JULY 20, 2023

Spears Abacus MidCap Opportunities Strategy 2Q23

"Attempt to be fearful when others are greedy and greedy when others are fearful" – Warren Buffett

Greed roared back into vogue in the second quarter as the economic impact of having three major US banks fail in the first quarter was less bad than the market feared. This greed expressed itself in a large increase in the market value of the largest U.S. companies without a commensurate increase in the earnings of most of these companies, as discussed in more detail in the *Spears Abacus 2Q23 Commentary* below.

But the skunk at this garden party is that monetary policy operates with a long and variable lag[1]. This in plain English means that nobody knows when the economy will see the impact of the 500 basis-point increase in the federal funds rate since March 2022. Federal Reserve officials themselves offer estimates that it might take anywhere from nine months to two years for the economy to feel the impact of this rate-hike campaign. AND it probably isn't over yet. The chairman of the Federal Reserve has stated that two more rate hikes will probably be necessary to reduce inflation to an acceptable level.

Given the uncertainty of the impact of this large increase in interest rates on the economy, our plan continues to be to opportunistically use market volatility to your benefit by increasing weightings or establishing new positions in companies with track records of success when they are out of favor and by reducing position sizes in holdings if their prices seem to us to have moved up too high, too quickly.

Those strategies helped us participate in a very narrow market this quarter, with our largest position, Adobe Incorporated (Adobe). We made Adobe our largest position when it was out of favor due to the high premium it agreed to pay to acquire Figma, a rival design platform. This quarter Adobe moved higher as it was recognized as one of the potential beneficiaries of economic changes driven by the rise of generative artificial intelligence.

Nobody knows when and by how much the Federal Reserve's anti-inflation campaign will slow down the economy. Perhaps the worst has passed, and the increase in productivity caused by the new generative artificial intelligence will allow inflation to slow without a significant increase in unemployment over the next 12 months.

But we do know, by looking at valuation and stock-price charts, which companies and sectors are out of favor. It has been our experience that an addition to the portfolio of the shares of growing companies at a time when they are out of favor can offer two ways to win. The first is the companies may come back into favor, like Adobe did this quarter. The second is that a lower valuation may reduce downward volatility, as happened when the Russell Midcap Index declined 17.1% last year, and our strategy declined 12.1% over the same period.

Whether the U.S. economy has a soft or hard landing, we believe the portfolio is well-positioned to achieve our goal of growing capital after inflation with less volatility than the Russell Midcap Index. If the U.S. economy were to have a soft landing, in which inflation subsides without a large increase in

[1] https://www.stlouisfed.org/en/publications/regional-economist/2023/may/examining-long-variable-lags-monetary-policy

unemployment, our portfolio of growing companies trading at reasonable valuations should move higher over time in line with their growth in earnings.

In a hard landing, however, in which a decrease in inflation only occurs after a recession and a substantial rise in unemployment, we believe that the generally capital-light nature of our typical holdings will put our portfolio in a good position relative to the stock market. Our portfolio has a return on invested capital of 18%, versus 8% for the Russell Midcap Index[2]. Companies with a high return on invested capital tend to generate more cash than they need to operate their businesses. This cash may be used in an economic downturn to buy competitors or to repurchase their own stock at lower prices.

Average Up, Buy the Business, Cut Losses, and De-Risk the Portfolio

We didn't average up on any positions this quarter. The dispersion in this quarter between technology stocks and pretty much everything else gave us plenty of opportunities to buy businesses with above-average financial characteristics while trimming some wonderful businesses whose share prices we felt had moved too high, too quickly.

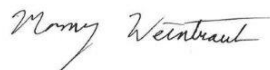
We purchased QuidelOrtho, a medical testing and diagnostics company that benefitted greatly from the COVID-19 epidemic. QuidelOrtho's shares declined in price as the pandemic subsided but are now trading at a reasonable valuation excluding COVID-19 testing revenue. Management has shown a talent for making accretive acquisitions, and we believe the company has upside from its new product pipeline.

