TUFTON CAPITAL
MANAGEMENT

Viewpoint

SPRING 2024

In a market that can be difficult to anticipate, there's a simple pleasure to seeing spring arrive right on time. And if the early April showers outside our office are any indication, it would seem that May is planning to make a colorful entrance, indeed.

Of course, encouraging though the view from our window may be, rest assured that your team of investment professionals remains focused on an entirely *different* landscape. In the first three months of 2024, as the Fed mulled over lowering rates and forecasters fretted over policy, the S&P 500 rose by roughly 10%, while the Dow Jones Industrial Average rose by over 5%. Together, these indices contributed to the best first quarter for American equities in five years, leading to record highs across the board.

To some, these gains signal clear skies—and good times—ahead. In a recent poll survey of C-suite sentiment, JP Morgan Chase found that over three quarters of executives expect the good times to keep on going! On Wall Street, where marquee brands like Reddit and Birkenstock have confidently stepped out into the public markets, the feeling appears to be mutual. As a well-known investment strategist pithily put it in a March presentation to clients: "It feels like...it's going to get growthier."

But as the equity markets continue their climb, some participants are less inclined to believe that hope and growth spring eternal. Nor are their fears without warrant. Casting aside the financial media's more frivolous concerns, the case for treading thoughtfully in the days ahead remains strong. Given the historically low levels of volatility that attended to this quarter's growth, we believe that large swaths of investment capital remain stuck on the sidelines, still waiting for the dust to settle around American policy. And as both physicists and economists will attest, the more pent-up energy a system contains, the more cause to handle it with care.

I'm pleased to report that your Tufton Capital advisors are handling the trust you have placed in us with the utmost of care. Since 1995, our firm has favored principled investing over economic forecasting, with the intent of protecting and growing client capital *regardless* of broader market conditions. Historically, we believe this "all-weather" approach has kept our clients in good stead. As the May flowers begin to bloom, in a period of prolonged uncertainty, we expect it to do more of the same.

In the pages ahead, you'll find a brief overview of our current market thoughts, including a timely discussion of one of our firm's top holdings, Amazon.com (AMZN). Should you wish to discuss these or any other matters related to your portfolio, we sincerely hope you won't hesitate to pick up the phone and give us a call. We remain at your service and look forward to continuing to provide you, our valued client, with the level of attention, insight and performance you have come to expect—no matter what comes next around the bend.

Chad Meyer, CFA
President

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The First Quarter of 2024: Head Fake

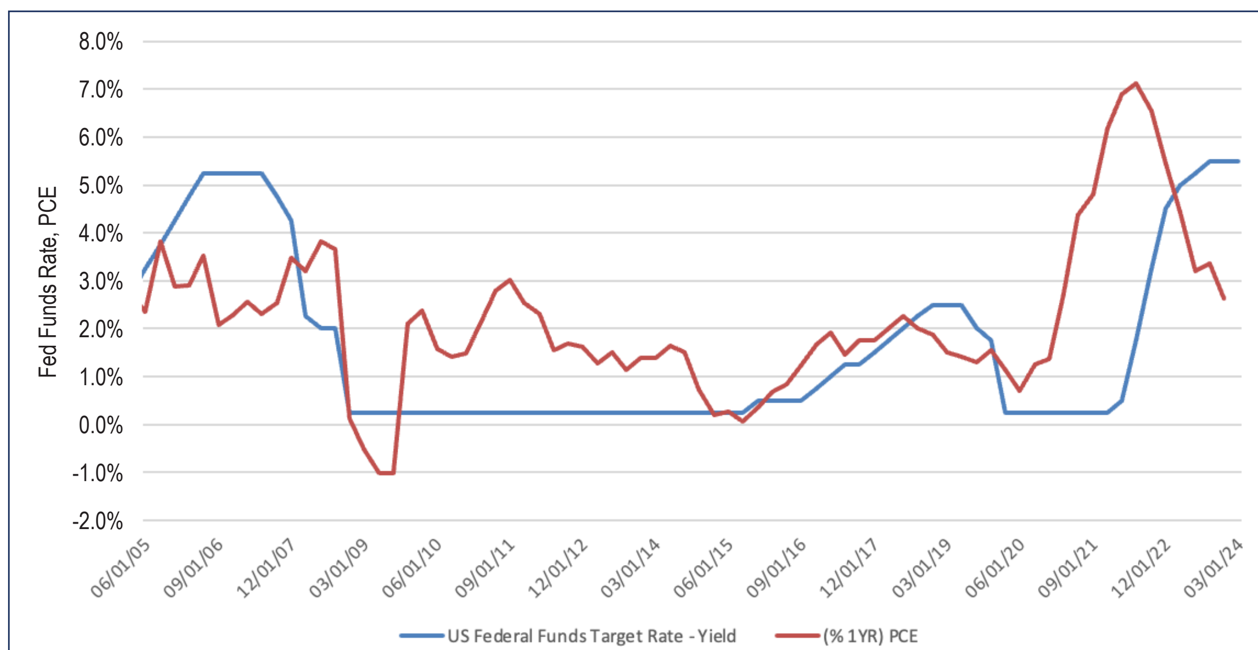
Eric Schopf
Director of Research/ Partner

