TUFTON CAPITAL MANAGEMENT

Viewpoint

WINTER 2024

"May you live in interesting times." Purportedly Chinese in origin, this cryptic maxim has been alternately interpreted as both a blessing and a curse. In that regard, it should strike a familiar note with American investors. As this note "goes to press," the country's major news outlets are allocating equal front-page real estate to interest rate predictions (when will the Fed "ease up"), to campaign efforts for a probable Biden vs. Trump rematch and to a foreign policy landscape with uncertainty and sadness spanning from the Middle East to Ukraine. Blessing or curse, there is no denying that these are "interesting times."

So, what do we make of it all? First, and most concretely, let's talk about the numbers. In sharp contrast to 2022, last year ended on a high note, with the S&P 500, Dow Jones and Nasdaq notching fourth-quarter gains of 12%, 13%, and 14%, respectively. And while the technology sector and its Artificial Intelligence (AI) fever was the main event of 2023's first three quarters, the year closed with the value stock, and overall market breadth, emphatically more *en vogue*. From financials to cyclicals, the data strongly indicates that a newfound conservatism may be gripping the marketplace.

As we look at the new year's outset, is Mr. Market making a compelling case for continued strength? And will the Magnificent Seven continue to pass some of the heavy lifting off to the other 493 S&P constituents? As we begin 2024, American stocks have been mixed, with a growing economy (albeit a slower one) and a Fed on the cusp of relaxing its interest rate policy providing a strong counterbalance to any early-January jitters. In other words, while the Grinch didn't steal Christmas, there's also reason to believe that he won't make off with the next fiscal year as well.

Of course, those aforementioned economic and Fed-related questions will continue to loom. And neither I nor anything you'll find in the pages ahead will presume to answer them. (Yet again, Santa forgot to bring my crystal ball.) Instead, as we set out into 2024 together, I'll simply reiterate a principle that has guided this firm and its clients since 1995. A good business, bought at a fair price, is among the most powerful—and reliable—wealth-creation vehicles in the world. From all of us here at Tufton Capital, we thank you for the trust you have placed in us and look forward to the tireless pursuit of your interests in this and many more years to come.

Here's to a Happy New Year for you and yours.

Chad Meyer, CFA
President

Inside This Issue

The Fourth Quarter of 2023: Great Expectations

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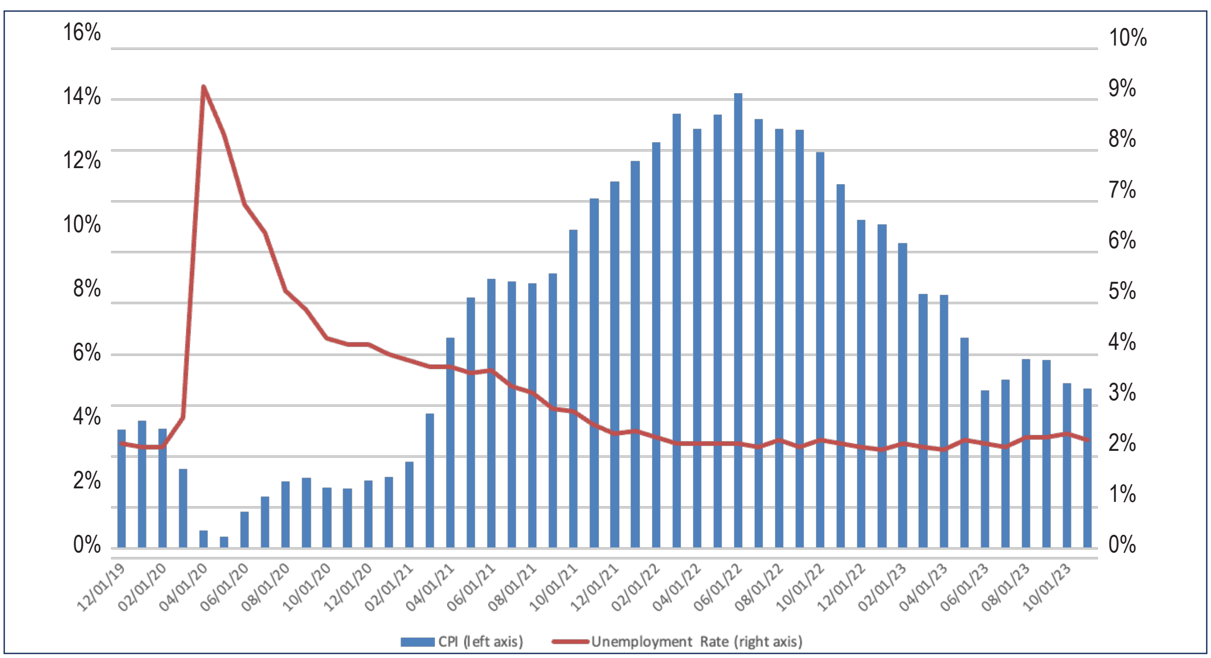
The fourth quarter provided excellent returns for the equity and credit markets. The Standard and Poor's 500 stock index gained 11.7% in the quarter and closed the year with a total return of 26.3%. The yield on the 10-year United States Treasury note fell from 4.57% at the beginning of the quarter to 3.88%. The drop in yields proved to be a strong catalyst for the surging stock market.