We also initiated a position in W.R. Berkley, a property and casualty insurer founded by Bill Berkley in 1967. We have followed this company for many years and have been waiting for an opportunity to buy the shares. We like this investment because management runs the company for the long-term benefit of shareholders. Why? Because the Berkley family is still the largest shareholder, owning 20% of the company. They have done a great job managing underwriting and investment risk over the years.

We cut our losses and moved on from Global Payments after the abrupt departure of long-time CEO Jeff Sloan, and we sold our position in PTC, the industrial software company, given the strong rally in technology shares this year.

We feel very good about the opportunities presented to us this quarter. Both to buy and to sell. We think that the next few quarters should continue to present opportunities, as the markets will likely stay volatile given the economic situation. The world keeps changing, but fear and greed go on forever.

With all best wishes,



Manny Weintraub, CFA

[2] Returns based off of last reported year for each company

Spears Abacus 2Q23 Commentary

I. Market Overview

A snapshot of the most recent quarter is almost indistinguishable from the one that preceded it. At least in terms of equity markets. In the second quarter, the S&P 500 was a touch stronger than the first (8.7% vs 7.5%). Combining the two yields a year-to-date total return of 16.9%, bringing that benchmark to within 10% of its all-time high. Given what seems to be a challenging environment*, this strength has surprised many. Peeking behind the aggregate statistic reveals that, more broadly speaking, stock markets have not been quite as friendly as the Index suggests.

***Challenging Environment**

- *Rapid rise in short-term interest rates*
- *Near banking crisis (impending regulatory changes)*
- *More stubborn than predicted inflation*
- *Debt ceiling standoff*
- *Accelerating tension in Russia/Ukraine*
- *Stalled recovery from China*

By far the most prominent feature in 2023 has been the outsized influence of a small handful of very large companies. Eight stocks were responsible for more than two-thirds of the performance of the S&P 500. Without them, the benchmark would have been up by only about 5%. Still respectable for a six-month period, but hardly noteworthy.

As always, it is more helpful to examine specifics than gloss over generalities. The Mega-Cap 8, like the FAANG stocks of the last decade, are a familiar gang. Not surprisingly, technology is a common theme uniting the group. Each company is either a provider or beneficiary of dominant technologies. Some fall into both camps. So far this year, the Mega-Cap 8's average return is an eye-popping 84%.

This statistic requires context. This same group averaged a negative return of 46% in 2022. The cruel math of negative results is evident. Only two, Apple and NVIDIA, have surpassed previous high-water marks, and Microsoft is close. Meta, Tesla, Amazon, and Netflix remain between 25% and 40% below previous highs.

