1st Quarter 2023 Market Commentary

A Quarter of Key Events, Yet Respectable Gains

The first quarter brought on a flurry of historic economic and market news. On top of meaningful actions by the Federal Reserve, which were on nearly everyone's radar, the quarter ended with several unexpected key events in March. In March alone, we saw the 2nd and 3rd largest bank collapses in U.S. history (Source: Kobeissi), notable moves by major countries to substitute the Chinese Yuan for the U.S. Dollar in trade, interest rates hitting the highest levels since 2007, collapse of Credit Suisse in about 48 hours (one of the world's largest banks), and we experienced the first ever criminal indictment of a former U.S. President.

If investors are thinking this led to disastrous results for the quarter, they would be incorrect though. Both stocks and bonds provided positive results, with nearly every holding in the TOPS portfolios recording gains. The TOPS portfolios delivered respectable returns of just over +3% to over +5% on average for the quarter, depending on the risk level, with riskier stock centric portfolios outperforming more conservative portfolios.

Worth noting, despite some longer-term headwinds, the technology sector of the S&P 500 returned almost 11% for the quarter, outperforming the financial sector by over 20%. While tech stocks likely face a much different environment in the next 10 years versus the favorable environment the last 10 years provided, their outperformance this quarter reminded investors why it is often unwise to ignore a major sector. We do not feel this short-term outperformance of tech stocks is necessarily a sign of a long-term outperformance opportunity though, as it was driven largely by expansion of the P/E ratio. From a low of 21.1 on January 6th, the P/E ratio for the large tech leaders (the MegaCap 8) rose to end the quarter near a lofty valuation of 28 times earnings. In other words, investors simply bid up the multiple of the stocks; it was not driven by earnings expansion. Important to note, the performance of these 8 stocks has largely driven overall large cap outperformance recently. On the fixed income side, it was unexpected to see interest rates fall in the first quarter – but they did, boosting bond values. Again, reminding investors of the diversification benefits bonds can provide.

Our portfolio management team remains optimistic about the long-term opportunities to provide meaningful risk-adjusted returns for our investors. Many of the asset classes we hold remain valued below historical averages, and we believe our unique fixed income strategy will provide value. Further, we feel there is opportunity for sizable portions of the portfolio to benefit if the U.S. Dollar falls from abnormally strong levels over the next few years.

After discussing Q1 2023 financial market results, we will address three general themes important to TOPS portfolio returns and strategies:

1) The Equation Gets More Complicated for the Federal Reserve
2) The Story of a Banking Crisis
3) Is There Enough Fuel in the Tank for Stocks?

Year-To-Date Markets Review

Equity indexes saw positive returns in the first quarter. Growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning +9.6% and +5.2%, respectively. Midcap (S&P 400, +3.8%) outperformed small cap equities (S&P 600, +2.6%). Developed international (MSCI EAFE) returned +8.5%, outpacing emerging markets (MSCI Emerging Markets), which returned +4.0%. Real estate

(MSCI World Real Estate, +0.7%) was slightly positive for the quarter, while Natural resources (S&P GSSI NA Natural Resources, -2.8%) saw negative returns to start the year.

Like equity returns, we also saw positive fixed income returns in the first quarter. The Barclay's US Aggregate Bond Index had a +3.0% return for the quarter, while the Barclay's US TIPS Index was up +3.4%. Credit (ICE BofA US Corporate Index, +3.4%) slightly outperformed government (ICE BofA US Treasury Index, +3.1%). To start the year, investment grade corporates (iBoxx USD Liquid Investment Grade Index, +4.5%), high yield (Solactive USD High Yield Corporates, +3.8%), and international bond indexes (Bloomberg Global Aggregate ex-USD, +0.1%) were also positive. The 10-year US Treasury yield decreased from 3.88% to 3.48% in the first quarter.

The Equation Gets More Complicated for the Federal Reserve

If investors thought the equation could not get more difficult for the Federal Reserve, they would have been wrong. As we have discussed, the Federal Reserve is carrying out a strategy of quantitative tightening, driven primarily by increases in the Fed Funds Rate, in an attempt to curb high levels on inflation.

The Fed had been dealing with difficulties regarding the blunt force impact of rate increases and the significant delay which typically occurs from the time in which they raise rates until the economic impact is reported. On top of that, the Fed voiced concerns regarding the strong jobs market, as it is hard to dampen consumer spending if consumers feel confident in their paychecks. To complicate things further, consumer spending is being boosted by the baby boomers, the largest and wealthiest group of retirement age consumers in U.S. history.

