January 4, 2024

Dear Client,

Re: **<u>January Conference Call on Tuesday, January 16, 2024 at 6:30 PM</u>**

Looking back and analyzing the events that took place in 2023, I was amazed as I was with the events that happened in 2022. History provides a learning perspective that when ignored can have terrible consequences for one's financial well-being or provides a fertile investment environment. In this special report, I would like to review the fundamentals that drive my investment decisions, review the course of events in 2022 and 2023, and finally, lay out a game plan for 2024.

Since the start of my investing career in 1977, I have seen fortunes made and lost. I have seen this from the perspective of a professional investment manager, and I have seen this occur by some of my friends. The markets can be tricky and a fool's paradise if not careful. The point being that stock selection is a process and discipline and if adhered to, it will lead to success. It is when you abandon that process or structure that an investor is led down the wrong path.

At the very beginning of my career in finance, I had the fortunate luck to read Benjamin Graham's *Intelligent Investor.* Just as Warren Buffett wrote in Appendix A of that very famous book, "you either get it or you don't, you don't slowly convert to be a value investor." I immediately received the message, and it made clear sense to me and still does, even considering all the degrees and education that I have. Graham's books, *The Intelligent Investor* and *Security Analysis (4th edition)* are my investing bibles. Although Graham died in 1973, his basic investment philosophy still holds true today and that is, sound businesses will produce sound results over time and the outcome of the stock and bond will depend on the price an investor pays for it. Buffett calls this the "cigar butt" approach in which an investor buys a dollar worth of assets for fifty cents. I would argue not many people are better investors than Charlie Munger or Warren Buffett.

I have been teaching Security Analysis at UCLA in the same manner as Benjamin Graham did when he was at first at Columbia University from 1934 to 1956 and then at UCLA from 1956-1965. As far as I know I am the only Professor who teaches Security Analysis in the manner that Graham did at UCLA or anywhere else, except Columbia University. When I was a visiting scholar at UCLA (1994-1998), I studied investing under uncertainty which was taught to me by Professor Moshe Rubinstein. I took Graham's principles mixing it with Rubinstein's theories of uncertainty and that has provided the sound basis for security selection that I employ today.

One of the downsides of value investing, the way I practice it, is that results come in lumps. There are rarely even returns. Some years, the returns are better than others and occasionally, there will be a losing year, like 2022. Although as painful as 2022 was for all of us, including me, it was a lot less painful than for others, especially those speculators who were top heavy in the FANG stocks (Facebook, Amazon, Netflix, and Google.) Stocks like Zoom and Teladoc, two market darlings, were down 70% or more at some point in 2022. To me, investing in those stocks is like gambling, not because many are not good companies, but because you must pay too high a price for a stream of future earnings. If something goes wrong and the earnings don't meet expectations, Wall Street takes and shoots the stock, and it declines. Stock picking isn't an exact science, but a combination of intuition, smarts, knowledge, and art. Just because someone on Yahoo Finance, CNBC or some other media outlet says a stock is a buy, it may not be. Look at all those stock jockeys saying that investors should buy Enron right before it collapsed or mortgage-backed securities before they imploded in 2008. Unless a security can stand on its own merits, be reasonable or cheap in price, I won't buy it. This is why I did not buy most of the Magnificent Seven stocks (Apple, Microsoft, Alphabet, Nvidia, Meta, Tesla, Amazon). However, we did buy Microsoft last spring. Simply put, I look at the fundamentals and price and they both must line up before I buy them.

I suppose I could abandon the approach I trust and know so well for an approach that I do not understand but could give me better short-term results. However, I think I would be adding a larger element of risk into the portfolios, and it may worsen any long-term performance. For example, the ARK investment funds suffered a 23.5% loss in 2021, followed by an even more severe 66.9% drop in 2022. It is up approximately 47% year-to-date. If my math serves me correctly, then ARK Funds are still less than they were in 2021. Yes, they are sexy and have lots of AI hope and bitcoin related strategies, but in the long run, do these types of funds outperform when one considers the volatility and risk? To be honest, I could not sleep at night with the ARK kind of volatility and risk, and knowing many of you the way I do, you couldn't either.