Strong fourth quarter momentum carried through to the first quarter resulting in robust gains for the stock market. The Standard & Poor's 500 delivered a total return of 10.56%, and unlike last year, price appreciation was more widespread. Five of the eleven index sectors outperformed the broad index and only one sector, real estate, posted a negative total return. The stock market stood in sharp contrast to the bond market. Interest rates moved higher across the yield curve and bond prices fell. The S&P U.S. Aggregate Bond index, an index that measures the investment grade U.S. fixed income market including U.S. treasuries, quasi-governments, corporates, covered bonds and residential mortgage pass-throughs, posted a total return of -0.56%. The benchmark 10-year U.S. Treasury yield climbed from 3.9% to 4.3%.

The poor bond market performance comes as no surprise. The gap between market expectations and Federal Reserve projections communicated through their dot plot chart grew too wide. At year end, the Fed was signaling for three interest rate cuts in 2024 while investors through the futures markets were pricing in six interest rate cuts. Economic data released during the quarter bolstered the Fed's decision to defer the initial interest rate cut and added credibility to their three-cut forecast. The timing of the three cuts is also a moving target. The consumer price index (CPI) and personal consumption expenditure (PCE) paint similar pictures of choppy progress. Although inflation continued to moderate, it is proving more difficult to reach the desired 2% Fed-imposed target. Logistics disruptions in the Red Sea and the dislocations that will result from the collapse of the Francis Scott Key Bridge will result in additional cost pressures. Although there is still room for improvement on the inflation front, the wide gap between current inflation levels and the Fed funds interest rate gives the Fed plenty of room to cut rates. Three cuts of a combined

Inflation & The Fed Funds Rate

Inflation is still having difficulty reaching 2%. Will the Fed cut rates?



Source: FactSet

75 basis points (three quarters of one percent) would still be considered somewhat constrictive based on historic spreads between inflation and the interest rate. Lower rates will serve as a catalyst to unleash further growth, and lower financing costs alone would benefit the automobile and housing industries.

The anticipation of lower interest rates has helped propel the stock market higher. The S&P 500 set twenty-two record highs during the quarter. The performance was even more impressive since the expectations for lower interest rates did not materialize. The stock market, however, has been more than a one-trick pony. Corporate earnings are poised to rebound from their slow growth of 2023. Consensus growth estimates for 2024 are now at 10.5%, and estimates for 2025 and 2026 are even more impressive at 13.3% and 12.8%, respectively. Underpinning the earnings growth estimates is a resilient economy which describes an economy that has withstood a 5.25% increase in interest rates without sliding into recession.

