INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES

PRIVATE LESSONS: INVESTING LIKE AN OWNER

Winter 2024

InvestorView

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Dear readers,

We hope that your 2024 is off to a successful start!

First, we would like to thank BBH Partner Suzanne Brenner, who has stepped aside as Co-Chief Investment Officer (CIO) as of January 1, 2024. Suzanne has provided unparalleled leadership of our Investment Research Group (IRG) for the past six years, and we are forever grateful for her partnership and counsel. Suzanne remains a BBH Partner and will continue working with IRG in an advisory role, meeting with clients, and sitting on our investment oversight committee. We are thankful to continue benefiting from her expertise.

In this issue of *InvestorView*, we discuss how to invest with an owner mindset, the positive outlook for bonds in 2024, and explore the benefits of freezing a GRAT in the current market environment. We also review the state of the markets and economy as we head into the new year.

In this issue's feature article, BBH Partner and Chief Investment Strategist Scott Clemons considers three main lessons at the intersection of business ownership and portfolio management, and the shared importance of patience and discipline for investors and business owners alike.

In another article, Justin Reed, BBH Partner and CIO, and Greg Steier, Head of Tax-Exempt Fixed Income, examine recent shifts in the fixed income environment, and why they might mean a more positive outlook for bonds in the new year.

In "When to Freeze a Failing GRAT," BBH Senior Wealth Planners Alison Hutchinson and Stacia Kroetz share why it may be beneficial to "freeze" a current GRAT in today's market environment. We also review key takeaways from a recent conversation between Justin Reed and Scott Clemons on the current economic environment and outlook for the future. Finally, we recap the events of our 2023 Owner to Owner Summit in Nashville.

We hope you enjoy this issue. If you have any questions about the topics covered, please do not hesitate to reach out.

Best regards,

G. Scott Clemons, CFA
Partner
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Partner
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PRIVATE LESSONS: INVESTING LIKE AN OWNER

By G. Scott Clemons
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Chief Investment Strategist

We at Brown Brothers Harriman (BBH) are fortunate to work with private business owners throughout our practice, whether we're lending money, investing private equity, counseling clients on business strategy, advising on estate planning or trust issues, or managing the liquid wealth that business ownership creates.

Private business is not only the history of our firm, it is the history of the American economy: Even today, less than 1% of all companies in the United States are publicly traded. 2024 marks the 206th year of BBH's own existence as a partnership, and we're proud to be part of the 99% of American businesses that are privately owned.

Many of our clients rely on us to invest their financial wealth while they focus on running their businesses. We are reminded repeatedly that managing an operating business and managing a financial portfolio are, at their core, the same exercise. Both involve the careful allocation of capital, which, in turn, requires prudent risk analysis, a careful assessment of value, and a prioritization of competing opportunities.

As investors of financial capital, we have much to learn from our friends and clients who are investing operating capital. Here, we consider the insights that successful private businesses have to offer to the art and science of investing and portfolio management.

Invest for Intrinsic Return

The difference between extrinsic (market-driven) and intrinsic (value-driven) returns can seem nuanced, but savvy investors know and appreciate the distinction. The best investments are those that have an internal engine of value creation. Rather than relying on another buyer to pay a higher price for an asset, the patient and disciplined investor or business manager instead focuses on nurturing the fundamental value of the business to generate long-term growth and cash flow along the way.

A financial investor who depends on the market for her return has no choice but to pay attention to price on a regular basis. Make no mistake – markets are good things. Public markets allow investors to price their portfolios daily, but it is dangerous to place too much meaning on daily market moves, or to make decisions based only on prices.

Private business owners, meanwhile, don't have the distraction of outside shareholders placing a daily price on their business, which allows them to focus solely on enhancing the quality and value of their business. This is the same case with portfolio managers. Rather than give into the temptation of daily pricing, the patient and disciplined portfolio manager spends time, energy and resources understanding the fundamental value of the business, and the growth intrinsic to the business itself.

Furthermore, the private business owner has control, or at least influence, over the value of the business through the management decisions she makes. This doesn't translate directly into the world of public markets: A passive shareholder of a traded stock rarely has a seat at the management table unless she is an activist shareholder. In the portfolio world, the equivalent of control or influence is the assessment of value, and the discipline to buy or sell an asset based on the deviation of price from value.

