

## 2023 Year-End Investment Review

Saybrook investments performed well overall in 2023, with our average equity account up 20%. After a brutal bear market in 2022, and amidst continuing financial turbulence, the stock market rebounded as inflation declined significantly and the U.S. economy proved surprisingly resilient. One year ago, most economists forecasted that we would be in a recession by now, as dramatic interest rate increases have historically been damaging to the economy. And indeed, other major economies around the world have been in or near recession. While the potential still exists for a U.S. economic slowdown in 2024, the case for a “soft landing” is gaining traction.

More importantly, we believe that many strengths of America’s economic engine are vastly underappreciated. We list ten at the end of this letter. In addition, we reflect on the wisdom of the late Charlie Munger and Byron Wien and provide an overview of our most recent purchase, RTX Corp. We begin with some comments on the Saybrook portfolio and broad market indices.

### 2023 Price Changes in U.S. Dollars (not including dividends)

|                              |      |                                     |      |
|------------------------------|------|-------------------------------------|------|
| Dow Jones Industrial Average | +14% | GSCI Commodities Index              | -4%  |
| S&P 500                      | +24% | Nymex Crude Oil                     | -11% |
| NASDAQ Composite             | +43% | 3-Month U.S. T-Bill (current yield) | +5%  |
| FTSE 100 (Great Britain)     | +4%  | Gold Spot \$/oz                     | +9%  |
| DAX 30 (Germany)             | +17% | S&P Municipal Bond Index            | +6%  |
| Nikkei 225 (Japan)           | +28% | HFRI Equity Hedge Fund Index        | +10% |
| Shenzhen A Shares (China)    | -7%  | U.S. Aggregate Bond Index           | +6%  |
| MSCI Emerging Market         | +10% | Dow Jones REIT Index (real estate)  | +9%  |

### *A Narrow Market*

Fueled by excitement about the prospect of the new AI wave, and coming off of painful losses in 2022, technology companies drove performance for the year, although most stocks had more modest returns. Just seven large tech stocks accounted for more than 60% of the capitalization-weighted S&P 500’s 26% gain (including dividends). However, the average stock in the S&P 500 was up 14%, and eight out of eleven of its sectors underperformed that.

The same trend was evident within the Saybrook portfolio. While Visa, Sherwin-Williams, FactSet, Berkshire Hathaway and Mondelez were notable contributors, most of our performance was driven by two of our largest holdings, Alphabet (Google) and Apple, up 59% and 49%, respectively, in 2023. Even after this run-up, Apple and Google have not broken out above the trading range they reached two years ago. We wrote extensively last spring about the emergence of generative artificial intelligence and how Alphabet, while facing potential competitive threats, is poised to be a leader in this transformative era. In

December, Google launched Gemini which it touts as a superior AI chatbot. While Apple's stock performance has been driven by an increasing stream of recurring services revenues, we suspect that CEO Tim Cook and his team are carefully monitoring AI developments and are working on their own consumer-focused initiatives. Other Saybrook holdings within industrials, food/beverages, healthcare, and payroll processing held back our 2023 results and are flat-to-down for the last two years. This period of consolidation should allow for stronger future returns, as these companies have continued to produce good operating results and valuations have become more attractive.

### *The Case for Raytheon in a More Dangerous World*

Amidst the horrors of war in Europe and the Middle East, and with China's escalating antagonism towards Taiwan, Western alliances are increasing their commitments to international security. NATO has provided essential military aid to Ukraine, while enlarging the alliance to 32 countries with the recent addition of Finland and Sweden's pending membership. Across Asia-Pacific, the U.S. has deepened its partnerships with Australia, Japan, South Korea and the Philippines, each significantly increasing multilateral deterrence capabilities. As the U.S. and its allies strive to restore world order, they face the reality of restocking and expanding vital weapons systems.

In the fall we purchased shares of Raytheon, after examining several defense industry companies since Putin's invasion of Ukraine. The company, recently renamed RTX Corporation, was formed by the 2020 merger of Raytheon (defense) and United Technologies (aerospace), after spinning off some non-core industrial assets. We kept an eye on both legacy companies for many years, and, given the lumpiness of Pentagon procurement cycles, we like that RTX is not a pure-play in defense. The company is a leader in two essential businesses: missile systems and commercial aerospace.

Defense businesses include radar, satellite, intelligence sensors, and the cornerstone Patriot air and missile defense system. Patriot batteries are deployed globally across 18 allied nations, including the "Iron Dome" over Israel and a newly-implemented installation over Kyiv, protecting civilian populations. Defense sales were up only 3% over the last year, as complex manufacturing and supply-chain constraints have not kept up with high demand. The division's current \$50 billion backlog of orders (out of a company-wide backlog of \$190 billion) is a reliable indicator of future growth. Shares of RTX and its other defense peers have periodically been held back by gridlock in Washington, including recent budgetary clashes in Congress. We are hopeful that a streamlined and multi-year appropriations process will emerge to ensure a more consistent supply of mission-critical defense systems.