The quarter was a welcome relief for a market that had been dominated by a small group of stocks. The anointed Magnificent Seven: Apple, Amazon, Meta (Facebook), Alphabet (Google), Microsoft, Tesla and Nvidia, accounted for about 60% of the market's total annual return, with individual returns ranging from 49% for Apple to 239% for Nvidia. The S&P 500's return for the year, excluding the Magnificent Seven, would have been a more modest 7.6%. The explanation for the dominance is found in the calculation of the S&P 500 returns. The index is capitalization-weighted, which accounts for the lofty returns. A company's weighting in the Index is calculated by multiplying the shares outstanding by the stock price, and these seven stocks represent 28% of the Index. The past year was far more lackluster for the remaining 72%. Had each index member been equally-weighted, index returns for the year would have been 13.9%. The equal-weighted index was in fact down 3.95% through October 27. Weakness was broad based with eight of the eleven market sectors underperforming. It was the late quarter surge of 18.6% in the equal-weighted index that made all the difference and provided relief.

Broad market weakness was accompanied by higher interest rates. The 10-year United States Treasury peaked at 4.99% on October 19, nearly to the day that the equal-weighted S&P 500 Index reached its low point. The 10-year Treasury was little changed for the year, rising from 3.81% to 3.88%. However,

Soft Landing?



Source: Factset

the intra-quarter move from 4.99% to 3.88% was high octane for the equity markets.

Signs of receding inflationary pressure were behind the big tumble in interest rates. The Consumer Price Index (CPI) and the Personal Consumption Expenditure Index (PCE) are approaching levels consistent with the Federal Reserve's inflation target of 2%. CPI started the year at a 6.35% pace, and the read for November was 3.12%. The PCE showed similar progress, falling from 5.4% in January to 2.64% in November. Employment growth is slowing as is wage growth, but not at an alarming rate. The unemployment rate closed the year at 3.7%. Strong retail sales reflect a strong consumer, and economic growth continues to chug along.

The moderation of inflation was not lost on the Fed. In December, the Federal Open Market Committee, a 12-member group comprised of seven members of the Board of Governors of the Federal Reserve System along with the president of the New York Federal Reserve Bank and four of the other eleven Reserve Bank presidents, released their dot plot report signaling their future interest rate expectations. The median expectation for 2024 was 4.625%, 0.5% below the number communicated in September. Based on the current fed funds rate of 5.5%, the Fed is now projecting three quarter-point interest rate cuts in 2024. The same December dot plot report indicates four additional interest rate cuts in 2025 and three more in 2026. The shift in policy was due to the moderating inflation and not the economic weakness.

The Fed's pivot was not lost on the market. Although the timing of interest rate cuts was not part of the Fed's press release, the market quickly shifted their expectations. Futures contracts, which are legal agreements used to make bets on future moves in security prices, indicate that market expectations are for six interest rate cuts in 2024. The market will see the Fed's three and raise it by three! The stock market responded to the lower rate scenario with surging prices lifting all boats in the last forty-five days of the year. Expectations are very high for the Fed to deliver.