This is easier said than done. In pursuit of intrinsic business growth, we prefer to invest in securities that afford us a greater than average degree of control over value, usually by providing an essential product or service, earning the loyalty of repeat customers, and enjoying the protection of a strong balance sheet and healthy free cash flow. Businesses with these characteristics are better able to withstand the perils of market and economic volatility. Why make it more difficult? To quote Warren Buffet, the dean of intrinsic value investing, "I don't look to jump over seven-foot bars: I look around for one-foot bars I can step over."

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Rather than give into the temptation of daily pricing, the patient and disciplined portfolio manager spends time, energy, and resources understanding the fundamental value of the business, and the growth intrinsic to the business itself.

This resonates with the family businesses with whom we work. 71% of respondents to the 2023 BBH Private Business Owner Survey indicated that their businesses were mostly or fully recession proof, and 95% reported that their business is at least somewhat recession proof. No business is completely free from the influence of its surroundings, but some have more control over the intrinsic path of success than others.

Price ≠ Value

This isn't to say that price plays no role in decision making in public markets, just that it should play the *right* role. The concept of price has a handful of appealing attributes. Prices are transparent, frequently updated, broadly disseminated, and generally agreed upon. Unfortunately, all these benefits come with one big downside: prices are volatile. Over the last decade, the annual price volatility of the S&P 500 large capitalization index has been 26%, and the prices of individual securities can vary much more widely.

The concept of value has the opposite characteristics. Value is not transparent, analysts often disagree dramatically on the true value of an asset, and it takes work and time to develop a robust estimate of the value of an asset.

Yet unlike price, value is a pretty durable concept. Compared to public equity volatility of 26% over the past decade, the volatility of nominal Gross Domestic Product (GDP) over this same period was only 3%, even accounting for the COVID-19 pandemic. The growth in the value of American businesses over time reflects broad economic growth rather than the price of the S&P 500 index.

This distinction between price and value leads to the observation that there are only two investment strategies in all the world – either a *price anticipation* or *value recognition* approach:

1. The price anticipation approach is far more common. Turn on any financial news show, and someone is recommending that you buy a certain stock before an earnings announcement or a product launch, or sell bonds before the Fed shifts monetary policy, etc. Algorithmic or high-frequency trading approaches fall into this category as well, with quantitative analysis driving the trading decisions rather than fundamental analysis.

There are three challenges with this approach:

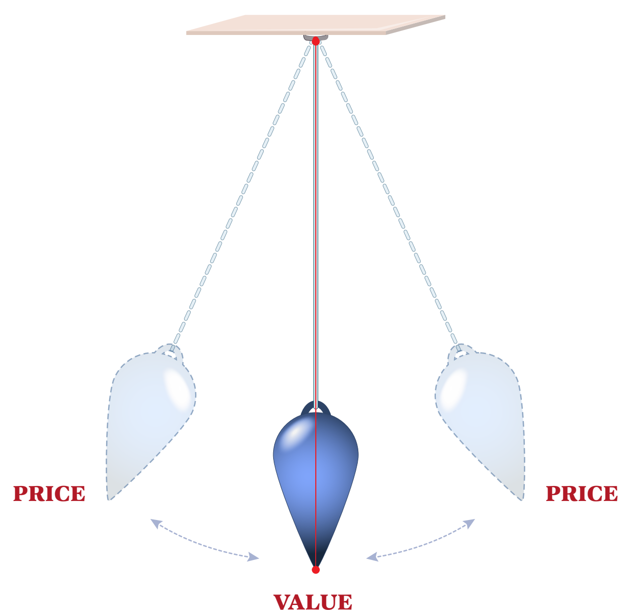
1. You have to know what the future holds
2. You have to know the timing of future developments
3. You have to know what these developments mean or asset prices

If we have learned nothing else over the past four years, we've learned that the future is forever an unknowableplace. Any investment strategy that relies on consistently getting all three of these things right is doomed to fail.

2. The value recognition approach, meanwhile, requires a keen analysis of the intrinsic value of an asset, but does not rely on a particular economic outcome, market condition, timing, or specific buyer to generate a return. We prefer this approach, as it transforms the volatility of price from the investor's worst enemy into her good friend.

It is precisely the difference between price and value that an investor seeks to exploit. So, too, in the world of business. A patient and disciplined business can benefit from anxiety or panic in the private marketplace by exploiting the difference between the price and value of private assets.

