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Statement of Investment Policy

Background

Declining inflation, probably the most important financial influence impacting our economy in 2024, offers greater assurance the US can avoid recession by strengthening household purchasing power and enabling the central bank to reduce *real* interest rates sooner than many had expected. Indeed, our firm's proprietary **Economic Model**, designed to signal a change in the direction of the economy six to nine months ahead of an inflection point, has been pointing toward expansion for the past six months. ***In short, the Federal Reserve appears to be winning its fight over inflation without plunging the economy into recession, an outcome few economists or financial market analysts foresaw*.**

Confirming the rapidly falling inflation rate, the Commerce Department's Personal Consumption Expenditures price index (PCE), the Fed's favorite gauge of inflation, showed a 0.1% drop in November, its first decline since April 2020. For the year, the PCE has risen 2.6%, not too far above the Fed's 2.0% target, after peaking above 7.0% in mid-2022. "Core" PCE prices, which excludes volatile food and energy costs, rose just 1.9% on a six-month annualized basis suggesting the Fed has made great progress toward reaching its goal. Based upon market pricing, the Fed is now expected to begin lowering rates as soon as March, though officials have declined to discuss the timing of rate cuts.

Meanwhile, personal consumption, which accounts for about 70% of *real* GDP, though moderating, remains resilient, underpinning the economy. Consumer outlays climbed 0.2% in November and 0.3% after adjusting for inflation. Both readings were stronger than the previous month suggesting growth remains positive, though not as robust as it was earlier this year. The University of Michigan's monthly survey of consumer sentiment, which has often foreshadowed the direction of consumer spending, rose 14% in December to a five-month high, as respondents, who have had to contend with high prices and recession fears for almost two years, reduced their expectations for inflation next year. Elsewhere, The Conference Board, a private economic research firm, reported that consumer confidence climbed for the second straight month in December, as views of both current business conditions and the outlook brightened amid lower expectations for interest rates and inflation. While consumers can now look ahead to lower interest rates and improved affordability, the lingering effects of higher borrowing costs will certainly be felt for a while and questions remain regarding the timing for the Fed's expected pivot. The difficulties some consumers are having, particularly those with lower incomes, can be seen in data showing surging credit card debt and rising auto loan delinquencies.

The labor market remains tight, but supply and demand conditions continue to come into better balance. Over the past three months, payroll job gains averaged 204,000 jobs per month, a strong pace that is nevertheless below that seen earlier in the year. The unemployment rate remains low, at 3.7%. Strong job creation has been accompanied by an increase in the supply of workers. The labor force participation rate has moved up since last year, particularly for individuals aged 25 to 54 years, and immigration has returned to pre-pandemic levels. Nominal wage growth appears to be easing, and job vacancies have declined, according to the latest Bureau of Labor Statistics' Job Openings and Labor Turnover Survey (JOLTS). Although the jobs-to-workers gap has narrowed, labor demand still exceeds the supply of available workers. The rebalancing in the labor market is expected to continue, easing upward pressure on inflation and the unemployment rate is expected to rise somewhat from 3.8% at the end of this year to 4.1% at the end of 2024.

Overall, recently released data shows economic activity has slowed rather substantially from the outsized 4.9% annual rate seen in the third quarter. Even so, GDP is on track to expand around 2.5% for the year, supported by still-strong consumer demand, as well as improving supply conditions. After picking up this summer, activity in housing has flattened and remains well below levels seen a year ago, largely due to higher mortgage rates. Higher interest rates are also weighing on business fixed investment. For 2024, forecasts we have seen expect growth to cool, with many projections coming in below 2% trend. Keep in mind that many of these same economists came into 2023 with recession as the most likely scenario for the year.

Equity Investment Policy

Entering this year, investor confidence was tempered by expectations for declining growth and recession fears. But China's reopening, large scale fiscal stimulus and resilient consumption stabilized growth which has been well above trend. Investors' Keynesian "animal spirits" were rekindled early in the year by excitement over prospects for ChatGPT, booming luxury goods sales and, as the year progressed, expectations for a Fed pivot as inflation data turned increasingly positive. The popularity of Oppenheimer, Taylor Swift and Barbie added to economic activity over the summer. The economic expansion and stock market recovery persisted despite the largest interest rate increase in decades, wars in Ukraine and Israel, a short-lived energy crisis which briefly drove WTI crude oil prices toward $100 a barrel, last winter's regional banking crisis and some signs of consumer credit deterioration. Looking ahead, with the Fed likely to commence a series of rate cuts as early as March, we see the economy continuing to grow, albeit more slowly through the early months of the new year, and then picking up steam in the second half as we enter a new economic cycle. Against this backdrop, we assess the outlook for risk assets to be positive. ***Accordingly, equity portfolios under our supervision remain fully invested within portfolio guidelines despite relatively rich valuations for many high-quality companies we follow and the possibility of a 5%-10%+ sentiment-driven correction early next year following the market's recent outsized gains.***

Clients' equity portfolios are well diversified, balanced between large cap *growth* and *value* shares, tilted toward *growth* which is our long-term bias. Our investment platform allows for modest allocations to domestic small cap equities and companies domiciled abroad in both developed and emerging markets. From a P/E perspective, while the S&P500 is currently selling at roughly 19.4x estimated 2024 per share earnings of $245.75, a full valuation in our view, it is more attractively priced at only about 16x next year's earnings when its component mega cap tech stocks are stripped out. We currently favor adding to *value* holdings over *growth* given *value's* statistical cheapness.

While the 2023 stock market has been dominated by the stellar performance of the Magnificent Seven large cap tech stocks, shares of a wider range of companies have shown relative strength since late fall. Still, the Magnificent Seven, which accounts for more than a quarter of the cap weighted S&P500, are up over 70% since the start of the year, accounting for much of the 25%+ gain in that index. More recently, as the stock market's leadership has widened, shares of previously lagging banks, industrials and real estate firms have risen sharply while former market leaders have marked time. Reflecting this broadening, nearly 75% of S&P500 stocks are now trading above their 200-day moving averages and this quarter S&P *growth* shares have advanced about 10% while S&P *value* has gained 13%, illustrating the reversal in market leadership under way.

As long-term investors, we prefer to look beyond near-term economic uncertainties and short-term investor preferences to the coming new economic cycle, spurred by easing credit conditions and sound underlying business and consumer fundamentals, to the investment opportunities it will inevitably present. We pay scant attention to market timing, momentum-based investment techniques or technically driven trading strategies. Instead, we focus our energies on the same fundamental equity research that has been basic to our wealth building strategy over the past thirty years.

Fixed Income Investment Policy

The Fed's repressive interest rate policy has presented investors with an opportunity for the first time in over a decade to invest in the bond market. Accordingly, we have used the recent period of elevated interest rates to extend durations in clients' bond portfolios toward a target of 2.5 years from durations short of 1 year. Maturing obligations, as well as some bonds nearing maturity, have been replaced among client's laddered corporate bond holdings with other high investment grade, marketable issues maturing over the intermediate term where yields-to-maturity of 5.5%-6.0% became available. We continue to invest cash additions to clients' bond portfolios in obligations maturing in less than five years.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: **Personal Consumption Expenditures Index (PCE)**: A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. **Conference Board's Confidence Index:** The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. **ISM Manufacturing Index**: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the US economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. **ISM Non-Manufacturing Index**: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. **S&P 500 Index**: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US. **S&P 500 Growth Index**: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. **S&P 500 Value Index**: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.