In the first quarter, the equation entered a new level of complexity for the Fed. First, we experienced a banking crisis, which required significant weekend intervention by a joint Fed, U.S. Treasury and FDIC task force to avoid significant risks. Second, just as the quarter ended, OPEC+ announced a sizable reduction in oil production, driving up oil prices. The potential of higher oil likely had some impact on the economy even before the announcement. Higher energy prices contribute to higher inflation, by certain measures. Third, and not to be forgotten, the country faces a potential political storm if the debt ceiling is not raised soon. The Congressional Budget Office has warned the U.S. Treasury Department will exhaust its ability to pay all its bills sometime between July and September, unless the current $31.4 trillion cap on borrowing is raised or suspended. All these concerns factor into the Fed's policymaking process.

Before the announcement of the failures of Silicon Valley Bank and Signature Bank in March, there were high expectations the Fed would increase the Fed Funds Rate by at least 0.25% at the end of March meeting, with a sizable chance they may increase by 0.50%. After the bank failures, it became a question whether the Fed would increase rates at all. We believe, actions by the European Central Bank to raise rates in March, along with worry a rate pause would signal the Fed was very concerned about the banking sector, helped the Fed to lean towards continuing their rate rise path. The Federal Reserve voted at their March meeting to raise the Fed Funds Rate target to 4.75%-5.00%, a 0.25% increase.

While the March meeting is now behind us, the variables the Fed is weighing are all still present. We see two paths of higher likelihood. First, what we will call the base case, is the path Fed Chair Powell had foreshadowed for months leading up to the banking crisis. It is likely, the Fed continues to raise rates towards what they believe is the appropriate terminal rate (rate at which rate rise cycles terminate), then maintaining rates at that level for some time. For months, the signals from the Fed led us to believe "some time" could be a relatively extended period (even up to a year). The second path is that we see the Fed cut rates shortly after hitting the terminal rate. Dr. Jeremy Siegel has highlighted his belief we could see rate cuts towards the latter end of 2023. We believe, the chances we see rate decreases near the end of 2023 are now viable; whereas, several months ago it was hard to believe as a possibility.

What would cause the Fed to start cutting rates? A few things could cause this. First, they would have to be certain inflation is licked, and feel comfortable cutting rates would not rekindle the inflation fire. We believe this is the most important factor. In a close second, the Fed may be forced to lower rates if the

economy starts to crash. As we mentioned in previous commentaries, we believe the Fed will maintain high rates until something breaks economically. The messages from the Fed and bond pricing in the markets are contradicting, however. Bond investors appear to be favoring high rates ending sooner rather than later.

These Fed movements affect our stock and bond investments in different ways. Stocks are most concerned with the risk of recession and the impact higher rates may have on earnings. The bond story is much clearer, as changes in interest rates have direct impact on bond values and yields. Further, interest rates can impact currencies and a recession would obviously have an impact on bonds as well. Our team is highly focused in these areas. We are managing the macro impact and economic effects, then translating that information into micro decisions which drive our strategic allocation decisions. We believe our tools, resources, processes, and experience provide us the opportunity to be valuable stewards for our investors during this time of crosscurrents.

The Story of a Banking Crisis

In the face of rising interest rates, banks encounter a conundrum. This issue is something our team has been talking about for some time. During the last decade of low interest rates, banks had little decision regarding depository rates, keeping them near zero. As a reminder, banks largely profit from earning a higher rate of interest on lending out assets or investing them, than paid out in depository interest. With rates low overall, depositors were in a TINA (there is no alternative) situation. Therefore, banks could maintain adequate levels of deposits by paying very little interest. Banks were then able to earn a moderate level of spread from lending and investing.

As interest rates increased over the last 18 months, the scenario changed. Instead of raising depository rates to be in line with market interest rates, banks largely kept depository rates low (offering the opportunity for them to earn a higher spread). This helped support their enterprise values and stock prices. Many bankers seemingly thought depositors were sleeping at the wheel, still functioning in a TINA environment. In their defense, that has been the case for a long time. However, TINA became TARA (there are reasonable alternatives). As some U.S. Treasury rates exceeded 5%, prudent depositors moved money out of low paying depository accounts into higher yielding alternatives. Why would someone keep anything beyond frictional cash in a low yielding bank account versus a higher yielding high quality fixed income investment?

While many depositors became investors on their own, recognizing this opportunity, it took a Silicon Valley Bank failure to really light the fire. In March, Silicon Valley Bank and Signature Bank crashed, resulting in the #2 and #3 largest failures in U.S. history. Once the fire was lit, another major wave of depositors woke to the reality of the logic they faced and prudently moved their low yielding deposits into higher yielding (and often safer) alternatives. It was not the low yielding depository rates which caused the second largest bank collapse in U.S. history overnight though; it was a poor risk management and investment process. In a press conference after the SVB collapse, Fed Chair Powell confirmed this by stating, "At a basic level, Silicon Valley Bank management failed badly." SVB did the opposite of what our portfolio management team does to benefit our investors. In our portfolios, we reduced interest rate risk and benefitted from significant outperformance in 2022. Instead, SVB rode a high level of interest rate risk right into a highly telegraphed buzzsaw of higher rates.