Looking back, in hindsight, it was clear that 2023 was a solid year for financial assets despite all the problems. In late 2022 and early 2023, the picture was very cloudy. Interest rates had gone up from 0% to 5% in six months, usually a death knell for stocks and until this past summer, it was. Then we had the ongoing war in Ukraine and three major bank collapses, First Republic, Signature and Silicon Valley Bank. I said last fall that anytime interest rates go from 0 to 5%, a financial accident was bound to happen, and it did. Higher rates pressured bank balance sheets and commercial real estate was decimated for the most part. Now we have trouble brewing in the Middle East and China is flexing its muscles towards Taiwan. To me, that was a sign to be cautious and we were. However, looking back, we most likely were too cautious. I said on our Thursday morning calls, "if I make a mistake this year, it would be by being too cautious." I reasoned if I could get anywhere from 5.5% to 6.0% on a less risky bond, why not do that instead, considering that the long term 20-year average of the S&P 500 ending September 2023 is 9.66%.[1] And, unless you have the stomach for gut wrenching ups and downs, then a 100% stock portfolio would not be warranted. In the last 30 years, a 60% stock-40% bond portfolio returned 7.99%.[2] In my opinion, a diversified portfolio that consists of stocks, bonds, and gold is a less risky way to invest.

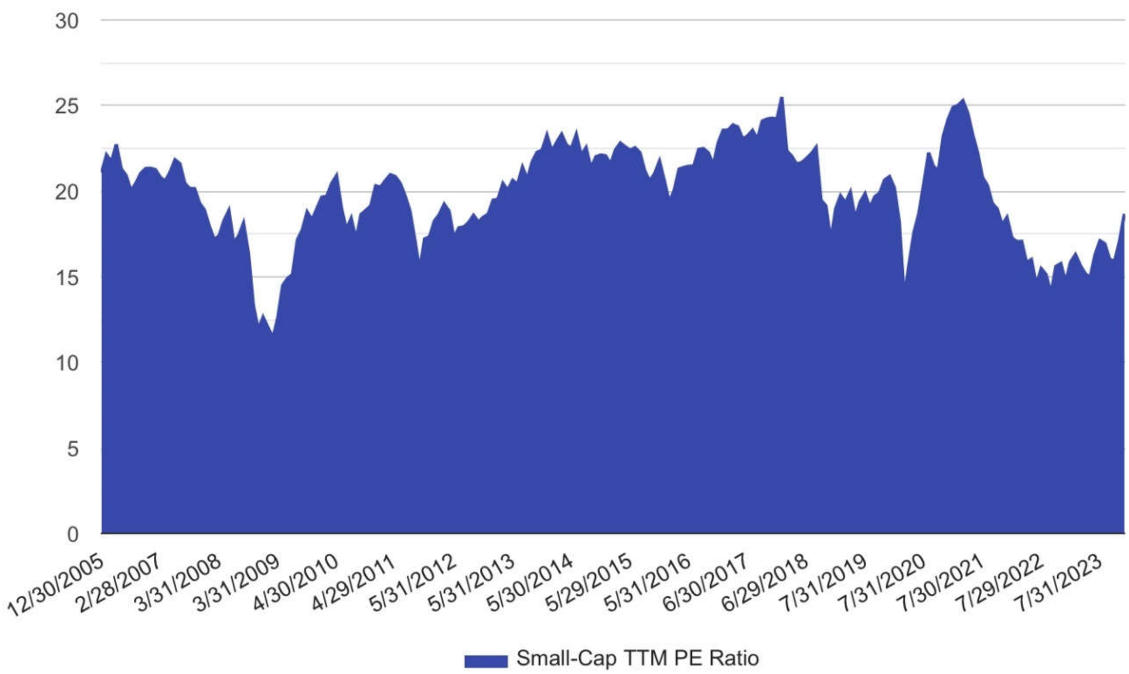
For 2024, I believe that market expectations are overly optimistic. In December, the market is pricing in expectations that inflation will be back at the Fed preferred level of 2%[3] and S&P earnings will grow 11%[4]. Valuations remain stretched and are not compelling in my opinion, especially when compared against interest rates.