Real fourth quarter gross domestic product (GDP) growth was 3.4%, exceeding the advanced estimates of 3.2%. The "real" figure considers inflation, which makes the number even more impressive. The quarter decelerated from 4.9% growth in the third quarter but contributed to a growth rate of 2.5% for the year. The employment situation reflects the economy. The unemployment rate stands at 3.9%, with March marking the twenty-fifth consecutive month with an unemployment rate being below 4%. The economic landscape remains favorable. Fiscal policies, including reshoring initiatives to relocate manufacturing and production operations, should continue to create jobs.

Although the outlook leaves us sanguine, we are mindful of potential bumps in the road. Stock valuations are one area of concern. Projected earnings growth for the year has already been met by stock market returns. Further price gains will require even higher earnings, lower interest rates or an expansion of

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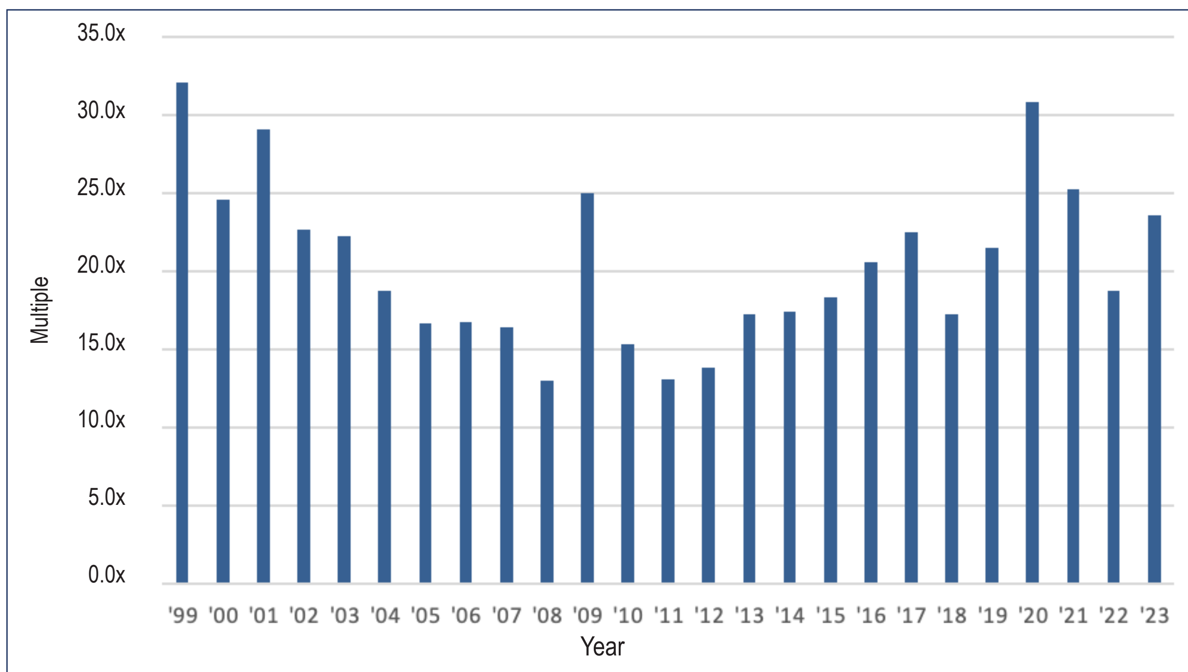
S&P Price/Earnings Valuation



Source: FactSet

First Quarter... Continued from page 3.

valuation multiples. We use various valuation metrics when valuing stocks. A widely used measure is the price/earnings ratio, which reflects how much we need to pay for $1 of earnings. The higher the figure, the more expensive the asset. The market is at the high end of historic valuation multiples, so multiple expansion may be difficult to achieve. Lower interest rates are almost certain given the Fed's rhetoric. Fewer than three rate cuts given the current level of inflation would be a head fake worthy of college basketball's March Madness. Corporate earnings could exceed expectations due to continued economic strength, while lower interest rates could spur economic activity, resulting in even greater earnings growth.