In a perfectly efficient world, price and value would be the same. We believe that markets are relatively efficient, and that prices trend towards underlying value over time, but the volatile range of human emotions often pushes prices far away from any reasonable estimate of value. Think of a pendulum, where the point of the pendulum is price, and the equilibrium position is value.



At rest, value and price are the same thing, but markets are never at rest. Patient capital allocation requires a focus on the equilibrium position (value) rather than the volatility of the pendulum (price).

The Critical Importance of Writing Things Down

Nothing went right on June 6, 1944. The weather, wind and tides confounded the Allies landing at Normandy, and very few troops wound up where they were supposed to be. Improvisation became a soldier's most valuable weapon.

After the war, Supreme Allied Commander Dwight Eisenhower was asked about the failure of pre-invasion preparation. "Yes," he agreed, "all of our plans turned out to be worthless. Planning, on the other hand, won the war."

In other words, the planning exercise itself created the adaptability that allowed the troops to respond in the moment to unexpected developments. The output of the exercise – the plans themselves – was far less useful.

Every good operator has a business plan. It may be PowerPoint slides, a Word document, a board presentation, or even just the back of a napkin (not recommended beyond the venture capital stage, although it makes for a good founding story). Yet as with D-Day, plans often begin to unravel as soon as they are put into action.

So why plan at all? A robust and repeated planning exercise and culture allows a business to adapt as unexpected opportunities arise and unforeseen challenges develop.

The investing world requires similar adaptability. At the individual asset level, a thorough investment memo outlines the rationale for a capital allocation decision, an assessment of valuation, and expectations about the development of the business. This forms a disciplined methodology to capture the reasoning behind a decision at the time it is made. This helps to prevent the all too human inclination to project future developments into a past investment decision, usually to the detriment of the investor.

For example, an investor might rationalize a missed product launch, a key executive departure, the rise of a competitor, or an adverse regulatory ruling by remembering (incorrectly) that these risks were part of the original investment thesis. A written and dated plan for the investment prevents this slippery thinking.

There is a similar benefit to writing things down at the portfolio level. Asset allocation should differ from investor to investor depending on needs for return, desired liquidity, and tolerance for risk or volatility. These needs can change over time, and so, too, should asset allocation.

It is easy, however, to allow market moves to influence asset allocation. It is tempting to buy more of whatever is going up, as it feels good to get a positive signal from price moves in the short run. Conversely, it feels good to sell things that are going down, as you no longer need to be reminded of them when you look at your portfolio. Good planning prevents this, and even imposes the discipline of rebalancing when one or another asset class rallies sharply.

A robust Investment Policy Statement (IPS), or Statement of Investment Objectives, is particularly valuable in periods of market volatility. Price volatility looms large in bear markets, amplified by breathless media coverage of how far the S&P fell, or how many stocks are making 52-week lows, and so forth. Behavioral psychologists call this an "availability cascade," as heightened media coverage amplifies bad news, which can induce more selling, which feeds tomorrow's bad news.

The risk in this environment is that investors naturally feel like they should do something in response to price swings. Yet if an investor is fully invested, the only available action is to sell, which is often the wrong response. A well-crafted IPS acts like a letter from a current composed you to a future anxious you, distracted and depressed by market volatility. Planning helps to win the war against your own emotions.

Conclusion

Investing is complicated, but it's not complex. Capital is capital, and the prudent allocation of it in business as well as markets requires an assessment of quality and value, coupled with the temperament and planning to withstand the temptation posed by price volatility in public markets. There are no guarantees of success in markets or business, but remaining disciplined and patient can help to stack the odds in your favor.

If you are interested in learning more about the intersection of business ownership and investing, reach out to your BBH relationship team. ■

Bonds are Back:

Shifts in Fixed Income

By Justin Reed
Partner
Chief Investment Officer

Greg Steier
Principal
Head of Tax-Exempt Fixed Income

Within our Investment Research Group (IRG), we believe a client's asset allocation, or mix between public equities, public fixed income, and private investment strategies, should be based on that client's goals, objectives, risk profile, and spending needs. Each of those major asset classes is meant to play a specific role in one's portfolio.

- **Public equities**, particularly the high-quality public equities in which we invest, provide growth and long-term inflation protection.