The economy is more fragile than what the market believes when one considers business conditions are deteriorating with non-farm payrolls, housing starts and consumer spending slowing. Additionally, the fastest rate hikes since the 1980's are beginning to bite just as the media hypes up a soft landing. Households, real estate, companies and others are feeling the effects of the most aggressive tightening of interest rates since Paul Volcker was Chairman of the Federal Reserve in the 80's. Distress is showing up in auto loans and credit cards, not to mention the higher interest payments that the U.S. Government has to pay on its massive $34 trillion in debt. We can even expect some municipalities to default on their bonds, so careful selection of these issues is in order. To me, that sounds like a pipe dream especially if the economy is slowing down due to the bite in interest rates. And, if you add the Artificial Intelligence (AI) hype, which in large part drove the US stock market in 2023 and geopolitical concerns, this again gives me reason to be cautious.

To get inflation down to 2%, a recession likely would need to occur. It is worthy to note that economists have been forecasting a recession for the past two years and it has never happened. However, it is also true that the Federal Reserve has rarely pulled off a soft landing.

In the long term, there is no doubt that AI will be a game changer, but the pricing of such stocks is reminiscent of the 1999 tech-dot com bubble. Again, it comes down to price and value, something I am always carefully watching. As a result, I am continuing to favor bonds over stocks although we have purchased a few new stocks in the past several days and may purchase a few more in the new year. No doubt in my mind that valuations are stretched (See Charts 1, 2, and 3), and it is difficult to find high quality value. That is not to say that markets can't go up when valuations are high, but it also means that markets can be vulnerable. When one considers that in Chart 3, the megacap stocks are cheaper 88.2% of the time, you can see why I am being cautious. Chart 2 shows that U.S. Stocks have traded cheaper 60% of the time.

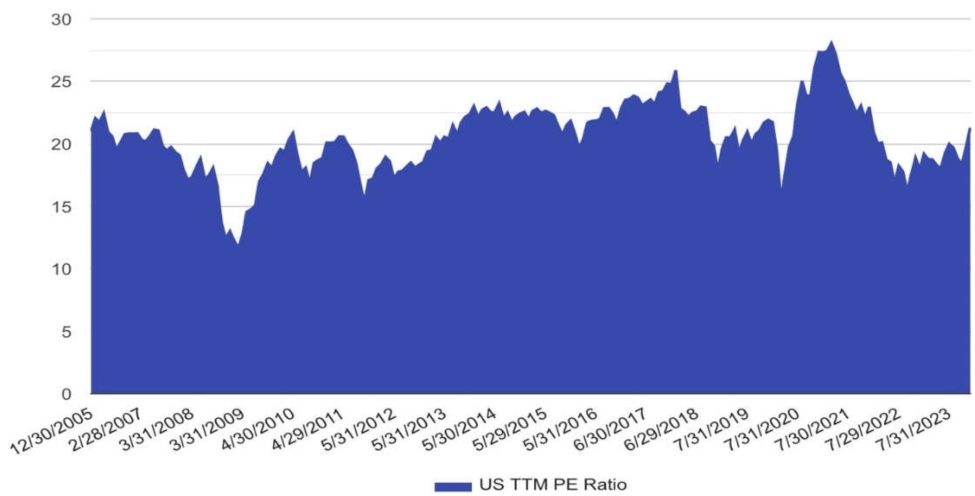
Chart 1: Small Cap Stocks Undervalued by approximately 5%