Another concern is the U.S. consumer. Of the four components (consumption, business investment, government spending and net exports) that constitute gross domestic product (GDP), consumer consumption was the clear star with a growth rate of 2.8%. Low unemployment rates provide the capacity for spending, and total personal debt levels are low in some part due to student loan forgiveness. More and more of consumer spending, however, is being covered by credit cards. Total household credit card loan growth was 15.2% in the fourth quarter, on top of the 14.5% growth in the third quarter. Delinquency rates hit 8.5%, which is 1.6% higher than pre-pandemic levels. High variable rates make credit card debt particularly onerous, and many consumers are beginning to buckle under the strain. Auto loan performance is showing a similar trend. Consumption typically makes up almost 70% of our economy, so any slowdown will have negative effects.

A third cause for unease is the debt level of the U.S. government. Policies passed during President Biden's term include the American Rescue Act, the Infrastructure Investment and Jobs Act, the CHIPS and Science Act and the Inflation Reduction Act. The various plans include investments geared toward improving and strengthening our economy. Like any

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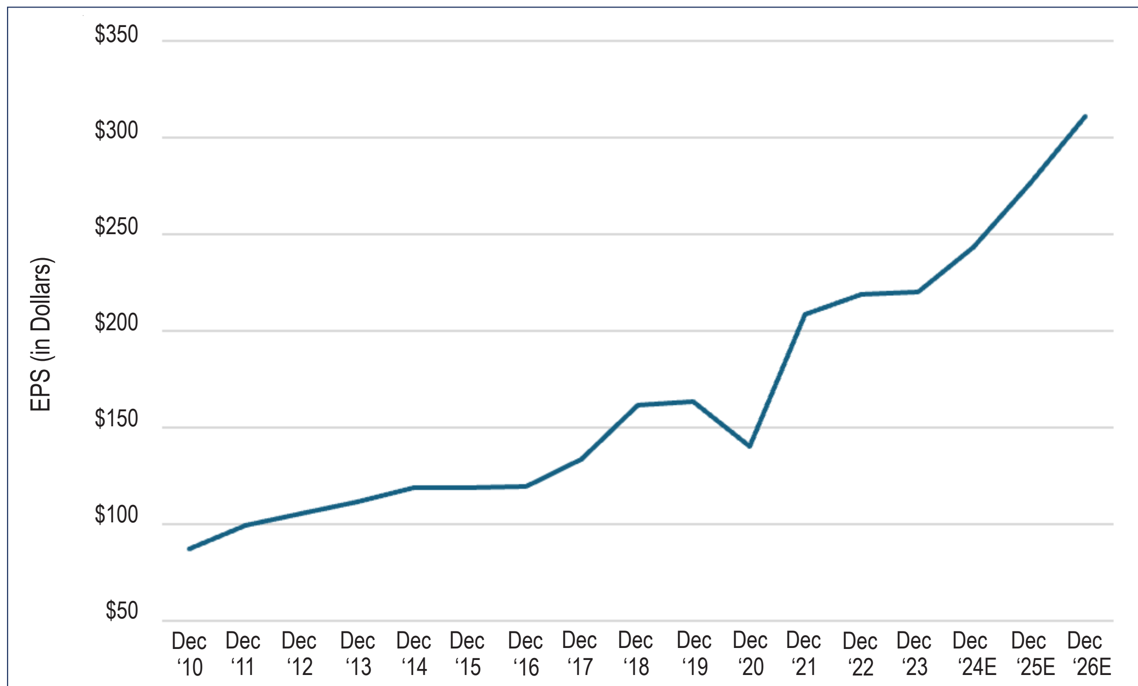
S&P 500 Historical and Projected Earnings (EPS)



