic data point worth paying attention to. The economy has been holding up well, job growth and pay have been steady. But affordability challenges are hurting sentiment. The cost of owning a home, owning a car, paying for basic services and discretionary services all are creating pressures. Those with low mortgage rates are not feeling the same pressure, but they will gradually over time.

Keeping interest rates higher for longer will slowly start damaging economic growth. Locked in low mortgage rates and things like extra savings income at the expense of a bigger US deficit are helping to thwart some of the pain from higher interest rates. But those can't offset the challenges meaningfully higher financing rates create over time. The biggest problem US companies face is a consumer pullback in the face of affordability challenges. Job and income growth help with affordability, but a percentage point higher pay isn't going to change the housing cost to income ratio much, which is at historically high levels. Psychology and savings impact that even more.

Speculation is a big part of the markets these days. The rise in bitcoin, gold and some profitless SPAC stocks are some examples, but also the rise in trading of zero-day options. Small-cap stocks and international stocks don't benefit from bullish zero-day options trading. That is largely focused on indices with big companies. Reversals there could hurt S&P 500 focused investing.

AI is also a huge part of the market as well. Widescale purchases of AI services from entities not in the S&P 500 could drive meaningful earnings growth for some S&P 500 companies. Many small cap stocks or international stocks would not benefit from this. But right now, we have a market where large S&P 500 companies are purchasing from other large S&P 500 companies. Meta or Microsoft purchasing a lot of GPU's from Nvidia shouldn't create a lot of value for the S&P 500. Revenue for one is a cost for the other. If Meta and Microsoft can turn the models into meaningful revenue dollars from consumers and businesses, then there is value. I am skeptical the uptake of things like copilots are going to prove economic for large parts of the economy anytime soon, but we will get more clarity there in the later part of 2024.

If earnings for S&P 500 companies were to grow in line, not above, a nominal GDP growth rate of 4%, (keep in mind that still involves maintaining historically high profit margins while facing higher interest charges and possibly higher taxes as the government will need to look somewhere for revenue) and a modest return for dividends and share buybacks were added, an investor is looking at a return quite a bit below historical average of 10%. Many of the OS stocks trade at discounted valuations so business earnings growth in the very low single digits could be good enough to create a double-digit return.

The OS once again had a large dispersion in performance between the best and worst. Embraer had a strong return this quarter. Demand is solid for the aircraft they produce. Embraer operates in the smaller seat commercial space, business jets and has a defense division. All 3 divisions have solid demand and a path to improved profitability which is crucial for Embraer. Embraer also has a stake in an EVTOL maker that has some value and might receive some proceeds from its lawsuit vs. Boeing.

Advancers/Detractors	2024 1Q Return
Embraer SA	44.4%
Impinj, Inc.	42.6%
Criteo	38.5%
Hanesbrands, Inc.	29.8%
Hitachi, Ltd.	26.1%
Canadian Solar Inc.	<24.7%>
Thyssenkrupp AG	<20.1%>
Dropbox, Inc.	<17.6%>
Bayer AG	<17.0%>

Impinj rebounded strongly in the 1st quarter. It is a very volatile stock. A positive legal verdict against NXPI helped the Impinj return but really the story here is how fast will high frequency RFID roll out to new companies and industries. There is a large untapped market here.

Criteo rebounded after disappointing investors in the 4th quarter about long-term growth prospects. There is a lot to sort out in the ad-tech marketplace over the next couple years. Criteo has some valuable technology, but it is in a very competitive market, so this stock is going to be volatile due to changing investor perception of who the ultimate winners and losers are going to be.

Hanesbrands is looking to sell its Champion line to pay down some debt. Optimism over sales proceeds there helped the stock. Hanesbrands has a very solid innerwear position, strong market share and solid margins, outside of a blip recently from inventory destocking. One could argue its entire Economic Value can be derived from its innerwear business. In addition to that, they own the Champion brand. Champion has been an

unperforming brand. I viewed Champion as having a lot of potential and there is potential with the revised marketing approach. However, there is the possibility Hanesbrands will sell Champion for a low price because of debt concerns and perhaps poor management.

Japanese stocks have continued to perform well, particularly the multinationals. The weak yen and the rise of Japanese stocks due to more market friendly activity are not the only reasons Hitachi has done well. Hitachi has some solid divisions. Its power grid business is well positioned to benefit from increased global investment there. Its connected industry and industrial digital business unit are well positioned for growth as well. The OS recently sold some Hitachi as the valuation is getting stretched.

Canadian Solar was the worst performing stock in the portfolio and it is a large holding so the performance meaningfully hurt returns. Canadian Solar has two divisions, one CSI solar is a Chinese module and battery maker. The other, Recurrent Energy, is a solar/energy storage developer. Canadian Solar has a market cap a little over 1 billion. Blackrock recently entered into a convertible preferred stock transaction with Recurrent for 500 million. This 500 million investment would convert into 20% of the stock outstanding. This investment indicates Blackrock believes there is a good chance in several years one division of Canadian Solar, Recurrent Energy, will be worth 2.5 billion overall or they likely wouldn't have done the deal. Meanwhile, its 62.5% ownership of its CSI solar division is worth over 4 billion US dollars and that is after CSI solar had a meaningful selloff. Companies in solar deserve a discount because of the hypercompetitive space but the extent of this one is extreme.

Thyssenkrupp for the past year has had a market capitalization below the net cash on its balance sheet. It does have a meaningful pension liability but still the pessimism toward the stock is extreme. Most of the pessimism surrounds the competitiveness of the steel division. I view the steel division as an option for this company - the company is only overvalued if the value of the steel division is significantly negative. While Thyssenkrupp has its challenges, I think the company is taking the necessary steps to address the competitiveness of its steel division and the extreme pessimism is unwarranted.

Dropbox was trimmed right before its earnings selloff, so the return impact was not that strong. Nevertheless, it should have been sold outright. Another reminder that when tech stocks lose their growth, the selloff can be extreme.

Bayer continues to struggle with legal liabilities. In addition, the market for some crop protection products such as herbicides has slowed down meaningfully and the fallout from its weak late-stage pharma pipeline continues to impact the stock. The OS trimmed Bayer in the 4th quarter and chose to keep a modest position. There still is a positive story to be told for Bayer. It has some very good assets and once litigation troubles finally do go away, the path to deleveraging is pretty quick.

Bond performance has modestly hurt returns this year. The OS does own a bond for Trinseo PLC, a chemical company facing a very uncertain future. Trinseo levered up to make a poor acquisition and now that markets have softened, it is struggling. The company needs a strong rebound in the material markets it focuses on. Bonds are currently pricing in a high chance of a default. There will be almost nothing provided to unsecured bondholders in a default so this is a tenuous holding. The OS also owns some bonds in Babcox and Wilcox. This company has some strong assets but it is struggling with its margin structure. These bonds have become distressed as well.

Looking ahead, the OS will continue to be cautious this year unless a large selloff takes place. The US economy is not going to be as strong as the recent resilience would indicate. Geopolitics, an uncertain election and an equity risk premium at low levels, all point to a dangerous market. The later part of 2024 will be when investors start to question the ROI on some of the enormous investments in AI that are taking place.

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