Current Small-Cap TTM PE Ratio: **18.69**
Average Small-Cap TTM PE Ratio: **19.78**
Over (Under) Valuation: **-5.5%**
Historical High Small-Cap TTM PE Ratio: **26.94 - 2/12/2021**
Historical Low Small-Cap TTM PE Ratio: **10.01 - 11/20/2008**
Percentage of Time Small-Cap Stocks Have Been Cheaper: **32.5%**

Source: Validea

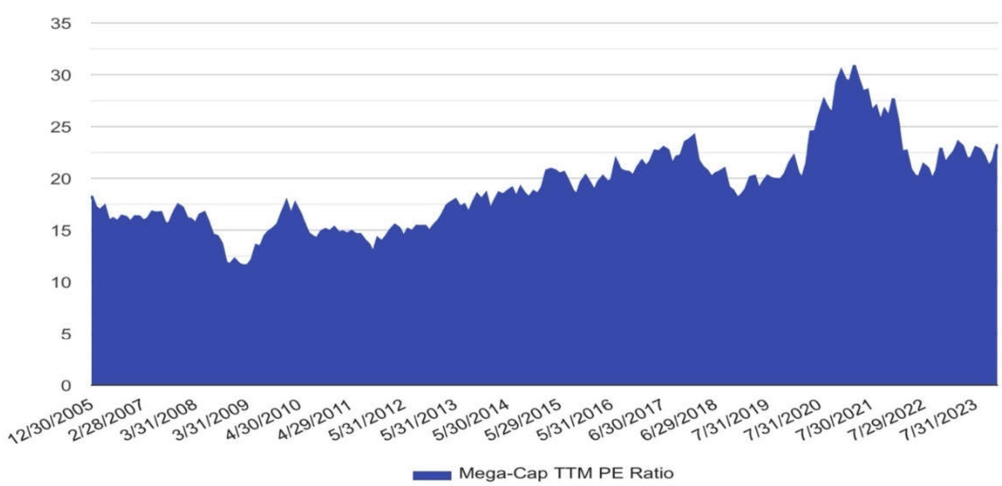
Chart 2: US Stocks Overvalued by 4.2%



Current US TTM PE Ratio: **21.31**
Average US TTM PE Ratio: **20.45**
Over (Under) Valuation: **4.2%**
Historical High US TTM PE Ratio: **28.84 - 1/12/2021**
Historical Low US TTM PE Ratio: **10.49 - 11/20/2008**
Percentage of Time US Stocks Have Been Cheaper: **60.7%**

Source: Validea

Chart 3: Large Mega Cap Stocks (Including the Magnificent Seven)



Current Mega-Cap TTM PE Ratio: **23.30**
Average Mega-Cap TTM PE Ratio: **19.12**
Over (Under) Valuation: **21.9%**
Historical High Mega-Cap TTM PE Ratio: **31.84 - 4/9/2021**
Historical Low Mega-Cap TTM PE Ratio: **10.73 - 11/20/2008**
Percentage of Time Mega-Cap Stocks Have Been Cheaper: **88.2%**