RTX's commercial aerospace businesses include crown jewel Pratt & Whitney – one of just three global manufacturers of aircraft jet engines (the other two are GE/Safran and Rolls Royce). This division also powers military jets and enjoys highly profitable long-term service contracts. The Collins division manufactures aerospace technologies including landing gear, avionic displays, and communication systems. Future initiatives include hybrid-electric propulsion systems, a critical step towards the aviation

industry's 2050 net-zero emissions goal. Commercial sales in these two divisions have grown 25% in the last year, as the global airline industry builds more efficient aircraft. In mid-2023 RTX discovered microscopic metallic defects in Pratt & Whitney's geared turbofan engines installed on as many as 700 Airbus passenger jets. RTX has taken a \$5.4 billion charge to cover the expected cost of removing, inspecting, and, if necessary, repairing each engine. Further setbacks during this two-year servicing process are, of course, possible.

In the wake of this bad news, we purchased RTX shares at 25% less than they traded at the onset of the Ukraine war nearly two years ago. RTX's October announcement of an accelerated \$10 billion stock buyback, equal to nearly 10% of its market capitalization, signaled to us management's confidence that they can successfully navigate the recall challenge. We believe the stock's low current valuation reflects much of this uncertainty. We bought our shares at 14x 2024 expected earnings, a material discount versus RTX's historic multiple and that of the overall market. Furthermore, the company pays a 3% dividend and has increased its payout by an average of 7% each of the last three years.

Long-held portfolio company Honeywell is also a key commercial and defense aerospace supplier, as a leading manufacturer of jet engine components, cockpit systems, and avionics. New CEO Vimal Kapur calls today's commercial aviation cycle the strongest he has seen and notes a recent increase in its defense orders from NATO allies. Aerospace is growing 18% versus last year and accounts for one-third of Honeywell's revenues. Honeywell's other divisions focus on critical areas such energy efficiency, safety equipment, and building technologies. The company recently acquired Carrier Global's security division (also formerly part of United Technologies) which provides hardware and software solutions for secure buildings and facilities. Together, Honeywell and RTX currently represent approximately 4-6% of Saybrook portfolios – providing us with balanced exposure to the rapidly expanding commercial aerospace market and increased defense spending in a world fraught with conflict.

### *Wisdom from Two Late Investment Legends*

We lost two wise men, Charlie Munger and Byron Wien, in the last quarter of 2023. Both impacted our approach to investing. Known for his wit and wisdom, Charlie Munger, the still active vice chairman of Berkshire Hathaway, passed away in December, just shy of his 100<sup>th</sup> birthday. Asked recently to explain what led to Berkshire's success, Munger said:

We got a little less crazy than most people and a little less stupid than most people, and that really helped us. Then, in addition, we were given a much longer time to run than most people...And, of course, we wised up over time, we got into better companies and understood the bad things that could happen and how easily they could creep in, and we avoided them.

Warren Buffett, who began his investing career buying lower-quality companies cheap, credited his long-time partner Munger with the blueprint for Berkshire's enduring investment approach: "Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices."

It was this (uncommon) common sense that Charlie and Warren shared that brought us to the Berkshire annual meeting in Omaha year after year, to hear them both in person answering questions for six hours, hoping that some of their collective wisdom – on investing and on life – would rub off on us.

Byron Wien died in October at the age of 90, still hard at work in a career as a senior investment strategist at Blackstone, and previously at Morgan Stanley. We were among many on Wall Street who eagerly awaited his annual top-10 list of surprises for the year ahead. On a personal note, we well remember attending an investment lunch with Wien in March 2009, in the throes of the Great Financial Crisis of 2008-09. He asked the investors to offer any positive case for the stock market outlook, but the usually inquisitive gathering was silent, shell-shocked from a bear market that had declined 60% amid talk of an actual depression. Given Byron's contrarian instinct, we suspect that his query implied that, in a period of maximum bearishness, it was time to start buying. As it turned out, the stock market bottomed that month, and a new bull market was beginning.

In the face of real challenges today and with surveys showing a general sense of malaise about financial conditions, we offer – in the spirit of Byron Wien – our own list of 10 long-term underappreciated positives about the U.S. economy. These trends may have encouraging investment implications for the years ahead.

