January 2024 – Volume 14, Issue 1

The Sweeter One

In this issue ...

A young boy was holding two apples with both hands. His mother came in and softly asked with a smile:

"*Sweetie, could you please give your mom one of your two apples?*"

The boy looked up at his mom for some seconds, then he suddenly took a quick bite on one apple, and then quickly on the other.

The mom tried very hard not to show her disappointment. Then the boy handed one of the bitten apples to his mom and said:

"*Mommy, here you are, **this is the sweeter one**.*"

The moral being to delay judgement until one has all the facts. That's how jury trials work. That's why a baseball season has 162 games. That's why one waits to see the literal paint dry before purchasing enough to finish the wall. And that's why, in most cities, weathermen wait for the first raindrop before making their predictions.

It is no different in investing.

"Normal" ≠ "Average"

Just as the mother in the "sweet" story should have waited until she had all of the information before judging her son's intention, so too should investors wait until all of the facts are in. While this seems obvious, is it possible – ALL the facts? How can any outsider ever truly understand everything about a company? Even **in**siders cannot know all, at any given time; they rely upon many others for decision-making, typically other than the most consequential choices, which impact many varied facets of the business.

So there has to be some "judgement" at play as well. How far shall we explore? How deep shall we dive? How many of the business' products must we sample? We at Aristotle Capital need to delay our judgements until sufficient facts are known, resulting

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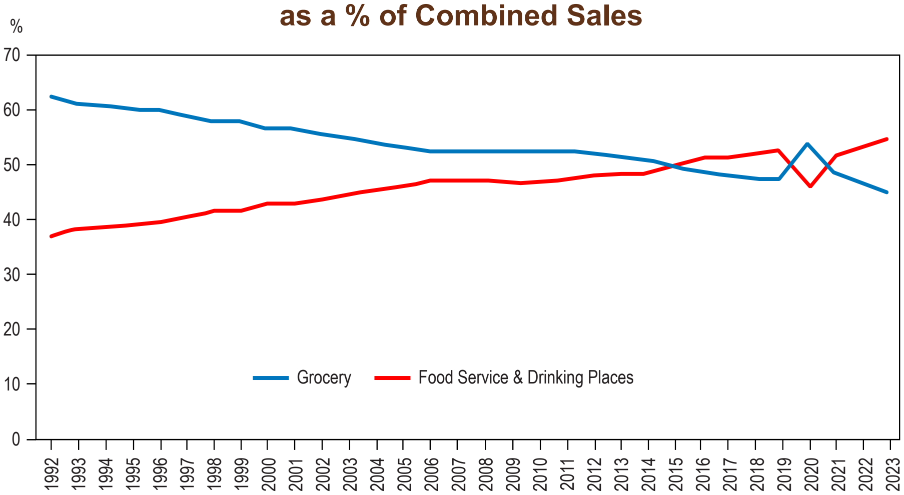
in the conviction of our theses. With this, we attempt to understand what is "normal" for a company.

By way of a few differentiating examples:

U.S. Grocery vs. Food & Drinking Places Retail Sales as a % of Combined Sales



Sources: U.S. Census Bureau, Piper|Sandler Research and Sysco Corp.

➢ In our last edition of *The Essence* entitled "*The Bet,*" we highlighted **Sysco Corp.** as a recent addition to Aristotle Capital portfolios. It is the world's largest dedicated food distributor with a number of *catalysts* available to propel its business forward. One of the questions we asked ourselves was if the away-from-home food trend had peaked. The above graph indicates a decided "no." Even though briefly interrupted by a near shutdown in on-premise dining during 2020 and 2021, waiting for all the facts has resulted in a "sweet" answer to an important question.

It turns out that "normal" for this industry continues nearly unabated as retail sales of food away-from-home are once again setting new records. Thinking the world of food consumption had changed during a pandemic would have been too short-sighted. Waiting for more facts, it appears, was a prescient move.