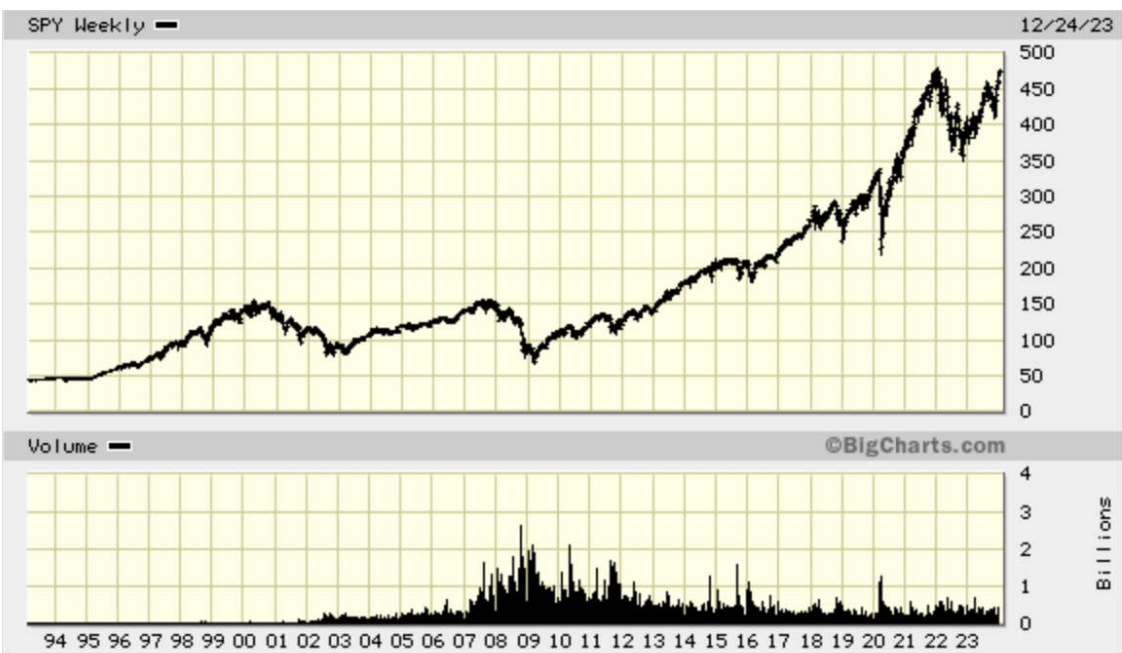
Source: Validea

Let us not forget that overvalued stock markets can go long stretches with little or no return. Chart 4 illustrates the high technology sector which was peaking in 1999. It took 13 years for the technology sector to recover after the dot com bust.

Chart 4: Technology Sector. (1999 - Present)

Source: bigcharts.com

Chart 5: S& P 500 (1999-2023)



Source: bigcharts.com

When the S&P 500 peaked in 2000, it took until 2007 to break even. After the 2008 financial crises, it took a few more years for the S&P 500 to come back to the peak in 1999-2000. For the most part, we had positive returns during those years because we stayed away from overpriced stocks, kept a bond portfolio and were carefully selective. I am hoping you can see why, right or wrong, I was so conservative in 2023.

On Tuesday, January 16, 2024, I will be holding our new year's town hall in which I will be discussing the individual stocks and bonds in the portfolio, why I picked them, what went right and what went wrong. I will also talk about risk and reward and asset allocation, please join us for this very informative meeting.

When: Tuesday, January 16th, at 6:30 p.m. (PST)
Topic: BFSG Conference Call Hosted By Steven Yamshon

Please click here to join the Conference Call.

Or Telephone: 1 (720) 707-2699
Webinar ID: 955 8799 7509
Passcode: 388235

International numbers available: click here

I want to take this time to wish you all a happy new year and thank you for your patience and confidence in me and our team.

Steve Yamshon PhD
Managing Principal

1. Source: Standard & Poor's. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market. Data from January 1, 2003, to September 30, 2023.
2. Source: Bloomberg, Standard & Poor's. The 60/40 portfolio is 60% invested in S&P 500 Total Return Index and 40% invested in Bloomberg U.S. Aggregate Total Return Index. The portfolio is rebalanced annually. Data from January 1, 1993, to September 30, 2023.
3. Source: Federalreserve.gov
4. Source: FactSet. 2024 EPS growth consensus estimates.

Remember to advise us if you have not been receiving account statements (at least quarterly) from the account custodian.

Historical performance results for investment indices, benchmarks, and/or categories have been provided for general informational/comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that your BFSG account holdings correspond directly to any comparative indices or categories. **Please Also Note**: (1) performance results do not reflect the impact of taxes; (2) comparative benchmarks/indices may be more or less volatile than your BFSG accounts; and, (3) a description of each comparative benchmark/index is available upon request.