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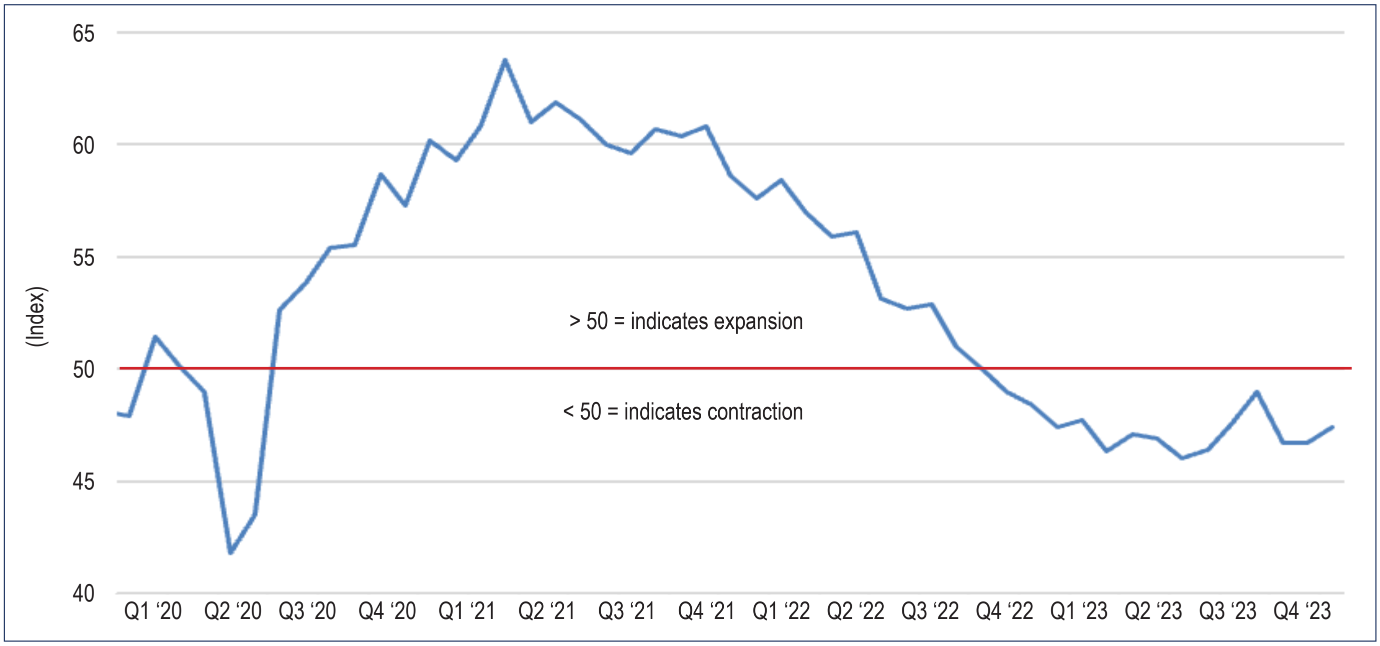
ISM Manufacturing (Seasonally Adjusted)



Source: Factset

Fourth Quarter... Continued from page 3.

The strong returns in 2023 were a response to an overly pessimistic market. The much-anticipated recession never materialized. But as we move into the new year, we are confronted by many risks—some old and some new. The nearby charts reflect the two broad sectors of our economy: manufacturing and services. The charts are based on diffusion indexes, with readings above 50 indicating expansion and readings below 50 indicating contraction. The manufacturing sector has been in a funk since October 2022. The service sector has remained strong, with a few bumps along the Covid path. The easing of interest rates and lower cost of capital should allow manufacturing to regain some strength.

The greatest risk may have been caused by the market's reaction to the shift in Fed policy. Appreciation in both stocks and bonds was built on a foundation of lower future interest rates—rates much lower than those signaled by the Fed. Should the timing or magnitude of rate changes differ materially from expectations, financial assets could suffer.

Geopolitical risks escalated with the Hamas attack on Israel in October. In addition to the human toll exacted by war, this dynamic region has a tangible impact on commerce as demonstrated by shipping restrictions through the Red Sea, and the potential for regional escalation is a concern. The Russia/Ukraine War continues to drag on as the human and financial costs continue to grow. Although the risk of regional escalation is lower than that of the Middle East, the potential impact on commerce is still material. Russia is the third-largest producer of worldwide oil, accounting for over 12% of global oil production. The relationship between the United States and China continues to deteriorate, and tariffs, product restrictions and general mistrust reflect the frayed relationship.

