Investment Management Commentary

Fourth Quarter 2022 (January 3, 2023)

SEM closes out 2022 celebrating 25 years of preserving and growing client capital. Following a difficult year, we remain optimistic and, importantly, our framework for investing is unchanged as we revisit what we wrote back in 1998 at the start of SEM. Our equity strategies and recent rankings are highlighted. We view the next 25 years with as much optimism as when we began. The future is bright and driven by innovation that will improve our standard of living and support satisfying investor returns over the next 25 years. Healthcare and alternative energy may lead the way. We wrap-up our year end commentary by sharing a few thoughts for the year ahead.

Framework unchanged

In the beginning of 1998 when Don started SEM, he wrote the following framework to begin the journey. Over time we have tweaked the discipline but, overall it is the same now as when we started and will be for the next 25 years. The commentary below is from our internal archives from the beginning (unedited so hopefully you can see our writing has improved over the years!):

"Our goal is to preserve and grow capital over time. Our methodology (and expertise) for reaching this goal is by investing in common stocks.

The entire emphasis of the investment process should be on Margin of Safety. Why? Because equity in the combined publicly owned corporate America moves forward over time with only a few significant setbacks in terms of time or amount.

The public stock market is constantly adjusting to new information usually judged or interpreted on a short-term basis. This in turn influences the buying and selling activity of many participants. However, much of the information is not of significance, and therefore should not be acted upon.

Therefore, investing for the long-term in prosperous businesses with fairly clear and defined positive long-term outlooks will produce decent portfolio rates of return, as has the S&P 500 (approximately 8-10% over the long run).

Consequently, investing in a portfolio of quality company stocks is a worthwhile process. The key element in achieving these results is to not lose substantial monies by investing in companies whose equity value is deteriorating on a permanent basis. Simply by not losing the results will be adequate or satisfactory.

However, to produce over time outstanding results in comparison to the S&P 500, it would have to be in a portfolio with some significant positions whose equity appreciates much more than the average, again, over time. This clearly requires concentrated positions.

So, the key is to have concentrated positions and no losers.

It is also important to know that activity in the portfolio (turnover) will probably defeat the objective/goal. Even if a portfolio was structured as suggested above, activity will diminish the return. This is because, as human nature would have it, the reaction to short term events even though insignificant within the long term, can have a significant effect on that individual stock's market price and on many stocks (the market).

There is a great deal of consistent randomness to stock prices. Changing portfolio positions based on market activity is a sure way to react with the market instead of with the long-term fundamentals of the business. It is this activity that can turn a temporary decline in a stock's price into a permanent portfolio loss. In many cases the money is then allocated to another portfolio position that may be less secure than the one sold in terms of long-term prospects…. D. Jowdy March 1998."

Suncoast Equity Growth Line-Up

Even though 2022 was a setback for equity investors in general and at SEM, we believe that our three portfolio offerings, which share the same foundational discipline, will continue to build on their strong track records. Below we provide a summary of each, with the rankings and statistics as of September 30, 2022, the most recent available (please refer to the respective portfolio commentary for performance returns and disclosures).

(1) **SEM-Select Growth** (25-year history) – All capitalization (mostly large capitalization),

- Ranked top 8% and top 20% in the eVestment Large-Cap Core / Large-Cap Growth Equity peer group, respectively, since our inception.
  - We have generated 3.80 annualized alpha (vs the S&P 500) since inception, with a beta of .82.
  - We have achieved 95% upside market capture while only incurring 73% downside market capture ratio.

(1) **SEM-Dividend Growth** (6-year history) – Large and Mid-Capitalization. Provides additional income on par with S&P 500 index and higher dividend growth.

- The current risk adjusted ranking is in the top 1% of the eVestment U.S Dividend Focus Equity peer group and has outperformed the S&P 500 while incurring less risk based on standard deviation.

(1) **SEM-Small to Mid-Cap Growth** (5 ½-year history) – Small to Mid-capitalization. Typically, a few more holdings than our other two growth portfolios, with higher earnings growth.