- **Public fixed income** is intended to provide stability (through diversifying exposures and deflation protection), liquidity, and yield.

- **Private and alternative investments** can provide different characteristics (depending on the underlying assets), including growth, long-term or unexpected inflation protection, and diversification.

Within each of those major asset classes, we always look to optimize allocations to best position portfolios for the future. As investors are aware, fixed income has not lived up to its potential over the past decade. However, with recent shifts in the fixed income environment, there is now a more positive outlook for bonds.

Here, we elaborate on these shifts, the "comeback" of bonds, and share how we repositioned portfolios in 2023 and how we will continue to respond moving forward.

The Bonds are Back in Town

After a decade of providing virtually no income, cash now outyields longer-term fixed income securities of the highest quality. Investors face two questions:

1. How long will the reign of cash persist?

2. Are there enough attractive opportunities in longer bonds to justify moving that cash out of the yield curve?

Dealing with the problem of low yields was a way of life in the bond market for over a decade. These are not the only issues facing investors and policymakers, who continue to grapple with many problems in the current environment. Only when the Fed had severely underestimated the inflation problem did they slam the brakes in second quarter 2023, with the most aggressive rate hikes since Paul Volcker in the early 1980s.

When Jerome Powell's legacy is written, we are sure he would rather be viewed as a Fed Chair who overcame inflation (Paul Volcker) rather than one who was overwhelmed by it (Arthur Burns). We view the Fed's stated strategy of "higher for longer" as a prudent way to balance their inflation goal with the risks of a hard economic landing and further trouble in the banking system.

Although inflation may remain stubborn, it is receding slowly from its decades-high levels. The investment implications of "higher for longer" and an eventual easing of policy should benefit bond investors. With higher yields, investors do not have to rely on rate cuts to earn healthy returns on their bonds.

The path away from the zero-interest rate policy (ZIRP) has been anything but smooth. Bond markets have been rattled by severe volatility, and a confluence of macroeconomic variables should keep interest rate uncertainty the norm.

The nearby list, which excludes the Covid-19 pandemic, reminds us why we avoid market timing and instead choose to focus on our credit and valuation criteria. We stick to a bottom-up process that has consistently produced benefits for our clients, and we patiently build our fixed income portfolios one bond at a time.

- Strong labor markets
- Strong housing markets
- Unions gaining strength
- On-shoring and deglobalization
- Geopolitics
- Risk of a hard landing
- Demographics and the aging population
- Migration to renewable energy
- Massive deficit spending
- Military spending
- Sticky core inflation
- Hyper-partisan politics
- Multiple wars

Benefits of Bonds

Long story short: After a long wait, the benefits of bonds in an asset allocation have finally returned. By the end of 2021, the role of fixed income had significantly diminished, and when bonds don't produce adequate income, their utility (apart from providing liquidity) is compromised.

Fixed income cannot properly hedge declines in equities or inflation unless yields can fall sufficiently to provide meaningful price appreciation. This was one of the difficult lessons of 2022 when stocks and bonds fell together, producing a ferocious bear market.

However, with a rally in fourth quarter 2023 and predicted rate cuts in the new year, investors may be able to expect a better outlook for the fixed income market in 2024. Bonds are back, and they are providing their full range of traditional values once again.

Role of Fixed Income	2021	2023
Income	✗	✓
Liquidity	✓	✓
Diversification to Equities	✗	✓
Deflation Hedge	✗	✓

The beauty of today's bond market is that you can stick to the basics and still generate healthy income.

Ironically, the simplest investments of all, Money Market Funds, are now providing stiff competition to traditional bonds. Is cash risk-free? In an academic sense, yes because cash has no mark-to-market variability. But the answer is not so simple as savers endured significant punishment in the post-Great Financial Crisis world of ZIRP. While stocks and bond investors enjoyed historic bull markets, holders of cash lost real purchasing power as rates lagged inflation.

Today's money market rates of over 5% are enticing in the short run and probably as good as they are going to get, but if your goal is long term income stability, holding cash is getting riskier. When the Fed does lower rates, holders of shorter-duration assets such as cash will see their returns deteriorate, while investors in longer-duration bonds will benefit from having locked in higher rates for longer.