SVB took on a massive number of deposits in the last two years. As their deposits swelled, they struggled to loan out all the money. Instead, they invested heavily in high quality fixed income, largely U.S. Treasuries. Seems prudent right? Well, as we have highlighted at length over the last few years, all bonds are not created equal. TOPS investors benefitted significantly in 2022 from the fixed income portfolio management we carried out. Many TOPS investors had fixed income returns which exceeded the US Aggregate Bond Index by over 6% for the year. This high level of outperformance was driven largely by shortening the duration (a complicated calculation factoring in time to maturity and yield) and heavy diversification into assets such as TIPS bonds and investment grade floating rate securities. SVB, on the other hand, bought large amounts of longer maturity treasuries. Their strategy equated to cancelling their flood insurance and overweighting exposure to real estate in the flood plain right before the most

telegraphed flood in over 100 years. The Federal Reserve has well telegraphed they expected to raise interest rates to fight inflation.

The longer maturity securities on SVB's balance sheet subsequently fell in value as interest rates rose, creating significant losses for SVB. As the losses became public, the bank (and its stock) began to crash. Then, in a matter of hours, the FDIC swept in and took control of the bank. We will say the swiftness in which the FDIC acted was incredibly impressive. There are people that wait longer at the BMV for their license renewal than the time it took the FDIC to take over what was formerly the country's 16th largest bank (source: Federal Reserve). In a matter of a few hours on a Friday morning, the FDIC took over SVB. Over the subsequent weekend, a joint task force of the Federal Reserve, FDIC and U.S. Treasury assured that all deposits in SVB would be protected, not just those within the published FDIC limits.

This action by the FDIC quickly brought more questions though. The basic idea of FDIC insurance is deposits are guaranteed up to the FDIC limits. Depositors are supposed to bear the risk of deposits beyond FDIC limits. In the case of SVB, the Federal Reserve, U.S. Treasury and FDIC worked together over the weekend to assure depositors their full deposits would be guaranteed. This unprecedented Sunday guarantee largely solved the problem for SVB depositors. However, depositors at other banks then started to ask: What about my deposits? Why am I keeping deposits beyond FDIC limits in my bank account? These logical questions threatened to begin the largest "run on the bank" in U.S. history.

As the quarter ends, some questions are answered, yet many remain. Fortunately, it appears the full scale "run on the bank" has been averted. However, there is still at least a lower scale run on the bank occurring. Assets are fleeing regional banks towards larger banks and fleeing lower yielding depository accounts in favor of higher yielding alternatives. We will not attempt to put makeup on this situation for regional banks. According to Kobeissi Research, the number of banks in the U.S. has dropped from 31,000 in 1920 and 8,200 in 2000, to about 4,200 in 2022. Bank consolidations have been occurring for over 100 years. The model of many investors who start a small bank is to grow it for a few years in hopes to be acquired, for a sizable profit, by a larger entity. We believe regional banking still has many questions which will need to be answered in the coming years, which may result in even more accelerated consolidation. Clearer, however, is the fact regional banks (and some large banks as well) will be under heavy pressure until deposit rates creep higher towards market rates. The gravy train of banks earning cushy spreads on depository amounts above logical levels is likely ending. The best chance many banks have is relying upon inaction by depositors. It is no longer 1975 though, when moving money out of a bank account was a pain. It can now be done electronically in seconds on a mobile device.

TOPS investors have relatively limited exposure to regional banks. Likewise, recent losses in these stocks have built in much of what we discussed into the prices. Therefore, the largest risk of this banking crisis to our portfolios would be if the situation spreads further to create a full-blown economic crisis. At this point, the likelihood of a full-blown economic crisis appears low. Instead, it appears a relatively orderly reallocation of assets will occur, with banking winners and losers in diversified portfolios largely washing out. The clearest impact we see is the issue regarding depository rates versus market rates. If market rates of interest remain high, why would depositors not continue to punish banks who keep their depository rates lower? Maybe banks are bailed out if interest rates drift lower towards the end of this year. Regardless, depositors' eyes are now open and bankers' opportunity to earn higher spreads from depositors sleeping at the wheel may be largely over.

Many of our investors have assets with Charles Schwab, which has been mentioned in several articles recently, due to their position as the 11th largest bank in the U.S. Schwab has a unique business model, however, as their bank is attached to the largest publicly traded U.S. securities brokerage firm. Among investors, questions mainly aimed at Schwab stock price were often confused with safety of brokerage assets.