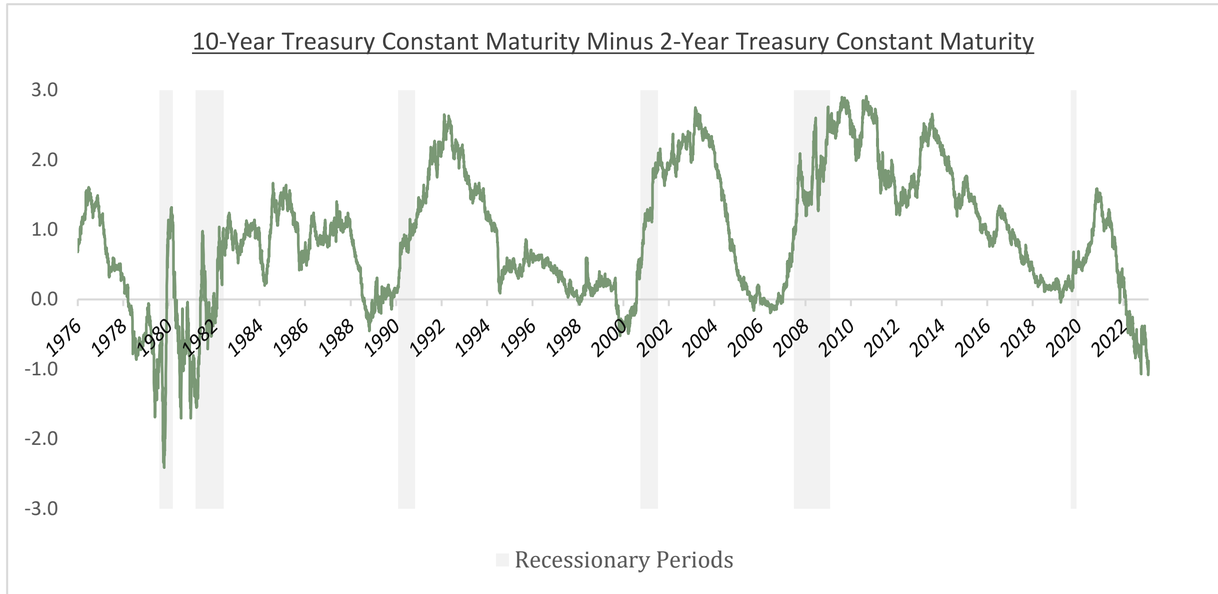
When eight so decisively outperform 492, it begs the question of how this anomaly will be resolved. Will the leaders fall back to the pack, or will the laggards catch up? To help to find the answer, we make two observations. First, the Mega-Cap 8 are hardly monolithic. While each trades at a higher-than-average valuation, there is a significant range from the lowest (Alphabet) to the highest (Tesla). Second, the remaining 492 companies trade at an average valuation of 16.5 times consensus 2023 earnings estimates, implying that there are bargains to be found.

Mega-Cap 8 Valuation[3]	2023 PE
Alphabet Inc. Class C	22.3
Meta Platforms Inc. Class A	24.0
Apple Inc.	32.1
Microsoft Corporation	35.1
Netflix, Inc.	39.3
NVIDIA Corporation	55.9
Amazon.com, Inc.	81.5
Tesla, Inc.	82.3
Average	*46.6*

[3] Source: Factset. Based on consensus 2023 earnings per share.

II. Looking Forward

The yield on the two-year U.S. Treasury note is more than 1% greater than that of the ten-year maturity. This is not normal. As can be seen from the chart below, it has not occurred since 1981. It is common wisdom that this so-called "inverted yield curve" presages a recession. It has done so correctly for the six official recessions in the U.S. over the last 50 years. Those economists forecasting an impending recession generally point to the inversion as evidence. Yet one full year after the yield curve first inverted, the economy is still showing surprising strength.



Source: FRED: Federal Reserve Bank of St. Louis. Data from 06/01/1976 to 07/07/2023.

The glass is half-empty crowd will point out, correctly, that history shows that a recession could begin as long as two years after the onset of an inverted yield curve. A more optimistic view is that being right six times in a row is no guarantee of future accuracy and that the economy could remain robust for the foreseeable future.

There is a trove of data to support either position. Eventually, one will be proven correct. However, it is important to remember that Covid-19 related shocks have been largely unprecedented. We truly are in uncharted territory. Never before has the global economy come to a complete stop. While there have been instances of supply-chain interruption, never have so many broken at the same time. We have never experienced the same degree of demand destruction, followed by a tsunami of pent-up demand. We do not really know whether Covid rendered traditional forecasting tools completely ineffective. But, as seasoned investors, we do know that now is not the time to bet the ranch on tenuous predictions.

Fortunately, we have other tools at our disposal. We have always looked to company-specific analysis to provide guidance. In general, we seek out those businesses that are less impacted by the overall economy. In uncertain times like these, we work doubly hard to maintain that discipline. Should a

recession occur, stock prices will likely retreat, including the prices of the companies we own for you. However, we strongly believe that none will be fatally impaired, no matter how unfriendly the climate.

Such an environment could present meaningful opportunities for new investments. We have higher-than-usual cash balances available to take advantage of attractive higher yields on short-term Treasuries. As mentioned, the average stock is currently reasonably valued. Should future market weakness occur, we will have a shopping list ready.

III. Artificial Intelligence

It was hard to go a day during the second quarter without reading a headline about artificial intelligence (AI.) Among investors, there has been a significant debate about who wins and who loses. The debate is far from settled.