Judging Longer Term Bonds

Investors may hesitate to extend maturities when the yield curve is inverted, as it has been since July 2022.[1] When judging longer bonds, we assess two factors:

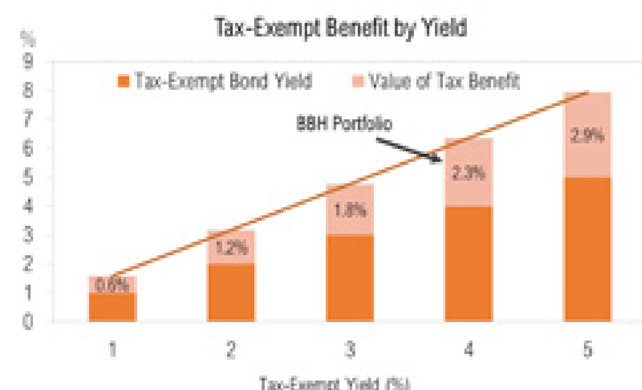
1. **The yields of Treasuries relative to investor inflation expectations.** This is what we call the real yield. Irrespective of tax status, Treasuries form the foundation of the U.S. bond market. On a ten-year maturity, the real rate was -1% entering 2022 – which was less than ideal, as it implied investors could expect to generate a -1% return after inflation.

   As shown in the nearby chart, today, that real yield is over 2%, which is much better in a longer-term context. For perspective, the ten-year real rate has averaged 2.3% over the past 40 years.[2] In other words, the "new normal" appears more consistent with the pre-crisis "old normal."

2. **The range of credit opportunities, since these form the backbone of our portfolios.** At the end of 2021, taxable and tax-exempt credit valuations were the most expensive we had ever experienced. We are excited that credit valuations have normalized, providing us opportunities to supplement the yields of our portfolios beyond that of Treasuries or Triple-A rated municipal debt.

When we combine these two factors, we conclude there are many attractive uses of cash today in both taxable and tax-exempt bonds. High-quality intermediate-duration tax-exempt portfolios now generate 4% yields. That is nearly 7% pre-tax for an investor in the top Federal bracket, which is not far from longer-term equity return expectations and similar to our core taxable fixed income strategy. This highlights the value of tax efficiency, which for the municipals we own, measures in the *hundreds* of basis points.[3]

Let us also not forget that the Tax Cuts and Jobs Act, which brought the top bracket down from 39.6% to 37%, is poised to expire at the end of 2025. This should further enhance the value of municipal holdings for our taxable clients.



For illustrative purposes only.

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Bonds are back and they are providing their full range of traditional values once again.

When we invest in fixed income, we aim to be appropriately aggressive. Stretching for yield is not in our DNA. Whether in municipal, corporate, or structured securities, we always get excited to identify high quality securities that provide more yield than they should, relative to their fundamental risks. We are thankful for the wide range of opportunities that the revaluation of fixed income produced.

As we begin the new year, the best way to protect and grow capital in bond portfolios is still to do your credit homework and make sure you don’t overpay. Today’s cash yields may look attractive, but they are far from permanent. When we are not investing, we are doing our best to spread the word around about all the longer-term opportunities in front of us. ■

[1]*Nicholas Jasinski. Why an “Un-Inverted” Yield Curve Could Be More Chilling for the Stock Market. 09 October 2023. Retrieved from Barron’s; https://www.barrons.com/articles/stock-market-treasury-yield-curve-inversion-f366e665.*

[2]*Federal Reserve Bank of Cleveland, 10-Year Real Interest Rate [REAINTRATREARAT10Y], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/REAINTRATREARAT10Y.*

[3]*One basis point or bp is 1/100th of a percent (0.01% or 0.0001).*

Past performance does not guarantee future results.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when sold prior to maturity.

Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax.

When to Freeze a Failing GRAT

By Alison Hutchinson
Principal
Senior Wealth Planner

Stacia Kroetz
Managing Director
Senior Wealth Planner

A grantor retained annuity trust (GRAT) is an estate planning technique that is very versatile. Creating a GRAT during times of market stress and then "freezing" it when the market recovers can be a tax-efficient way to transfer wealth free of gift or estate tax. Although GRATs created during periods of high interest rates will have to outperform a higher hurdle rate to be successful, there are still a lot of opportunities in a robust market if you are diligent in keeping track of performance and freezing when it makes sense.

What Is a GRAT?