Source: FactSet

Company Update: Amazon.com (Ticker: AMZN)

J. Scott Murphy
Portfolio Manager/Partner

Amazon.com (AMZN), a broadly owned stock in our core portfolios, was recently anointed as the newest member of the Dow Jones Industrial Average (DJIA). As one of the largest publicly traded companies, one could argue this was long overdue. The S&P Dow Jones indices, which manages this thirty-stock benchmark, said the changes were prompted by Walmart's (WMT) 3-for-1 stock split, which became effective on February 26, 2024. Amazon replaced Walgreens Boot Alliance (WBA) as one of the thirty stocks in the index.

The evolving nature of the U.S. economy and the weighting of the Dow Jones Index explain this change. Unlike the S&P 500 and the Nasdaq Composite, the blue-chip index is weighted by share price, not by market capitalization. Walmart's 3-for-1 split reduced its effect on the index due to its stock price falling from $180 to $60, and thus decreased its overall weighting in the index. The Dow is calculated by adding the prices of the thirty stocks and dividing them by a factor that accounts for changes such as stock splits and index entrants. This means that a company with a higher share price has a greater effect on the index moves, regardless of its total market value. Given Amazon's current share price of $180, its influence on the index will be much higher than Walgreens' $20 share price.

In addition to keeping the consumer sector's representation in the DJIA at an appropriate level, the Committee also looks for companies with an excellent reputation, sustained growth and a high level of interest from investors. Inferred but not stated is the simple fact that the Dow has lagged behind the S&P 500 and Nasdaq in recent years because it is less oriented toward technology stocks. The blue-chip index has climbed about 50% over the past five years, while the S&P 500 has surged more than 75%, and the tech-heavy Nasdaq has more than doubled. The underlying beauty of the addition of Amazon is that the index gets greater representation in the consumer sector because Amazon is one of the world's largest retailers. The DJIA also gets a nod in the technology space due to

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Amazon.com (Ticker: AMZN)

Source: FactSet

Everyone Loves a Trophy

Alex Olshanskiy
Investment Analyst

Automatic Data Processing, J.P. Morgan and Microsoft share a common trait. All three are trophy companies. In the intricate art of constructing an equity portfolio, Tufton Capital categorizes companies into three distinct groups: trophy, economically sensitive and special opportunities. Among these, trophy companies occupy a special pedestal, serving as the bedrock of stability and long-term growth potential. With its established market dominance, proven profitability and enduring management excellence, trophy companies stand as the cornerstone of strategic investment portfolios. An exploration of the essence of a trophy company provides our clients with an insight into the advantages of these companies in a diversified portfolio. These investments offer the potential for capital appreciation while reducing downside risk.

Growth in earnings: Warren Buffett's timeless wisdom, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price," reinforces our emphasis on owning companies that exhibit growth in earnings. A company's ability to generate profits consistently and increase earnings often translates into higher shareholder value. As earnings grow, companies may distribute dividends to shareholders or reinvest profits into further growth initiatives, both of which can enhance shareholder returns.

Quality Management: A proven and stable management team is indicative of a company's ability to navigate challenges and to capitalize on opportunities for growth. In our analysis, we look for companies with visionary leaders who prioritize long-term value creation over short-term gains. This emphasis on quality management is reflected in our commitment to identifying trophy companies that demonstrate leadership continuity and a track record of strategic decision-making. We seek out companies that consistently demonstrate a high return on capital employed (ROCE). This metric serves as a gauge of how effectively a company generates profit from its operational investments, reflecting its efficiency and profitability. Measuring a management team quantitatively is more useful than measuring it qualitatively. No management team will openly admit that they don't care for the customer, that they have stopped innovating or that they hire unqualified individuals. Have you ever heard a company leader criticize their products or services, admit their competition is doing a better job or that they are tired of company politics? On a qualitative basis, most management teams are very persuasive. The president of Enron, Jeffrey Skilling, and his senior management team during the launch of Enron Broadband in 2000 were poised, confident and you could even say competent. However, less than two years later, Enron filed for bankruptcy, and in 2006, Skilling was sent to prison. We find that a quantitative measurement of ROCE provides a good yardstick to measure management's success. Think of the top running back, or fastest marathoner, greatest baseball hitter or fastest swimmer. We don't rate their abilities based on their interviews or their confidence, we rate them based on their results. Similarly, we value management's efforts to reduce debt, allocate capital wisely, properly manage the buyback of shares and encourage ownership of company stock by the management team. However, no matter how brilliant management might be, it is not the sole criterion.