Take for example Adobe, which in the span of just a few weeks went from being viewed as an AI loser to an AI winner. The narrative shifted from "AI is going to render creative workers obsolete, reducing the number of people using Adobe software" to "look what you can do with AI embedded in Adobe software!" From the beginning of the quarter to mid-May, the stock declined over 10%. From mid-May to mid-June, the stock went up almost 50%. In reality, not much changed. Adobe has been integrating increasing amounts of artificial intelligence into its design software for years, and investors today have little more clarity about what the "AI revolution" means for Adobe than they did when the quarter began.

We don't know what the future holds (we tried asking ChatGPT) but the ongoing debate about how artificial intelligence, large language models, etc. will reduce demand for Adobe's software, and many other companies' products and services, reminds us of the Jevons Paradox.

In 1865, an English economist, William Jevons, observed that contrary to intuition, after the introduction of the far more efficient Watt steam engine, England's coal consumption increased rather than decreased. Put simply, additional coal demand resulting from new applications enabled by the more efficient engine more than offset the improvement in fuel economy.

We think the same lesson applies. People won't simply be content to use ChatGPT and its successors to accomplish the same things more efficiently. They will use technological advancement to do things that aren't possible or practical today.

IV. Personal Finance

The steep increase in interest rates over the past 12 months has created a two-tiered population of debtors. Or more accurately, a two-tiered population of debts, sometimes for the same borrower. On one hand, those who incurred debt at a fixed rate prior to the increases are still enjoying historically low interest rates and debt-service payments, and likely will for years, if not decades. Conversely,

variable (or floating) rate loans, and debts more recently incurred, are now at significantly higher rates. The interest-rate payments may render that debt a bad financial decision.

Many borrowers who were able to obtain mortgages at extremely low fixed rates also utilize home equity lines that have floating rates tied to prime. Prime today is 8.25%. Likewise, brokerage margin rates are over double digits, and loans secured by portfolios have rates in the high single digits. Borrowers became accustomed to carrying debt on a permanent basis, as it was not difficult to earn a rate of return higher than the interest-rate cost.

In today's bifurcated debt world, it is even more important to analyze whether a loan is still serving its purpose. For example, with cash accounts earning 5% interest, holding cash is a far better investment than paying off debt with an interest rate that is lower than that level (a fixed-rate mortgage, for example). Likewise, when interest on loans becomes higher than can be reasonably earned through prudent investing, paying off floating-rate debts (like home equity lines of credit) may be the wisest decision.

Given this higher hurdle for investment returns and the rapid moves of rates of interest, we would be happy to work through these decisions with you.

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MidCap Opportunities

SPEARS/ABACUS

Quarterly
Fact Sheet
As of June 30, 2023

Investment Strategy Overview

Spears Abacus' MidCap Opportunities strategy is a long-only equity strategy that seeks to minimize downside participation and deliver attractive risk-adjusted returns over a market cycle. The team's investment approach focuses on high quality, growing companies (fundamental momentum) trading at attractive valuations (value). Utilizing this approach, the goal is to construct a concentrated portfolio designed to participate in the upside of equity markets while limiting downside risk through disciplined stock selection and risk management.

Target Investment Characteristics

- High return on invested capital and high free cash flow
- Resilient businesses benefiting from long-term thematic trends
- Strong balance sheets and effective capital allocation
- Exceptional management
- Attractive valuation and asymmetric risk-reward

What Makes Us Different

- We make new investments when the crowd is selling
- We look for companies that are temporarily unpopular because of something that *might* go wrong
- We quickly admit when we are wrong and sell losers
- We like high quality businesses with long-term tailwinds that should do well in *any* environment
- We focus on ROIC and FCF instead of commonly used metrics like *adjusted* EPS
- Our portfolio will not look like the Russell Midcap or S&P 500
- We are more likely to average up than average down
- We have a track record of generating excess returns in periods of high volatility

