INVESTMENT MARKETS AND THE HUMAN PSYCHE

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Global stock markets delivered strong returns to shareholders in the first quarter of 2024, fueled by strong economic activity, growing corporate earnings and an expectation that inflationary pressures will trend in the right direction as the year progresses. In the U.S., all key stock market benchmarks rose. Including dividends, the S&P 500 gained +10.6%, the Dow Jones Industrial Average added +6.1%, and the Nasdaq Composite increased by +9.3% in the first quarter. U.S. small cap stocks, represented by the Russell 2000 Index, provided a positive return of +5.2%. A key international stock benchmark, the MSCI ACWI ex-U.S., gained +4.7%, including dividends.

The only detractors in U.S. investor portfolios in the first quarter were bonds, as yields rose in response to inflationary data and a change in the expected timing of Federal Reserve rate cuts.

For example, the benchmark 10-year U.S. Treasury note yield rose from 3.88% to 4.31% between December 31, 2023, and March 31, 2024. Corporate and municipal bond yields rose in concert, pressuring prices across bond markets. The bond markets are quite sensitive to investors' outlook on inflation and Fed policy, and the news was less favorable in the first quarter relative to investor expectations in the closing months of 2023. The benchmark Bloomberg Aggregate Bond Index declined by -0.8% for the quarter.

Price activity in the first quarter is a reminder that markets move based on changes in investor expectations. As noted above, bond price movements are most closely tied to a changing inflation outlook. A normal fixed-rate bond delivers a fixed stream of coupons, the value of which is depleted by inflation. If expectations of inflation change adversely, then it will weigh on bond values. Investor expectations also drive stock price movements, but there are many more factors at play beyond inflation. Unlike a fixed-rate bond, a quality business can still deliver growing earnings even in an inflationary environment, warranting a higher valuation over time. Positive first quarter stock market returns reflect investor expectations of such earnings growth into the future.

Following a period of strength in the stock market, individual investors may reasonably ask whether investor expectations have become too optimistic, setting the stage for a reversal. Should current expectations not be realized, and expectations reset downward, could it weigh on future stock market performance? We have no answer to the question of where markets will go for the remainder of the year, but drawing on our years of experience through a wide range of economic, geopolitical and market environments, we caution clients not to think in terms of whether it is timely to be in or out of the stock and bond markets, and instead to focus on the long-term expected returns one can earn from owning individual investments based on their current prices and their fundamentals. We don't think we're being lazy to not try to divine market direction; rather we are being realistic about how we can, with the highest probability, produce attractive long-term investment returns for clients commensurate with their needs and loss aversion, and to secure comfortable financial futures for them. Warren Buffett is aligned with our philosophy when he says, "I make no attempt to forecast the general market – my efforts are devoted to finding undervalued securities."

Any stock market chart confirms that markets do reverse course periodically, sometimes abruptly and violently. The late Charlie Munger offered his perspective on market volatility as only he could: "If you're going to invest in stocks for the long term, or real estate, of course, there are going to be periods when there's a lot of agony and other periods when there's a boom. I think you just have to learn to live through them." Munger knew that as you zoom out on charts of the stock market indexes, extending the time frame to longer investment horizons, markets deliver solid returns to those who have the fortitude to stay the course. Markets test the human psyche like few other things in life. The stakes are high, and the rewards disproportionately accrue to those who have a certain temperament that allows them to see through temporary periods of adversity.

In last quarter's letter, we briefly eulogized Charlie Munger, who passed away in November. The first quarter of 2024 saw the passing of another individual whose work had a significant influence on the investment community, not because he was a renowned investor, but because his life's academic work in cognitive psychology provided a reference guide for investors for how to identify and counteract natural human biases that impair their good judgment. Daniel Kahneman received a Nobel Memorial Prize in Economics for his work on this subject in 2002, and later published a work titled "Thinking, Fast and Slow" in 2011 that sits next to Benjamin

Graham's "The Intelligent Investor" on the bookshelves of most security analysts and portfolio managers. The book describes the process of human decision-making and the struggle between intuition and emotion (which he calls "System 1") on one hand, against logic and deliberation ("System 2") on the other. While the book is not written for Wall Street, the investment markets provide a perfect laboratory to test his theories. On Wall Street, decisions with large economic consequences are made against a backdrop where decision makers, despite having a vast pool of information to enable decisions under System 2, frequently make impulsive, System 1-type decisions, more often than not to their detriment.

Consider the question posed earlier in this letter, "Have investor expectations become too optimistic, setting the stage for a reversal?" A decision to stay invested in stocks or to move to the sidelines has significant economic consequences and can be made either impulsively or after deliberation. Human beings are wired to believe their instincts, as Kahneman's research showed. But we know that when money is at stake, human instincts frequently mislead. We have concluded that we have no reliable basis for timing the markets and outsmarting the consensus. Instead, we stay with what gives us conviction and keeps us operating in System 2, which is to commit capital when our analysis concludes that an adequate return on that investment is likely to be produced over a long holding period (usually five years). When stock prices rise quickly and meaningfully as they have in the past 15 months, the expected returns from this day forward will be less than they were 15 months ago, but we still find many of them to be attractively valued relative to bonds or cash. If they're not, we will trim position sizes or sell them outright, as we have in recent months.