- The track record is ranked in the top 10% and top 35% range of the eVestment Small-Mid Cap Core / Growth Equity peer group since inception, respectively.

<u>Innovation abounds! Healthcare and Alternative Energy Lead the Way</u>

At Suncoast, the first 25 years are in the books, but what is in store for the next 25 years? We expect more great progress and improvements in our standard of living. At Suncoast we are futurists and optimists! If you are not, then why would you invest? Although we discuss music distribution for the nostalgia, importantly the great advancements will be in health, well-being, and alternative energy. SEM does not currently have any investments in alternative energy, mostly attributable to those businesses requiring heavy capital investment. But we monitor emerging and existing publicly traded companies in this industry for future investment should they qualify. We are active investors in several healthcare service and product companies, both large and small, as long as they meet our **SEM – DIS (Disciplined Investment System)** criteria.

Look at how far we have come. From a humorous perspective, we have progressed from 8-track, cassette tapes to compact discs to now streaming. I do not believe any of us miss those clunky media storage devices taking up space in the car!

The most important advances have been medical, helping us extend our lives, fight off disease and remedy a virus. Examples include treatments for rheumatoid arthritis, devices for heart conditions and the quick production of vaccines to fight off the Covid pandemic. While Covid's devastation shows in recently released statistics on life expectancy, where in the U.S. it fell to 77.3 from 78.8 years of age, sadly the biggest peacetime decline on record, we still see much ahead that could improve that.

The innovations will be startling in the next 25 years, a list too numerous to even consider compiling here will improve medical care and our lives. *Smart pills* with tiny sensors will communicate with your smart phone and eliminate the need for endoscopy. *Artificial intelligence* will advance preventative care and help doctors diagnose more about an illness than ever before by deep learning of digital scans for cancer detections, significantly enhancing the traditional analysis done by a radiologist. There is still so much that nature and the advanced study of the world around us can contribute. Regrowing body parts is in the early stages of development. This is inspired by the salamander, the champion of regrowing body parts, and thanks to the European team that released the first genomic profile for this creature in 2018. Also in the works is a non-toxic, surgical superglue formed from a sticky compound found in an algae plant in 2017 by a Harvard materials scientist, which may repair cartilage or patch a hole in the heart of an infant someday.

The most excitement over the next 25 years may come from the development of *alternative energies*. Sparked by environmental concerns and a commercial push by Elon Musk's Tesla electric vehicles, there is so much potential ahead. Two recent examples include a Brooklyn based start-up and recent breakthrough at the U.S. Energy Department lab in Livermore, California. Air Company is a 5-year-old Brooklyn based start-up with fifty employees. The company created an elegant concept, per a recent article by Jared Newman of *Fast Company* magazine, to mimic plant photosynthesis by converting carbon dioxide into alcohol, which could generate a wide variety of products including hand sanitizer, perfume, and jet fuel. Air Company operates a small conversion reactor near its headquarters, but plans to build a bigger hydropowered reactor near Niagara Falls in 2024 and aims to build facilities where it can capture carbon and draw from nearby renewable sources including wind and solar power. It has also been testing sustainable jet fuel for the U.S. Air Force and has agreements with major airlines to produce a billion gallons of fuel over the next decade. NASA has also provided a grant for research and development into rocket fuel. In this case carbon dioxide "can be part of the solution," per Air Company CEO Gregory Constantine. While this is not a company we can currently invest in, as it is private, it's a wonderful example of the type of opportunities that lie ahead.

Additionally, in mid-December, the U.S. Energy Department said it reached an "unprecedented breakthrough" in research on *nuclear fusion*, when a controlled reaction produced more energy than it consumed. At work in the lab for over a decade it is a key step in transforming fusion into a practical source of energy, according to a *The Wall Street Journal* article. Nuclear fusion's broad appeal is that is does not produce any waste, so it is a clean alternative to burning fossil fuels and the release of greenhouse gases and carbon dioxide. It improves upon nuclear power, responsible for about 10% of the world's electricity, which generates electricity by nuclear fission and creates radioactive waste that can last thousands of years. The hydrogen atoms that fuel nuclear fusion reactions are essentially a limitless supply. More than thirty firms, most of them in the U.S. are trying to commercialize applications to deliver nuclear fusion electricity to the grid on the scale of a power plant, though it could take a decade or more to work through technical issues.