Balance Sheet Quality: The goal of *all* beings is to survive for as long as possible. They can make errors that fall into two broad categories: they do things that they are not supposed to (type 1, error of commission) and/or they don't do things they are supposed to (type 2, error of omission). At Tufton, we try our best to avoid big risks and to refrain from investments in

which the probability of *losing* money is higher than the probability of *making* money. We tend to think about risk first, and then return. One of the ways that we can reduce a type 1 error is by being great rejectors. We want the companies we invest in to survive since they are long-term investments. We certainly don't want the company to go bankrupt. Bad things happen to businesses at remarkably regular intervals, and therefore, we try to pick trophy companies with manageable levels of debt. A higher credit rating also gives us comfort. A company that strives to minimize debt to maximize the safety of capital lets us know that this company aspires to trophy company status. Warren Buffett famously remarked, "You only find out who is swimming naked when the tide goes out," highlighting the perils of excessive leverage. Therefore, a strong balance sheet with moderate debt levels provides a buffer against unforeseen challenges and enhances the resilience of the business.

High Margins: A trophy company is also one that demonstrates a consistent track record of profitability and efficiency. One way to measure this is by assessing a company's gross profit margin, which measures the percentage of revenue that remains after subtracting the cost of goods sold. An ability to maintain high margins can translate into a sustainable competitive advantage (also known as a moat). Ultimately, high margins provide a window into a company's financial health, including its profitability, competitive edge, resilience to market fluctuations and its ability to invest in growth opportunities.

Market Leaders: A market leader is a company that has a large market share resulting from a combination of metrics. The business also sells a product or service that is needed or desired. Moreover, indicators such as distinctive product offerings, robust brand loyalty, streamlined operations and proprietary technology