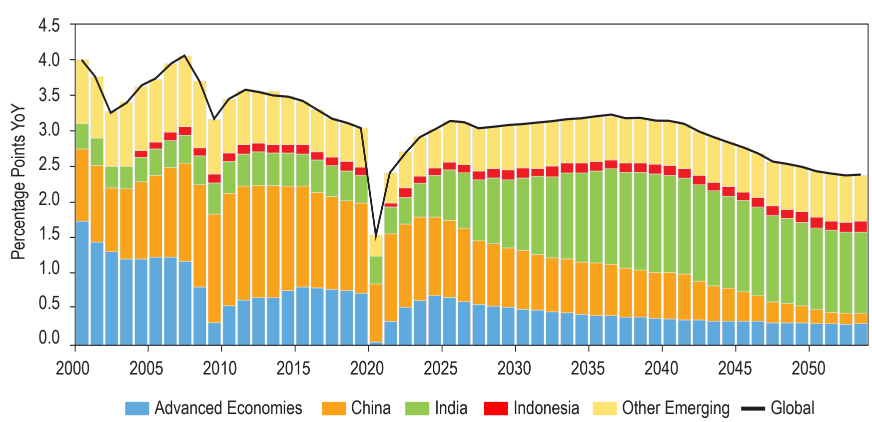
➢ We have, in prior editions of *The Essence* described how "normal" is difficult to ascertain in many cases, but closer to "assured" in others. The following could be an example of the latter.

Here we see contributions to global growth – actual for the past 23 years, since the turn of the millennium, and a projection for the next 30, until just past 2050. The blue bars represent Advanced Economies including the U.S., Canada, the U.K., most of Western Europe and Japan. Note that prior to 2010, Advanced Economies generally led the world's economic growth. Then, as depicted by the orange bars, China ascended and for nearly two decades produced more than half of global growth. With about as much certainty as we can have, we believe this is now changing.

For the coming two+ decades, "normal" may be that emerging markets generate the majority of the world's growth. India (green bars), Indonesia (in red) and others (Vietnam, Thailand and – if they can get their political "acts" together – vast parts of South America and Africa as represented by yellow bars) could propel economic growth. China's "normal" will be a dramatically lower share of growth and Advanced Economies could maintain, but not materially add to, their output. While, of course, the graph below is not "in stone," we believe we have sufficient factual evidence of this outcome. It is as "sweet" as the current state of facts can be.

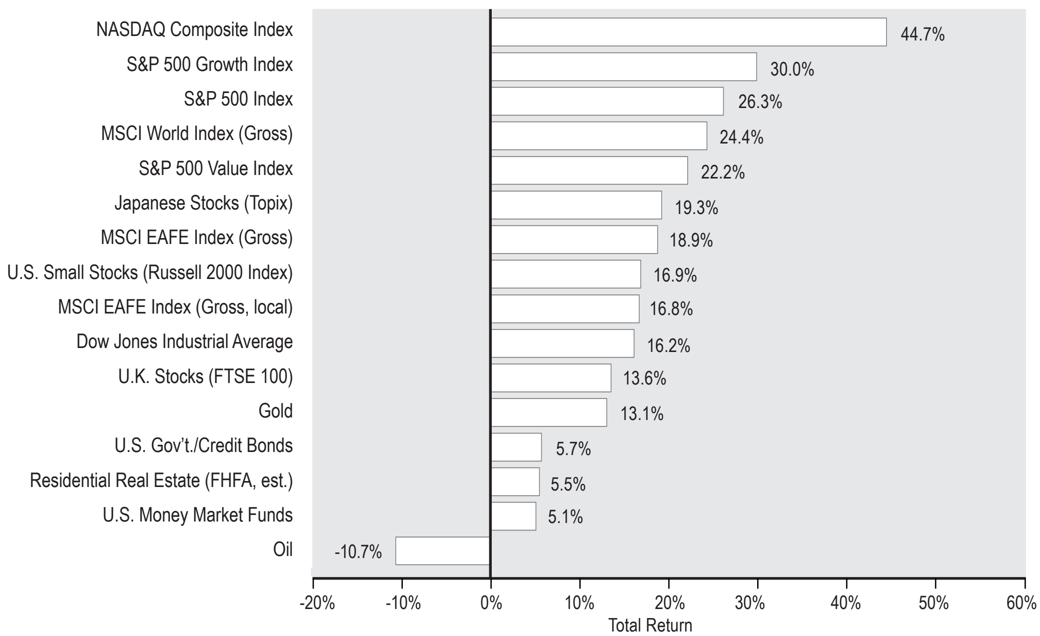
➢Aristotle Capital's process is to uncover facts related to the investments in our current portfolios. We continue until, in our estimation, the marginal return of the next marginal piece of data is de minimis. While we never stop this process, we do periodically decide if we have sufficient evidence from which to draw conclusions. Rarely are these conclusions measured in "buy" or "sell," but in "do we truly understand this company and its fortunes?" Sometimes we can draw these conclusions within months, while sometimes even years does not suffice. All within the context of understanding that which makes a business "tick," not that which makes a stock "ticker."