1. America continues to outperform: The U.S. economy today accounts for 58% of the G7 nations' GDP, up from 40% in 1990, with U.S. per capita income 30% higher than those other countries today versus 24% higher in 1990. Over that same period, an investment in the U.S. stock market returned four times what could have been earned investing elsewhere in the developed world. According to Federal Reserve data over the three years through 2022, Americans have experienced a record gain in wealth, with median net worth up 37% after adjusting for inflation. America's labor market remains surprisingly resilient, despite recent inflationary pressures and rolling slowdowns across different sectors. For instance, employees laid off a year ago through large tech company cost-cutting measures have already been absorbed across many other technology-starved industries or have started their own businesses. Overall unemployment levels remain near 50-year lows and well below other G7 nations, and U.S. average hourly earnings are growing over 4%.
2. Inflation is trending down: After a surge that surprised policy-makers in 2021-22, the rate of annualized inflation has fallen from 9% to 3% in the last 18 months. In fact, on a six-month basis, core inflation has actually declined faster than the Federal Reserve expected and is near its 2% target. Contrary to past periods, this has been achieved so far without a painful economic slowdown. While consumers are still feeling the pinch from three years of cumulative price hikes, this recent disinflation finally allows for real wage gains which are translating into robust retail spending.
3. Productivity is rising: American labor productivity has increased by 67% since 1990, versus increases of 55% in Europe and 51% in Japan. The U.S. remains the most productive economy in the world. America leads in internationally-recognized patents, corporate R&D spending, and technological innovation. Also, 40% of Nobel prizes have been awarded to Americans, a third of whom immigrated

to the U.S. The most recent data suggests a nascent surge in productivity, not even accounting for the future impact of AI, which is expected to unleash an efficiency surge such as we saw with the introduction of the internet in the 1990s. Some economists predict that, consistent with past upcycles, productivity could grow in a 4% range for an extended period over this decade, benefiting both wages and profits.

4. Income growth is broadening: Wage gaps in America have been shrinking since 2016, with real weekly earnings for those at the bottom of the pay-scale growing faster than those at the top. According to one estimate, the recent progress has reversed 40% of the pre-tax wage inequality of the previous 40 years. Growth in wealth between 2019 and 2022 was actually the largest in percentage terms for the poorest segment of U.S. families. For blue-collar workers, a boom may come from the 10-year bipartisan infrastructure legislation signed in 2021, which is expected to account for over 800,000 jobs by its peak year 2025. Non college graduates, often left behind in the information economy, are most likely to fill these well-paid construction jobs.
5. The era of extremely low interest rates – and resulting economic distortions – is likely over: After an *abnormal* 15-year period of historically low interest rates, from the Great Financial Crisis through the pandemic, the benchmark 10-year Treasury bond interest rate is now back in its average range of the last century. The journey to higher long-term interest rates, although challenging for financial markets over the past two years, can be seen as a healthy normalization process. Speculative excesses have been wrung out of the system, while higher rates (i.e., “cost of capital”) make valuations more reasonable and capital allocation decisions more rational. Furthermore, higher rates mean decent income for savers holding bonds and cash reserves.
6. Supply chains are becoming more diverse and domestic manufacturing more robust: Following pandemic-era factory shutdowns and growing concerns about national security, the U.S. has reduced its share of Chinese imports to 17% from 22% over the last five years. High-value manufacturing of chips and other vital industrial components are being reshored, prompting an increase in domestic factory production. In addition, imports have increased from more reliable source countries in Asia and Latin America. To wit: Mexico recently surpassed China as the U.S.’s largest trading partner. Apple, for example, is diversifying its supply chain away from China (and forgoing some near-term profits) by committing to manufacture 25% of its products in India within seven years.
7. There are signs of improvement for the environment: Even as our economy and population grow, U.S. greenhouse gas emissions are down 16% since 2000. While consequential challenges remain, the recently-released Fifth National Climate Assessment reveals genuine progress. Renewable energy now makes up 80% of new electricity generation capacity, as the costs of generating wind and solar energy have declined by 70% and 90%, respectively, over the last decade. U.S. coal consumption is declining, while global coal usage is forecasted to peak this year, according to the International Energy Agency. Climate-focused actions taken by state and local governments, along with recently-enacted federal legislation, should accelerate this progress. Encouraged by generous tax incentives and end-user

demand, the private-sector is directing massive R&D spending toward a cleaner, more sustainable environment.

8. Delayed household formation provides an economic tailwind: The number of weddings in 2023 surged past pre-pandemic levels. We all know couples who postponed wedding ceremonies because of COVID, and then, as the pandemic subsided, found that choice venues had 18-month waiting periods. As these couples finally marry, they begin the process of renting or buying new homes, fixing them up, painting them, furnishing them, etc., and, over time, having children. All of this, of course, contributes to economic growth.
9. Young people are the hope for the future: In our own admittedly anecdotal and sometimes biased observations, we find today's young adults caring, industrious, and, compared to past generations, more focused on living healthy, responsible lifestyles. The generation now entering the workforce is passionate about their careers and compassionate about their communities. Notwithstanding the hardships of the financial crisis and the pandemic, millennials are making economic progress and are now outearning prior generations, at the same age, on an inflation-adjusted basis.
10. In an ever-changing world, the secret to investing hasn't changed: At its core, successful investing not only requires the patience to wait for opportunities to buy great business at reasonable prices, but also time to let them grow and fortitude to hold them for the long run. Albert Einstein is reputed to have said "Compound interest is the eighth wonder of the world." Charlie Munger added "Never interrupt it unnecessarily."