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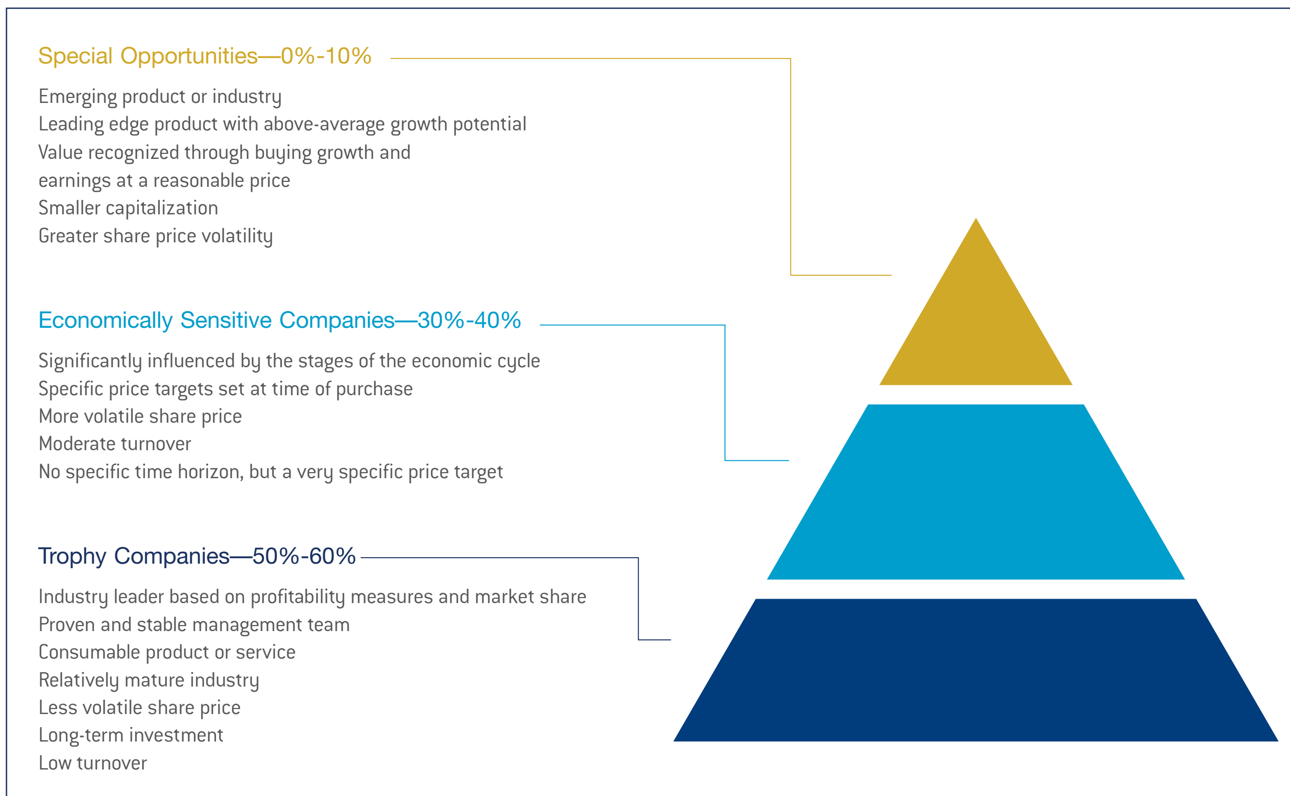
Tufton's Equity Portfolio Construction



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investment, we expect a payoff. The outcomes will be years away, and we are unsure of their successes. In the short term, we know what the cost is as measured by the interest expense associated with financing the projects. Like consumers, the federal government is being squeezed by higher interest rates. Lower interest rates will help, but more important are the rates of return on the spending. GDP growth that is lower than the cost of capital will impact future budgets as greater outlays will be required for interest coverage. With $34 trillion of debt outstanding collateralized by a $27.4 trillion dollar economy, it is important that we see a good payoff.

Our team at Tufton Capital Management devotes its time and resources to monitoring and deciphering the economy and financial markets. Although circumstance change, our goal remains unchanged in delivering a good payoff for an acceptable level of risk. ■

Amazon....continued from page 5.

Amazon's role in cloud computing through its AWS segment, which is an industry leader in helping companies manage and store their data through its industry-leading web hosting business.

Whether this inclusion going forward in the Dow Jones index will improve Amazon's stock price is open for debate, and only time will tell. It does, however, give Amazon additional support as a member of the three preeminent indices—the Dow, Nasdaq and the S&P 500—that investors use daily to access the overall health of the market. Amazon will be one of only a handful of stocks in all three, and if it continues to outflank its competitors in both the retail and cloud space, which we believe it will, the addition will turn out to be a solid choice going forward, and a must-have holding in a diversified portfolio. ■

Trophy....continued from page 7.

can also signal market leadership. A company that continues to increase its market share might be building a moat—a defensible competitive advantage that is very valuable. Just like a medieval castle, the moat serves to protect those inside the fortress and their riches from outsiders.

Trophy companies form the foundation of portfolio construction at Tufton. By emphasizing growth in earnings, quality management, balance sheet strength, high margins and market leadership, we can clearly identify and incorporate trophy companies into a diversified portfolio. ■

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