A GRAT is a type of irrevocable trust to which the creator of the trust (the grantor) transfers specific assets and retains the right to receive an annual annuity payment for a designated number of years. The total of the annuity payments is equal to the value of the assets transferred to the GRAT plus interest calculated at a rate determined by the IRS for the month of the transfer (the hurdle rate). The hurdle rate (or 7520 rate) is 5.8% for GRATs funded in December 2023.[1]

Any appreciation experienced by the transferred assets in excess of the hurdle rate will pass to the beneficiaries designated by the grantor without the imposition of any transfer tax (assuming the grantor survives the term of the GRAT). Consequently, the best assets with which to fund a GRAT are those that are likely to appreciate significantly over the trust's term (often two years).

A Closer Look at GRATs

GRATs are used to minimize federal estate and gift tax. To create a GRAT, a grantor makes a gift to a trust. The trust agreement says the trust will last for a certain number of years, and that the trustee must pay an annuity back to the grantor over that timeframe – this is the "grantor retained annuity" part of the trust. The grantor funds the GRAT account, while the trustee is responsible for making timely annuity payments and transferring the balance (if any) to the beneficiary, or to a trust for his benefit. For example, assuming a trust term of two years, after two annuity payments back to the grantor anything remaining in the trust passes tax-free to a trust for the grantor's descendants.[2]

If you are planning to create a GRAT, consider the following:

- **Health of the grantor:** If the grantor dies during the trust's term, the GRAT assets are included in her estate.
- **Who you want to help:** Appropriate beneficiaries for a GRAT include children, siblings, parents, and non-generation skipping transfer (GST) trusts.
- **Timing:** A GRAT does not give beneficiaries immediate access to assets.
- **Tax considerations:** GRATs can be great for clients who have used their lifetime exemption because they can be "zeroed out" and have no gift tax consequences.

GRAT Examples

For example, if Olivia transferred $1 million of Stock X to a two-year GRAT in April 2020, the hurdle rate would have been 1.2%, and the two annuity payments, due on the first and second anniversaries of the funding of the GRAT, were $462,995 and $555,593, respectively. Assuming Stock X generated a total return of 8% per year, the remaining trust assets in April 2022 would have been $110,772. If the appreciation was instead 20%, the remaining assets would be worth $328,813.

When the markets are volatile and the assets in the GRAT either lose significant value or gain significant value, this presents an opportunity for planning. In these instances, we recommend "freezing" the GRAT.

As an example, assume that instead of funding the GRAT in April 2020, Olivia funded it in January 2023 with $1 million of Stock Y. The hurdle rate would have been 4.6%.

On the first anniversary, assuming Stock Y performed similarly to the S&P 500, the GRAT would have increased by around 24% and would be valued at $1,240,000. At the same time, an annuity payment of $487,140 would be due back to Olivia. Once Olivia makes that required annuity payment, the GRAT is left with a value of $752,860 (current GRAT value minus the annuity payment). We also know that in February 2025, we have to make the last annuity payment of $584,567 back to Olivia.

This would be a great time to consider freezing the GRAT! We know that if we froze the GRAT today, Olivia's beneficiaries would receive $168,293 (current value of the GRAT minus the required 2025 annuity payment) free of transfer tax. If, instead, we let the GRAT continue, we run the risk of the stock reverting to prior values, reducing the amount that is left after that required annuity payment. If the stock falls precipitously, we run the risk of the GRAT falling below $584,567, meaning the entire value would be paid back to Olivia as the final annuity, with nothing passing to the beneficiaries by the end of the term.

Even if Olivia thought it was impossible for the stock to fall that far, and believed there was more upside to the stock, she could freeze the current GRAT to lock in the accumulated appreciation and roll the investment into a new GRAT to capture any additional upside.

When to Freeze a GRAT

Although it depends on the type of asset in the GRAT, it usually makes sense to freeze "underwater" GRATs around the time of the first annuity payment and re-GRAT those assets if you believe they will appreciate moving forward. It also makes sense to freeze GRATs when the underlying assets have appreciated significantly over the hurdle rate.

What does it mean to "freeze" a GRAT? It means that the grantor utilizes a provision found in most GRATs allowing the grantor to substitute or swap assets of equivalent value in and out of the trust. Typically, the grantor will swap cash or a similarly stable asset (some attorneys even suggest a promissory note) into the GRAT in exchange for the remaining GRAT assets. As outlined in the example above, the grantor can then "re-GRAT" those assets by funding a new GRAT with the same assets. This allows you to start over if prices have declined, or lock-in your appreciation if prices have gone up and stay invested with a new GRAT to capture any additional upside.