The World Economic Forum, an international not-for-profit foundation formed to shape global, regional and industry agendas, released their survey data seeking to determine the five risks most likely to

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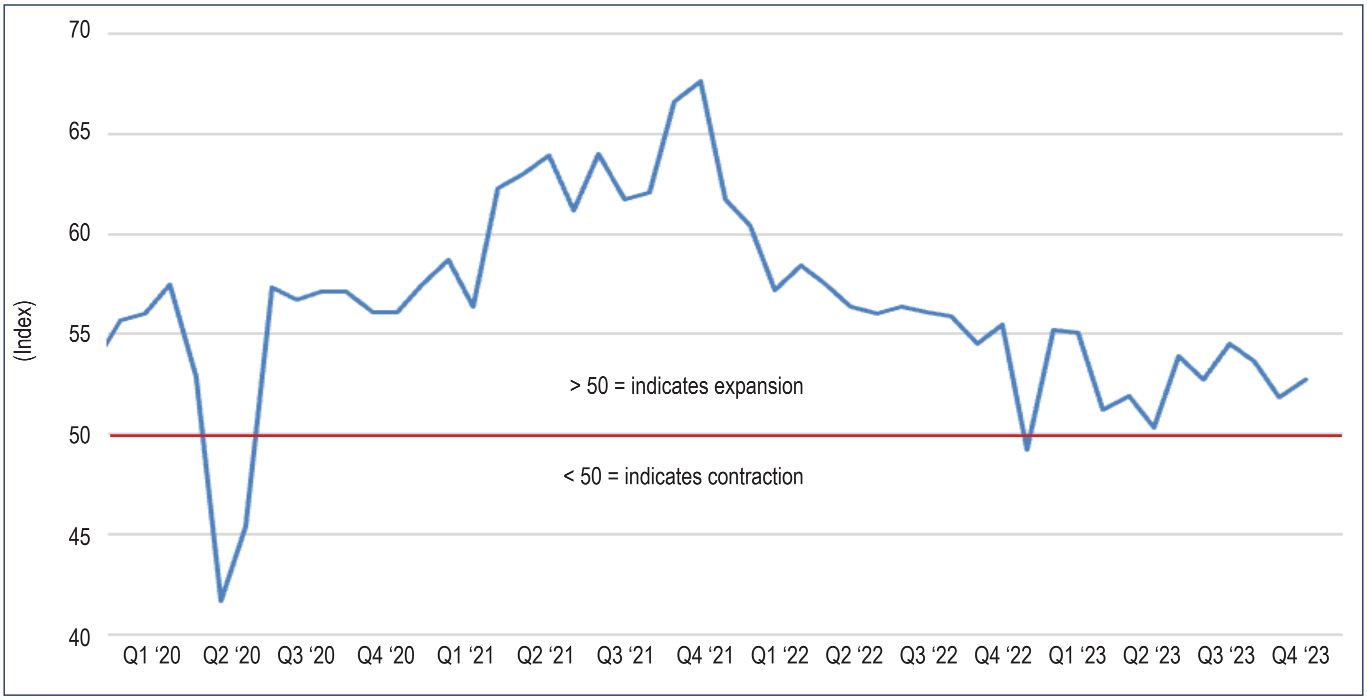
ISM Services (Seasonally Adjusted)



Source: Factset

Company Spotlight: Chevron (Ticker: CVX)

Alex Olshanskiy
Investment Analyst

Chevron (ticker: CVX) is the second-largest integrated oil & gas company in the United States. Only Exxon Mobil Corporation (ticker: XOM) is larger. Chevron's two largest business segments are exploration and production (upstream) and refining, marketing and transportation (downstream).

Chevron's (upstream) operations yield a daily output of 3.0 million barrels of oil equivalent, encompassing 7.7 million cubic feet of natural gas and 1.8 million barrels of liquids. Production activities are spread across North America, South America, Europe, Africa, Asia and Australia. On the (downstream) side, the company's refineries, located in the U.S. and Asia, have the capacity to process 1.8 million barrels of crude oil per day.

Proved reserves at Chevron stood at 11.2 billion barrels of oil equivalent and 30.9 trillion cubic feet of natural gas, while Exxon by comparison had 17.7 billion barrels of oil equivalent and 37.6 trillion cubic feet of natural gas. Proved reserves represent the estimated amount of oil and natural gas that a company reasonably expects to extract profitably from its reserves. Think of these reserves as the company's bank account of readily available oil wealth.

Chevron faced challenges in 2023. There was a significant decline in oil prices in 2023 after the previous highs of 2022. Recessionary fears increased global oil supply, and weakened demand from China directly impacted Chevron's revenue and profitability. Despite robust operational performance, quarterly earnings fell short of analysts' expectations, which dampened investor sentiment.

