APRIL 20, 2023

Spears Abacus 1Q23 Commentary

I. Market Overview

Not that long ago, the common wisdom was that a full market cycle (a bull market followed by a bear market) lasted, on average, three years. Times have changed. It is not much of an exaggeration to say that the first quarter contained one and a half market cycles. Stocks rose nearly 10% in January, fell about the same amount over the next six weeks only to rise again starting in mid-March. When the dust settled, broad market averages of large company stocks advanced 7.5%. The star performer was the tech-heavy Nasdaq composite, which appreciated nearly 17%, recouping some of its 33% decline in 2022. Despite the gyrations, the real focus of the period was on a small handful of medium-sized banks that became household names overnight.

In the wrong hands, cheap money is the parent of bad decisions. At the risk of grossly oversimplifying a complex issue, we believe that the latest round of bank failures was the result of poor judgment, unrealistic optimism and the ultra-low interest rate environment of the past several years.

In previous commentaries, we have pointed out that speculation is a frequent side-effect of aggressive monetary policy. Think about meme stocks, NFTs (Non-Fungible Tokens), blank-check companies, 100-year bonds, certain types of venture capital investing and others. All soared in value in 2020-21 but came crashing back to earth in the face of rising interest rates last year.

It would be unfair to conclude that the failure of Silicon Valley Bank (SVB) was the result of this level of speculation. However, it is not a stretch to say that management literally bet the bank on the notion that interest rates would remain historically low for the foreseeable future and beyond.

Perhaps SVB management was lulled into overconfidence by knowing that its large portfolio of longer term U.S. government bonds would always be "money good." Management failed to account for the possibility of changing behavior among the bank's customers. As short-term rates rapidly rose, SVB's depositors became a less-reliable source of funding. The bank was trapped by poor investment decisions, and liquidation followed.

At this point, the failures of SVB and Signature Bank do not seem like the harbinger of systemic risks. Though rapidly rising interest rates were a common theme, each management team created its own specific set of problems. Regulators responded swiftly and appropriately. We believe the passing of time will show that the risks were isolated rather than broadly based. However, we do think that there will be longer term impacts for most banks. Regulatory scrutiny is almost certain to intensify. Lending standards have already tightened, but for how long is difficult to predict. There should be pressure on profit margins for all but the biggest banks for the foreseeable future.

As April begins, investors are already retraining their focus on employment, the economy and the future paths of inflation and interest rates. Markets are back to the business of differentiating between good companies and bad and strong and weak management teams. We remain cautious with healthy levels of cash reserves ready to take advantage of bargain-priced investments should they appear.

II. Portfolio Thoughts

Warren Buffett once said one should "Invest in businesses that are so wonderful that an idiot can run them because sooner or later, one will." In addition to providing a comment on the quality of banking as a business model, we think that recent banking industry events highlight the importance of management. Poor decision-making by executive leadership at SVB and Signature Bank led to their demise. First Republic's equity is likely to be permanently impaired.

For a bank CEO, the post-COVID era offered a difficult trade-off. Fiscal and monetary policy was accommodative. Companies and households were awash in cash and deposits were abundant. Bank executives could sit on the excess liquidity or try to maximize current net interest income ("NII" - the difference between interest earned on loans and the interest paid on deposits) by investing surplus deposits in low-yielding loans and securities that were vulnerable to mark-downs if interest rates were ever to rise.

This trade-off wasn't a secret. JP Morgan CEO, Jamie Dimon, explained the options well on an October 2020 conference call in response to a question from Jefferies analyst, Ken Usdin, about putting the influx of deposits to work:

> *We're not going to invest in stuff making 50, 60 or 70 basis points so we get a teeny little bit more of NII. We're going to make long-term decisions for the company. And, if your NII, in the end, gets squeezed a little bit, so be it. But we don't want to be in a position where we lose lots of money because we made investments in 5 or 10-year securities which you'll lose a lot if rates go up. So, we're not protecting NII.*

Allocating balance sheet capital to longer duration securities to boost current earnings was a management decision. Some chose to ignore the risk that future interest rates would rise, but Dimon didn't. As a result, JP Morgan didn't just avoid a landmine, it solidified its reputation as a "fortress balance sheet" and appears likely to profit in the future from an influx of low-cost deposits and new customer relationships.

The example of JP Morgan's performance in the most recent banking crisis illustrates why we think that owning "wonderful" businesses that are also well-managed is the right strategy, especially in a difficult environment.

III. Personal Finance

It's well known that interest rates are higher than they have been in many years. The implications are sometimes obvious, for example, negative impacts such as higher mortgage rates or auto loan rates, or positive implications such as higher bank-deposit rates and bond yields. We wanted to point out a few less obvious implications. For a timely example, consider estimated quarterly tax payments. The tax code requires you to make payments evenly throughout the year either through wage withholding or quarterly payments. If you underestimate your required payments, you will be subject to a penalty and interest – that interest rate today is 7% (and may go higher throughout this year). That is more than double the 3% rate at the start of last year. While some may have been tempted to underpay when rates were low, 7% is a significant hurdle to overcome. Of course, if you have to make tax payments using a line of credit, your borrowing rate may be even higher. The prime rate, while less popular as a lending benchmark than in eras past, is still commonly used for many personal and home equity lines of credit. Today the prime rate stands at 8%, up from just 3.25% one year earlier.