The two key takeaways are:

- If you currently have a GRAT, you should check the value of the assets in the GRAT and work with your relationship team to evaluate whether or not freezing the GRAT makes sense.
- If you don't have a GRAT, you should consider whether creating one might help accomplish one or more of your wealth transition goals.

If you wish to discuss this technique in further detail or to review your investments, we encourage you to reach out to your BBH relationship team. ■

[1]*To find the current rate, see the latest monthly IRS revenue ruling with the applicable federal rate tables (see Table 5 of the revenue ruling), or consult the IRS's "Section 7520 Interest Rates" webpage.*

[2]*The remainder to beneficiaries may also be income tax-free if the grantor has swapped assets prior to termination.*

This material is for general information and reference purposes only and does not constitute legal or tax advice. Please consult with attorney, accountant, and/or tax advisor for advice concerning your particular circumstances.

Scott Clemons
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Chief Investment Strategist

Justin Reed
Partner
Chief Investment Officer

The Economy, Markets, and Investments at Q1 2024

Looking Back and Looking Forward

The big surprise of 2023 – and one of the primary topics of conversation during the year – was the recession that did not happen. Looking back, many of the fears we had at the beginning of 2023 turned out to have been overstated: Economic growth accelerated into the third quarter of the year, before coming off slightly to end the year at an annual pace of 3.3%.

This paints a remarkably robust economic picture, behind which we identify three primary factors. Looking forward, we will be keeping an eye on these same factors as 2024 unfolds.

1. The labor market: This is a primary driver of economic activity, and as of November 2023 there is still an imbalance, with 2.5 million more job openings than available supply of labor. However, this gap has narrowed over the past year; when we gathered in January 2023 the gap between labor supply and demand was five million jobs. This narrowing was driven by a 2.4 million decline in job openings and a rise of 600,000 in supply of labor. So, while there is an imbalance in the labor market, it is relatively soft and can be interpreted as a tailwind to economic activity – albeit not as much of a tailwind as in 2023.

2. The relative durability of the housing market: In about two-thirds of the country, housing prices are up year-over-year despite the rapid rise in mortgage rates. The quick rise of interest rates dissuaded people from refinancing their homes, which in turn decreased housing market supply. Here, too, these trends are beginning to narrow. As people refinance, the actual average mortgage rate will rise; however, over the past couple of months the new mortgage rate has decreased slightly from 8% to approximately 7%.

3. The continued relief on inflation: Inflation in the consumer price index (CPI), which peaked in June 2022 at 9.1%, has since come down to end 2023 at 3.4%. We believe that 2024 may see further progress toward the Fed's "comfort range" of around 2%, as during the past few months the food and energy baskets – where people experience the everyday effects of inflation – have been deflationary. As 2024 unfolds we will closely watch CPI excluding food and energy, which is proving to be relatively sticky, especially the cost of shelter basket. We do predict further improvement in 2024, as the leading indicator – the new tenant rent index – is already down.

Various measures of inflation indicate that there is probably more improvement to come in 2024:

- The Producer Price Index (PPI) has been negative for five of the past seven months
- As of November 2023, the PCE Deflator (the Fed's preferred measure of inflation) is already down to 2.6%
- The "misery" index (CPI inflation plus headline unemployment rate) shows a tailwind of consumer confidence

A Potential Pivot

Notably, the December 2023 statement from the Fed signaled the beginnings of a pivot toward a more balanced approach to monetary policy. For the first time in the cycle, the Fed is acknowledging a slowdown of economic activity and also that "inflation has eased over the past year but remains elevated."[1] This is not a declaration of victory over inflation, but it is a significant observation.

[1] *Sources: Federal Reserve, BBH Analysis.*

4.637
4.637
4.637
1.326
2.126
3.852
4.637
3.852
3.852

Perhaps the most important edit in the December statement compared to their November 2023 remarks is the inclusion of "any" in "determining the extent of any additional policy firming…." This opens the door for the Fed to announce that they may be done raising interest rates, and we will be monitoring this in the coming months. The market, meanwhile, has concluded that the Fed is done raising rates, and 15 out of 19 Fed governors believe that the Fed Funds rate will be 4.25-5% at year end 2024.