Therefore, it is important for investors to look at the difference between Schwab stock and the safety of Schwab brokerage assets, with investment accounts offered by Charles Schwab & Co., Inc. (a registered clearing broker-dealer and SIPC member). The reality is, investors holding assets with Charles Schwab, along with all the protections this brings, shouldn't be directly affected by short term performance of

Schwab stock. Schwab stock could conceivably perform poorly for decades with little impact on custody investors. Holding assets in custody with Schwab is a very different decision from being an investor in Schwab stock. Regardless of short-term fluctuations in Schwab's stock price, related to overall weakness in publicly traded banks, Schwab remains one of the top custodians for investor assets in the world.

From a portfolio management perspective, this banking crisis highlighted the risk of concentration in portfolios. The TOPS portfolios are importantly diversified, allowing us to perform well during this high level of volatility. However, portfolios overweighted towards financial stocks would have fared much worse. Often, investors can find themselves overweighted in certain areas by focusing on one benefit and not realizing the other aspects of the decision. We feel our process and experience help us to avoid this risk.

Is There Enough Fuel in the Tank for Stocks?

Our long-term investors know, we refer to earnings as the fuel in the tank for stocks. Ultimately, all the thousands of factors we discuss come down to whether the economic environment (which we call the climate) will be good enough for stocks (which we call the weather) to perform well. Stocks are driven by earnings, more specifically, earnings expectations and valuations.

Valuations are poor predictors of short-term results, yet they have historically been one of the best predictors of longer-term success. If investors start out an investment period with a low valuation level, it has historically improved their chances of longer-term success. The good news is, most of the stock asset classes held in our portfolios appear to be historically undervalued currently. The exception would be large cap U.S. stocks, which are registering levels a bit above historical average. This gives our long-term investors a good base going forward.

Next, we have to look at the economic environment (the climate). As we have discussed, the economy is facing many uncertainties. However, despite high inflationary numbers and an aggressive program of quantitative tightening, the economy is still quite robust. The question is, when will things roll over? As we know, the economy ebbs and flows, each expansion lasting until the next contraction, and so on. A key economic figure is PMI (Purchasing Managers' Index). For PMI, a figure above 50 reflects expansion, while a figure below 50 reflects contraction. In March, Global-M-PMI registered 49.6, which is goldilocks, not too hot and not too cool. Of some concern, the US- M- PMI came in at 46.3. As we have discussed many times, there are thousands of important variables though. These economic figures, in balance with others we monitor, show us that the economy is right about where we would expect it to be, in a goldilocks zone, waiting to see how inflation plays out.

The weather report for stocks will be heavily reliant upon the upcoming Q1 earnings season in April and May. Yardeni Research, a contracted resource for our team, summarized earnings very well in saying:

> *"As the Q1 earnings reporting season in April and May approaches, industry analysts are still paring their estimates for the four quarters of 2023. They now expect to see a 7.4% y/y decline during Q1 followed by -5.8% in Q2, 2.1% in Q3, and 10.5% in Q4.*
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> *Nevertheless, S&P 500 earnings per share is still expected to be up 1.5% y/y for 2023 to $221.40 and 12.0% in 2024 to $248.03. As time passes, forward earnings—the time-weighted average of analysts' consensus operating earnings-per-share expectations for 2023 and 2024—is giving more and more weight to the 2024 estimate. As a result, it has stopped falling over the past three weeks through the March 23 week. It is currently $227.55. At year-end, it will equal whatever the 2024 estimate will be at that time."*

Therefore, the biggest reminder for earnings is to look out the windshield, beyond the hood of the car, instead of out the back window. Stocks are already looking forward to 2024 and beyond. It is important not to crash optimism by overweighting focus on 2022 (the back window) or even 2023 (the hood of the car). As we look to 2024 and beyond, we are encouraged by the opportunity for there to be enough fuel in

the fuel tank to propel our vehicles in a sunnier economic climate to come. This requires the discipline to look beyond the weather today and focus on the future.

TOPS Portfolio Strategies

While we always work hard for our investors, 2022 and 2023 have surely kept us on our toes. Falling short of highlighting analogies comparing our work to other respected professions, we can simply say we have had ample opportunity to put our training and experience into action. Investing in the most recognizable technology names and experiencing above average returns, as was possible for much of the last 10 years, is quite easy. While that strategy may in fact provide decent returns in the next 10 years as well, it would portend to be a very risky path to take. On the other hand, we feel the environment is ripe for our risk managed strategies to provide appropriate risk-adjusted returns for our investors. We are pleased with the relative performance we have been able to provide for the last two decades and feel our strategies may have never been more relevant than they are right now.

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