Contributions to Global Growth



Source: Bloomberg Economics

2023 Asset Performance



Total return in U.S. dollars unless otherwise noted

Source: Bloomberg

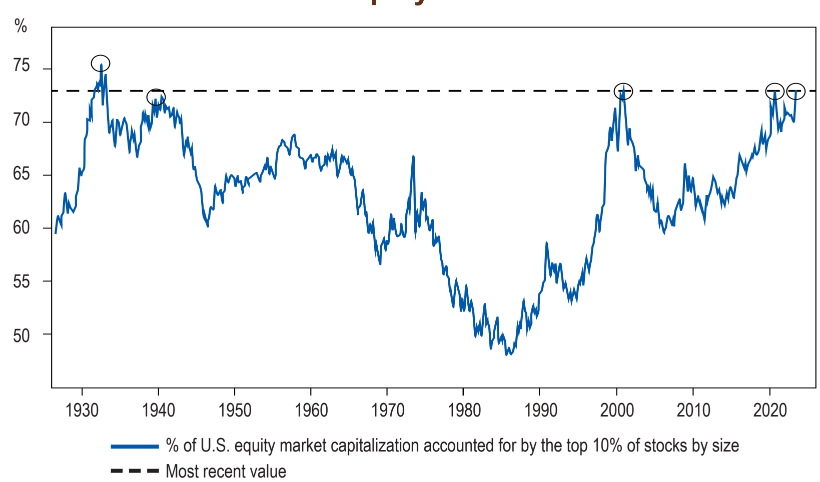
EQUITIES STRATEGY

As shown in the above chart, the rollercoaster of the past several years has continued. Strong advances in most asset classes in 2021 were followed by some steep declines in 2022. This reversed again last year with strong advances that were nearly universal. Only commodity prices declined (such as oil -10.7%), perhaps in advance of a suspected weakening global economy. The largest gains (technology equities rose more than +40%) offset the prior year's declines (when technology equities dropped more than -30%). Even bond total returns were positive in aggregate as yields for only the very shortest maturities rose. Foreign companies, big companies, small companies and even residential housing saw increases nearly across the board.

There has been much discussion in the economic and financial press about the increasing concentration of the U.S. equity markets. For instance, in 2023, while the capitalization-weighted S&P 500 stock index (including income) gained +26.3% – more than a reversal of the prior year's -18.1% fall – the same 500 companies, if **equal** weighted, gained a "mere" +13.8% (after dropping "only" -11½% in 2022). Thus the "average" return was +13.8%, yes "sweet" in and of itself, but paling in comparison to those few large constituents of the capitalization-weighted index. Looked at another way:

Here we see the percent of the U.S. equity market capitalization accounted for by just the largest 10% of companies by market size. Using the roughly 4,500 companies listed on a U.S. exchange, then the 450 largest account for a nearly record 73% of the total. The top seven {Amazon.com, Apple, Alphabet (formerly Google), Meta Platforms (formerly Facebook), Microsoft, (newly added) NVIDIA and (fairly recently added) Tesla} now represent greater than **30%** of that alone. Per the graph below, this is nearly uncharted territory. In the 1960s, these highly

Level of U.S. Equity Market Concentration



Sources: Kenneth R. French Data Library and The Center for Research in Security Prices as provided by BCA Research favored companies included General Electric, General Motors, IBM, Xerox and Polaroid. The 1970s and 80s were largely dominated by energy-related companies. The "dot-com bubble" of companies included Microsoft (the only repeat entry), WorldCom, AT&T, Vodafone, Nokia and NTT Docomo. Ten years later it was back to large energy companies. Today it's back to technology, plus a few social media companies within communications.

In our view, none of these extremes is "normal," fluctuations are highly likely over time and, at least in some instances, current concentration has little relevance to future investment returns or even the worth of those few businesses. Short-term stock price movements, even though swift, may not provide a sufficient factual basis for fundamental analysis.