Performance[7]	Annualized Total Returns					
	YTD	1 Yr.	3 Yr.	5 Yr.	10 Yr.	Inception
SA MidCap (gross)	8.6%	16.4%	6.7%	8.9%	9.1%	9.7%
SA MidCap (net)	7.9%	15.0%	5.3%	7.6%	7.8%	8.2%
Russell Midcap	9.0%	14.9%	12.5%	8.5%	10.3%	9.3%
S&P 500	16.9%	19.6%	14.6%	12.3%	12.9%	9.7%

Source: Spears Abacus, FactSet. Inception Date 3/31/2004. [1]All statistics based on weighted average unless otherwise noted; [2]Dividend yield of total portfolio including cash; [3]ROIC calculated using cash returns for portfolio holdings; [4]Long-term growth is based on the consensus 3-5 year EPS growth forecast; [5]Downside capture trailing 3 years, monthly basis vs Russell Midcap; Alpha based on Risk Index = Russell Midcap, Risk Free Rate = 10 Year Treasury note; [6]Sector weights excluding cash; [7]Returns for less than one year not annualized; YTD as of 6/30/23

Portfolio Statistics[1,2,3,4,5]	SA	Russell Midcap
Number of Securities	21	-
Cash & Equivalents Weight	17.1%	-
Dividend Yield	0.75%	1.58%
Market capitalization ($b)	56.1	22.4
Harmonic Avg. TTM P/E	20.9x	18.0x
Harmonic Avg. NTM P/E	19.1x	16.5x
LT Debt / Total Capital	0.23x	0.46x
Return on Invested Capital	17%	7%
Estimated LT Growth	12%	12%
Payout Ratio	21%	30%
Downside Capture (3-Year)	82%	-
Volatility (3-Year)	17.8%	19.3%
Active Share	98%	-

Top 10 Holdings	% of Portfolio
Adobe Incorporated	7.1%
Intercontinental Exchange, Inc.	6.3%
Church & Dwight Co., Inc.	5.4%
Fiserv, Inc.	5.3%
CME Group Inc. Class A	5.1%
Franco-Nevada Corporation	5.1%
Globus Medical Inc Class A	4.8%
Take-Two Interactive Software, Inc.	4.6%
Centene Corporation	4.4%
Wheaton Precious Metals Corp	4.3%
Total	52.3%

Sector Diversification[6]	SA	Russell Midcap
Consumer Discretionary	0.0%	10.3%
Consumer Staples	6.6%	3.8%
Energy	4.8%	4.6%
Financials	26.4%	14.1%
Health care	22.3%	11.6%
Industrials	2.2%	18.7%
Information Technology	20.9%	13.8%
Materials	11.3%	6.1%
Real Estate	0.0%	7.7%
Communication Services	5.5%	3.8%
Utilities	0.0%	5.5%
Total	100.0%	100.0%

PLEASE SEE ADDITIONAL DISCLOSURES ON THE FOLLOWING PAGE

SPEARS ABACUS

Market Cap Breakdown[1]

	SA	Russell Midcap
$0 to $5 billion	0.0%	5.0%
$5 billion to $15 billion	13.4%	32.3%
$15 billion to $50 billion	46.9%	60.5%
$50billion to $100 billion	27.5%	1.9%
Greater than $100 billion	12.2%	0.0%
Total	100.0%	100.0%

Portfolio Construction

- 15-25 Stocks
- Primarily U.S. based
- Max 30% industry concentration limit
- Target market capitalization below $60 billion

Source: Spears Abacus, FactSet. [1]Market cap weights excluding cash

Managed by

Spears Abacus MidCap Opportunities Team

Portfolio Manager	Years Experience
Manny Weintraub	33

Senior Analyst

Daniel Wetchler	13

Style

GARP

Inception Date

31-Mar-04

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Comparisons to the S&P 500 TR (Total Return) and Russell 3000® are for informational purposes only, as the composites may hold securities not in the S&P 500 TR (Total Return) and Russell 3000® and may have more or less volatility and risk than an investment in the S&P 500 TR (Total Return) and Russell 3000®. Management fee information available upon request.

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