The petroleum industry's operations and profitability hinge on various factors, with prices determined by the supply-demand dynamic for crude oil, natural gas, liquified natural gas (LNG), petroleum products and petrochemicals. OPEC, the Organization of the Petroleum Exporting Countries, is a coalition of major oil-producing nations that coordinates oil production and stabilizes prices.

OPEC+ is an expanded alliance that includes OPEC in addition to other non-OPEC members—most notably Russia. By adjusting input, these two groups aim to stabilize prices and safeguard the interests of member countries. OPEC+ oil producers recently agreed to voluntary cut oil production totaling about 2.2 million barrels per day (bpd) for early 2024, and these cuts could be extended if needed. The impact of these cuts could lead to potential price hikes which could favorably affect Chevron's future revenue.

In a bold strategic move, Chevron acquired PDC Energy and proposed an acquisition of Hess Corporation. Despite investor apprehension, the consolidation of the oil and gas industry is seen as positive by Tufton. Furthermore, heightened global economic concerns, including rising inflation and potential recession risks, might have caused investors to shy away from oil stocks, redirecting their attention towards alternative energy companies. The last time energy stocks faced such skepticism was in 2020, and those who invested during that time reaped rewards.

Chevron's announcement in October 2023 regarding the acquisition of Hess Corporation (ticker: HES) in a $53 billion all-stock transaction is expected to conclude in the first quarter of 2024. CEO Mike Wirth of Chevron underscores the significance of this strategic move, emphasizing its importance not only for the company but also for American energy, job creation and energy security. The addition of Hess brings valuable assets into Chevron's portfolio, notably in the Stabroek block in Guyana, showcasing

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Investors Beware: The Pitfalls of Mutual Funds

Rick Rubin, CFA
Portfolio Manager

For their affluent clients, many financial advisors build a book of business using mutual funds. Is it because funds have favorable characteristics and offer stronger investment returns? Absolutely not. Mutual funds have many drawbacks!! First, they limit an advisor's ability to customize a portfolio and effectively manage risk. Second, they add an additional layer of fees, which reduces an investor's returns. Third, they are inefficient for investors who want to manage their tax bill. Small retail investors have few options and mutual funds may make sense for them. Fortunately, our clients enjoy a customized approach to managing their money. We invest in a diversified portfolio of individual stocks and bonds to meet our clients' goals.

Often, advisors put clients into mutual funds because of the lack of robust in-house research or to free up the advisors' time to attract new business. While funds offer investors instant diversification, it's a one-size-fits-all approach. A fund manager's objective may be quite different from that of the investor. For example, a manager's compensation may be linked to outperforming a benchmark with no consideration for the level of risk taken, the amount of taxes passed on to investors, earned income or growth of income. Also, a fund's objective can change over time, as can the manager, which leads to greater portfolio turnover. This cycle can be unsatisfactory for the client's bottom line.

We believe limited transparency of mutual funds is problematic. Most investors don't know what stocks they are holding in the fund, and many funds only disclose their holdings quarterly. A mutual fund may consist of fifty or more stocks. Imagine tracking a portfolio made up of ten or more mutual funds. An investor's portfolio may be holding 500 or more stocks! Diversification is a good thing, but over-diversification not so much.

At Tufton Capital, risk management is one of the keys to our process. Our clients can see what they are holding at any time, and we can readily identify a portfolio's risks and sector positioning. While we are not traders, our disciplined approach allows us to take advantage of intraday volatility in stocks that we want to purchase on weakness or to sell into strength. Also, we can quickly reduce portfolio risk and raise cash on short notice. This may not appear to be a big advantage, but mutual fund investors can only execute transactions at the fund's closing price at the end of the trading day. An investor is beholden to the fund manager and may miss an opportunity to profit from large intraday price spikes (e.g., selling a stock into strength on buyout chatter). Often a rumor is just that, and the mutual fund investor can miss the profit potential.

We have a flexible approach which helps us meet our clients' needs. For example, a client may need to withdraw $50,000 of cash in six months but wants to keep the portfolio fully invested until then. We can simply handle the client's request by buying a bond that matures in six months. Meanwhile, an advisor that uses bond mutual funds to raise cash will expose an investor to the risk of rising rates. Alternatively, an advisor may be forced to sell an equity fund during a period of declining prices. Neither of these alternatives is ideal.