INVESTMENT ACTIVITY

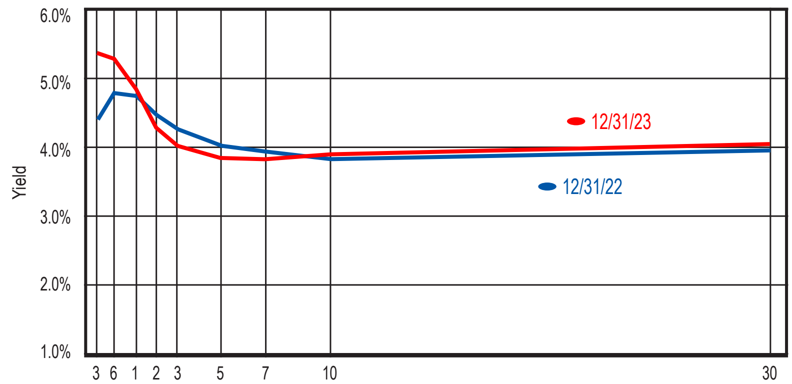
We would now like to highlight a recent addition to Aristotle Capital equity portfolios:

- **U.S. Bancorp** is, in our estimation, a good, stable bank with a diversified loan portfolio, consistently above-peer asset quality, ~45% of revenues from non-interest income (leading to a consistently above-peer Return on Assets) and a proven M&A process. The company clearly gets through our valuation "gate" with estimated "normal" earnings of ~$5.00/share. There are several major *catalysts* that led us to learn about this business, particularly the December 2022 acquisition of Union Bank of California. We have also monitored the company's market share gains in most geographies and significant expense control after a decade-long build-up due to regulatory requirements. As with most peer banks, we will continue to monitor some challenges including banking's commodity-like industry, capital adequacy, the regulatory environment, and a business model relying (at least to some extent) on a positively sloped yield curve.

STANDARDS OF LIVING COMMENT

Reminding our readers that beginning with the previous issue of *The Essence*, we have replaced the "Fixed Income Strategy" section with a "Standards of Living" section. We will continue to discuss inflation, interest rates and fixed income markets and the "*risk-free*" rate's ramifications for other asset classes and standards of living (both U.S. and global). We will leave strategy to our capable partners at Aristotle Pacific Capital.

U.S. Treasury Yield Curve
12/31/22 versus 12/31/23



Source: Bloomberg

While short-term interest rates continued their climb in 2023, with the Federal Reserve (Fed) raising the target rate four more times (ending at 5¼% - 5½%), longer-term rates closed the past year exactly where they began (with 10-year Treasury yields at 3.88%). This, after dropping as low as 3.30% in April and rising up to 5.00% in October. Surely a near-record movement to wind up unchanged. More proof that "normal" ≠ "average."

CONCLUSION

The credit for the opening story was referenced to us from a 2018 edition of the *Accidental Talmudist.* Truly, we hope that delaying judgement until all the facts are known becomes the "new normal" – not only for investing, but in all aspects of life.

At the end of our previous edition of *The Essence* entitled "*The Bet,*" we used a quote from Charlie Munger, Vice Chairman of Berkshire Hathaway. While we were aware of his age, we had no inkling that between then and now he would pass away at the age of 99. Many have filled books with his quotes and stories of wit and wisdom. Another message of his, one which long-term investors particularly appreciate, is his optimism for mankind, particularly in the United States.

Mr. Munger would marvel at the progress of society, just in the span of his lifetime. He used the example of the Covid-19 pandemic and how it was contained relative to that of the Spanish Flu of just prior to his birth. The Spanish Flu killed roughly 3.5% of the world's population. In the U.S. – perhaps amongst the most accurate recordkeepers – according to Johns Hopkins University, roughly 0.34% of the population has died of complications related to Covid-19. A 90% lower death rate only 100 years apart. Mr. Munger attributes our many advances to human ingenuity UNLOCKED as we all have "*more time to think*" without the constant need to forage for food and basic necessities.

This edition of our letter highlighted a mother's quick reaction to her son, before giving him time to show his intentions. We think we all do this on occasion and hope for the world we do less of it going forward. We also described how the investment process at Aristotle Capital allows for ample work to uncover the true intentions and "normal" characteristics of a business, even though such "normal" is often (perhaps even always) over and under achieved.

We used a few examples of our studies including food away from versus in the home, then the share of global growth from various countries and geographies. We highlighted our process as taking as long as required to uncover the relevant facts of a business, and we finished with our usual brief description of the year just passed.

We thank you for reading our periodic reports and always welcome your feedback.

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price. Charlie understood this early; I was a slow learner."

~ Warren Edward Buffett

The characters described and stories told herein are often, but not always, based on true incidents. Poetic license is taken to dramatize a point about an investment topic. Not all securities mentioned herein are necessarily owned in all Aristotle Capital portfolios. Differences due to restrictions, tax considerations, cash flows and other factors may have impacted the decisions to buy and/or sell certain securities at specific times. Inclusion does not imply that investments in these securities have been profitable and it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities listed. A list of at least five contributors to and five detractors from performance is available upon request.

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