Perhaps paradoxically, there are several financial planning opportunities when rates are high. For example, Qualified Personal Residence Trusts (QPRTs) are often used to make a future gift of your personal residence to others, usually your kids or grandkids. In short, it allows you to discount and freeze the value of that gift, as it only transfers to the beneficiaries after a specified number of years (generally 10 or more). Higher rates translate to a smaller current gift and therefore either less use of your lifetime gifting/estate credit, or less gift tax if there is no credit remaining. Likewise, Charitable Remainder Unit Trusts (CRUTs) are often used to make a current gift to a charity of a future actuarial amount. Higher interest rates result in a larger amount of the future gift, allowing more planning opportunities for the donor today.

We would be pleased to discuss these changes, and any opportunities they present, with you and/or your tax advisor.

IV. Spears Abacus Midcap Strategy

"The best time to repair the roof is when the sun is shining"

– President John F. Kennedy

In light of our two recent communications regarding the bank crisis, this note will be shorter than usual.

It was a strange quarter. We had the largest series of bank failures since 2008, and the S&P 500 went up.

We have been through environments like this twice before. First in the fall of 1998, after the Asian Crisis. Financial conditions eased after Russia went bankrupt, and the S&P 500 went up over the next two years. The second time was in the summer of 2007. The S&P 500 continued to rise despite an inverted yield curve, and the failure of several companies associated with subprime lending. That, in hindsight, was the prelude to the Great Financial Crisis of 2008.

If we learned anything from both occasions, it's this: it's very hard to predict in which direction the market is going to go in the short term.

With the outlook roughly balanced, we took advantage of this proverbial "sunshine" in the stock market. We sold some of our smaller companies to reduce our exposure to economically sensitive sectors that we felt might trade lower in a market pullback.

We invested the proceeds in businesses with share prices that we thought would be more stable in a recession: Check Point Software – a leading provider of cyber-security; Elevance Health – one of the largest health insurers in the US; Globus Medical – a medical device company specializing in musculoskeletal devices; and Snap-On – the tool company with a large franchise in auto repair.

After these adjustments, we believe that the portfolio is well prepared either to bask in the sunshine of a rising stock market or to weather the storm of an economic recession.

Important Note About SA Investor Commentaries

This letter should not be relied upon as investment advice. Any mention of particular stocks or companies does not constitute and should not be considered an investment recommendation by SA. Any forward-looking statement is inherently uncertain. If you would like to learn more about SA and its investment program, please contact us at www.spearsabacus.com.

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MidCap Opportunities

SPEARS / ABACUS

Quarterly
Fact Sheet
As of March 31, 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)	3.1%	-5.0%	10.2%	8.1%	9.3%	9.7%
SA MidCap (net)	2.8%	-6.2%	8.8%	6.7%	7.9%	8.2%
Russell Midcap	4.1%	-8.8%	19.2%	8.1%	10.0%	9.0%
S&P 500	7.5%	-7.7%	18.6%	11.2%	12.2%	9.1%

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 3/31/23

PLEASE SEE ADDITIONAL DISCLOSURES ON THE FOLLOWING PAGE

Portfolio Statistics[1,2,3,4,5]

Portfolio Statistics	SA	Russell Midcap
Number of Securities	22	-
Cash & Equivalents Weight	19.3%	-
Dividend Yield	0.88%	1.58%
Market capitalization ($b)	48.2	22.4
Harmonic Avg. TTM P/E	19.3x	18.1x
Harmonic Avg. NTM P/E	17.4x	16.3x
LT Debt / Total Capital	0.23x	0.47x
Return on Invested Capital	16%	7%
Estimated LT Growth	12%	13%
Payout Ratio	23%	30%
Downside Capture (3-Year)	87%	-
Volatility (3-Year)	19.3%	20.4%
Active Share	98%	-

Top 10 Holdings

Top 10 Holdings	% of Portfolio
Globus Medical Inc Class A	6.3%
Intercontinental Exchange, Inc.	6.1%
Adobe Incorporated	5.9%
CME Group Inc. Class A	5.6%
Franco-Nevada Corporation	5.5%
Church & Dwight Co., Inc.	5.0%
Wheaton Precious Metals Corp	5.0%
Fiserv, Inc.	5.0%
Centene Corporation	4.3%
Schlumberger N.V.	4.2%
Total	**52.9%**

Sector Diversification[6]

Sector Diversification	SA	Russell Midcap
Consumer Discretionary	0.0%	12.4%
Consumer Staples	6.6%	4.0%
Energy	9.5%	4.9%
Financials	30.3%	13.8%
Health care	17.7%	11.4%
Industrials	2.1%	17.7%
Information Technology	20.0%	15.7%
Materials	13.7%	6.5%
Real Estate	0.0%	7.6%
Communication Services	0.0%	0.0%
Utilities	0.0%	6.0%
Total	**100.0%**	**100.0%**

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MidCap Opportunities

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Market Cap Breakdown[1]

	SA	Russell Midcap
$0 to $5 billion	1.8%	5.3%
$5 billion to $15 billion	13.7%	32.1%
$15 billion to $50 billion	46.7%	59.8%
$50billion to $100 billion	28.6%	2.6%
Greater than $100 billion	9.2%	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	32
Senior Analyst	
Daniel Wetchler	12

Style

GARP

Inception Date

31-Mar-04

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