On a final note, while we are making decisions at the portfolio level, you need to consider the appropriateness of the portfolios we employ given your individual financial circumstances, future financial commitments, retirement plans and temperaments when it comes to market volatility. Summitry can walk you through the tradeoffs that exist between a more aggressive portfolio versus a more conservative one. Completing a detailed financial plan with your Financial Advisor is likely your path to making System 2 decisions with your wealth, and these decisions are best made when the markets are in a steady state rather than during periods of volatility. We invite you to engage with us.

Q1 PORTFOLIO CHANGES

*Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.****

During the quarter we initiated a new position in Carrier Global Corporation and exited our position in W. W. Grainger.

W.W. GRAINGER

We love businesses that provide mission-critical products. We love them even more if they are managed by talented leaders. Grainger benefits from both characteristics. While not a household name, millions of facility maintenance professionals rely on Grainger to maintain, repair, and operate hospitals, manufacturing plants, data centers, warehouses, office buildings, and shopping centers. The business benefits from efficient scale, cost advantages, and customer switching costs. Top-notch management created the most dominant player in the maintenance, repairs, and operations (“MRO”) industry.

Regardless of how much we love the business, we only like stocks that are attractively valued. Fortunately, this was the case when we bought Grainger in 2015. Investors were concerned that a temporary slowdown in manufacturing and energy markets would negatively impact sales. As often happens, investors were too focused on short-term results while downplaying longer-term trends. This dynamic created a buying opportunity in the stock.

Almost a decade later, Grainger exceeded our expectations. Despite facing choppy end market conditions, a major global pandemic, supply chain challenges, rising competition from Amazon, and an unprecedented spike in inflation, revenue over our holding period jumped by 70% and earnings per share increased over 3-fold. Investors who stuck with the business were rewarded with nearly 4x appreciation in the stock. Our lesson from Grainger? Long-term ownership of a competitively advantaged and well-managed business purchased at an attractive price increases the chance of a good investment outcome.

But we also know we shouldn’t fall in love with our stocks. We stick with high quality well-performing businesses but only if the stock offers a reasonable return. As Grainger’s stock appreciated to a level that reflects rosy scenarios, we decided to exit the position.

CARRIER GLOBAL CORPORATION

Carrier is in the business of keeping our homes and workspaces cool and properly ventilated. The company is a global leader in the heating, ventilation, and air conditioning (“HVAC”) industry. Its products include air conditioners, heat pumps, thermostats, and more.

The HVAC industry has been expanding and improving people’s lives for over 120 years, but it’s not done growing. Rising temperatures and new regulations on energy efficiency across the globe are expected to drive demand for HVAC solutions for years to come. Rising standards of living in emerging markets provide additional tailwinds.

Carrier is a boring but attractive business. Like Grainger, it sells must-have equipment, particularly for those who live in extreme climates. Carrier’s moat stems from scale in manufacturing and distribution. The primary driver of new unit sales is replacement demand, while Carrier’s vast global network of distributors and installers, along with a portfolio of reputable brands, allow it to outcompete peers. Scale in manufacturing produces competitive products at affordable prices. We are also excited by Carrier’s opportunity to grow higher-margin revenue from servicing and replacing HVAC parts, which are also more recurring and stickier.

We followed this business for many years (and owned it through our investment in United Technologies over 2009-2017) but recent capital allocation actions re-kindled our interest. Carrier is divesting non-core businesses and integrating a recently acquired European competitor. These changes will simplify the business, while creating meaningful scale synergies and cross-sell opportunities that should lead to higher margins and returns on invested capital.

NEW TO SUMMITRY

We welcomed two new individuals to Summitry on March 25th.

Lisa Ozaki, CFP®, serves as an Associate Financial Advisor, helping the Private Client Group deliver comprehensive advice to our clientele on financial matters important to them, communicating our investment philosophy and portfolio actions, and ensuring that client questions are answered. As a CERTIFIED FINANCIAL PLANNER™ and former Associate Advisor at Allworth Financial, she has a wealth of experience building financial plans, evaluating employer incentive stock programs, reviewing tax returns for opportunities for future savings, and performing similar tasks in support of individuals and families. Lisa graduated with a Bachelor of Science degree in Financial Services from San Diego State University. She lives in San Jose

Michel'le Correia joins Summitry as a Client Service Specialist, ensuring that clients receive timely and quality execution of a wide array of transactions involving accounts under our care, and responding to client needs as they arise. Michel'le comes to us following roughly seven years of service with wealth management teams at Merrill Lynch and at a San Francisco-based independent registered investment advisory firm launched by one of those teams. She was raised on the Monterey Peninsula, received an Associate degree in Business Administration from Monterey Peninsula Community College, and currently lives in San Mateo.