Over the long term, a majority of actively managed funds fail to match the returns of passive benchmarks. Many funds charge an annual fee of 1% or more. It's hard for investors to know how much they pay since the fees are embedded within the funds. On top of that, financial advisors often charge at least 1% for their services, so the all-in cost can exceed 2% each year. High fees can significantly impact results, particularly over long time periods.

Mutual funds don't help investors who want to manage their capital gains taxes. A fund is required to distribute capital gains annually. An investor may get stuck with large capital gain distributions even though he or she didn't sell the fund. Why? One reason may be that another investor decided to redeem the fund, and an existing holder got stuck with the tax liability. It's a structural flaw of mutual funds, which is exacerbated during times of market stress such as the 2008 financial crisis and the coronavirus pandemic.

If you are concerned about your outside mutual funds or accounts, we are happy to perform a complimentary portfolio review. Our firm's careful and disciplined approach can help you meet your financial goals. ■

A Comparison: Tufton Capital (TC) vs. Mutual Funds (MF)

	Expected Outcomes		
	Favorable	Reasonable	Unfavorable
Investment Management			
Offers Diversification	TC/MF		
Customizable Client Reporting	TC	MF	
Identify/Manage Risk	TC	MF	
Manage Legacy Portfolios	TC		MF
Transparency of Holdings	TC		MF
Control Portfolio Turnover	TC		MF
Investment Fees			
Fee Transparency	TC		MF
Avoid Conflict of Interest Due to Fees	TC		MF
Tax Management			
Project Capital Gains	TC		MF
Manage Portfolio Taxes	TC		MF
Tax Impact Due to Other Investors	TC		MF

Please Note: We are comparing Tufton Capital's (TC) customized approach of investing in individual stocks and bonds compared to basic characteristics of actively managed mutual funds. We are not making representation of any specific TC client or any specific outside mutual funds. This is for general discussion purposes only.

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present a material global crisis in 2024. The question was posed to 1,490 leaders from around the world. Coming in at number one, reflecting a 66% response rate, was extreme weather. Number two, cited by 53% of the participants, was artificial intelligence (AI) misinformation/disinformation, providing cold comfort with our presidential election just eleven months away. The number three threat with a 46% response rate was societal/political polarization, while the cost-of-living crisis was not far behind at 42%. Year-over-year inflation peaked at 9% in June 2022, and although the final push to 2% may be a struggle, the Fed has made meaningful progress. Conviction in reaching the 2% inflation target and taking the necessary steps to get over the hump may determine the difference between a soft economic landing and recession.

We at Tufton remain committed to investing in companies with good value and strong fundamentals. We realize that short-term volatility can be uncomfortable, but we are typically rewarded for the risk over the long term. Through diversification and asset allocation, we ensure that your portfolio reflects your risk tolerance and investment time horizon. ■

Chevron....continued from page 5.

one of the most significant oil discoveries in the past decade. With estimated recoverable resources surpassing 9 billion barrels of oil equivalent, Chevron will also gain access to acreage in both the DJ Basin and the Permian Basin, strategically positioning the company for future growth. Despite the potential for share dilution, Chevron's steadfast share buybacks serve as a reassuring countermeasure. Our internal calculations indicate positive developments in Chevron's proved reserves and daily production numbers.

Acknowledging the challenges of 2023, we believe Chevron's fundamental principles remain intact. The company delivers an annual dividend of $6.04, or a 4% yield, surpassing the S&P 500's approximately 1.5% yield. Recent strategic moves, such as the closure of PDC Energy and the impending addition of Hess, contribute to the company's consolidation efforts in the upstream sector, leading to a growth in daily production, the expansion of proved reserves and the acquisition of valuable assets. Chevron's adept management of elevated oil prices has facilitated debt reduction, and with disciplined capital practices, the company continues to improve its liquidity and solvency ratios. This improves its operational efficiency and enables increased cash flow for reinvestment.

While Wall Street holds a pessimistic view on the longevity of oil, Tufton believes that its lifespan surpasses current expectations. Our optimism is anchored in Chevron's commitment to reducing its operational carbon footprint, a move that could potentially enhance oil's long-term competitive edge. The company's investments in carbon capture and hydrogen initiatives open doors to potential revenue streams, whether through service fees or technology licensing, which could offset operational costs. In contrast to Wall Street's sentiment, we express confidence in Chevron's future trajectory. ■

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