<u>Looking forward to 2023 and beyond</u>

Undoubtedly, 2022 was difficult year for the equity and bond markets. We still have post pandemic challenges including economic inflation, global supply chain issues and higher energy prices, along with Russia's war with Ukraine, and U.S. global relations with China and other global hot spots.

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If the past is a prologue the markets have often been a barometer (versus a thermometer) relative to the economy. For example, equity markets declined in 2008 and early 2009 ahead of the economic recession that occurred in 2009. CEO confidence this October, as measured by the Conference Board, has dropped to the lowest point since 2008. We are also in the unusual territory, supported by the Federal Reserve's actions, in which the interest rate on the 10-year U.S. Treasury is lower at 3.88% than the 2-year and shorter maturities in the 4.41% to 4.76% range. Traditionally, investors demand a higher yield the longer the timeline for which they lend.

With the pandemic further away in the rearview mirror, inflation may subside. New evidence of softening prices during the past few months add to our comments in our October letter. Car prices have come down from their peak in July according to J.D. Power and surveys show car dealers are concerned about 2023. Walmart's CEO McMillon delivered a message in October to product suppliers saying they are not going to pay higher prices anymore and are asking for discounts from new orders, according to *The Wall Street Journal*. Heating our homes this winter may not be as expensive as some have feared. Natural gas futures back in August briefly pushed above $10 per million BTUs, the first time since 2008, but that price is down nearly 50% to the low $4.50 range now.

We have always managed our portfolios for the long-term not the next 12 months. We do not make economic predictions, as it is guesswork whether an economic slowdown may be heading towards a "hard" or "soft" landing.

For next year, the early look at each of our three portfolios, per Refinitiv Eikon estimates, is for mid-single digit earnings growth or higher for 2023. This is below our historical earnings growth average of 10%-12% but compares favorably against the flat to slightly negative earnings outlook for the S&P 500. But we shall see, as growth rates can change. Importantly we do not own the entire economy as the S&P 500 represents. We own a small collection of business that can still grow in the aggregate during an economic contraction. The lowest year of earnings growth for our flagship **SEM - Select Growth** strategy was up mid-single digits in 2009; we have never had a year when earnings declined.

Whatever 2023 brings, we remain optimists as we look out to the next 5, 10 and 25 years. As we alluded to in our “Framework” discussion in the first section of this letter, the economy and equity markets advance over time with occasional setbacks. When SEM started in 1998 U.S. Gross Domestic Product was $8.6 trillion. For 2022 the estimate is in the $23.5 trillion range; likewise, the S&P 500 was 970, and today it is 3840, excluding the dividend payouts. That is a nice advance for both.

We see a future of electric air taxis whisking us to work, e-bikes transforming urban centers, and modern airplanes supported by alternative energy which NASA has already requested prototypes that could fly by 2027. Additionally, we envision new medicines to fight or reverse some of our great challenges today such as Alzheimer’s, obesity, blindness, and sickle cell, as well as vaccines for HIV and cancer.

We always strive to preserve and grow our clients’ capital over time in our role as investment managers. We have in the first 25 years and will continue to aim to earn returns superior to the market averages and our competitors, while taking what we believe to be less risk, in all three of our equity growth portfolios, **Suncoast Select Growth**, **Suncoast Dividend Growth** and **Suncoast Small to Mid-Capitalization Growth**. Thanks for your continued confidence. We wish our valued clients a happy and healthy 2023!

Sincerely,

Don	*Dan*	*Amy*
Donald R. Jowdy	Daniel T. McNichol	Amy A. Lord, CFA
CIO	President	SVP / Co-Portfolio Manager

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