All of this paints a relatively benign backdrop of economic activity for the year ahead, and we believe that the "soft landing" recession discussed in past webinars could be in sight.

What Could Go Wrong?

While a soft landing in 2024 is appearing possible, we are still remaining watchful of several factors, particularly around consumer debt levels. As of September 30, 2023, the U.S. had an outstanding consumer debt of approximately $17 trillion.

At first glance, this paints a dire picture; however, interest rates – while they have come up – are still relatively low. Therefore, the debt service on this debt is not yet overly burdensome. Household debt has also come down, and we have not seen a large increase in household debt delinquencies.

While neither the debt service nor household balance sheets dismiss the challenge of consumer debt, they do put it into broader context.

Economic Outlook for 2024

Overall, the path and pace of the economy in 2024 is largely about private consumption: As goes the consumer, so does the economy. Twin slowdowns in housing and labor markets are already beginning to weigh on growth, but the relative health of household balance sheets should act as a shock absorber, preventing a sharp downturn. As inflation continues to wane, the Fed ought to be able to respond to slower growth with lower interest rates, providing support for the economy as well as financial markets.

Market and Portfolio Review for Q1 2024

First, we would like to take this opportunity to thank Suzanne Brenner, who has provided unparalleled leadership as Co-Chief Investment Officer of the Investment Research Group (IRG) for the past six years. We are forever grateful for her partnership and counsel. As a BBH Partner, Suzanne will continue working closely with IRG in an advisory role and sit on its investment oversight committee. We are thankful to continue benefiting from her expertise.

What a Difference a Year Can Make

When comparing 2023 cross-asset classes market returns with 2022 returns, by and large what was down in 2022 was up in 2023 and vice versa. 2023 witnessed strong performance not just in equities but also in fixed income, with the "main show" remaining U.S. Large Cap equities – particularly technology stocks. The Nasdaq, which is comprised largely of tech-oriented companies, returned 44.7% in 2023, and the S&P 500 returned a little over 26%.

Over the longer term, 10-year returns for the Nasdaq and S&P 500 are up, at 14.9% and 12%, respectively. The 10-year results look impressive; however, we do think it is unlikely that the S&P 500 will continue to generate such a high return over the next 10 to 20 years. These types of returns are endpoint sensitive, and our focus remains preserving and growing your capital long term.

Market Overview: Equities

Looking closer at U.S. equities, we saw a strong rebound in equity class returns from 2022. Entering 2023, many investors were concerned about what appeared to be an imminent recession. During this time, we focused on the fundamentals and kept in mind that recessions are not predictors of equity market distress. Technology led the S&P 500 in 2023, followed by communication services and consumer discretionary – all three being 2022's laggards. Utilities and energy, meanwhile, were the only negative performing sectors in 2023.

As fundamental investors, we always ask ourselves "How were these returns generated?"

As inflation continues to wane, the Fed ought to be able to respond to slower growth with lower interest rates, providing support for the economy as well as financial markets.

In this case, multiple expansion was the primary driver of the S&P 500's performance in 2023. The index's 2023 performance can be broken down into four distinct periods, with the S&P 500 price closely followed by the forward P/E multiple in each.

1. Drawdown #1: Regional banking crisis
2. Recovery #1: Banking crisis containment
3. Drawdown #2: 100 bps spike in real interest rates
4. Recovery #2: Possible Fed pivot

The seven so-called "Tech Darlings" could not be ignored in 2023. They returned 86.7%; without them, the S&P 500 would only have returned about 10%. A question posed by 2024 is if their dominance will continue. We believe that they are getting stronger and improving with respect to their fundamental performance; however, we must also note that their dominance comes at a time of historically high market concentration.

Outside of the U.S., MSCI EAFE and MSCI EM generated returns of 18% and 10%, respectively. This is the MSCI EAFE's highest annual return since 2019; its top contributors for 2023 were Japan, France, and Germany, and its top detractors were Hong Kong and Macau.

Meanwhile, the MSCI EM underperformed MSCI EAFE for the third consecutive year. Its top contributors for the year were Taiwan, India, and South Korea, and its top detractors were China and Thailand. Notably, our portfolios were meaningfully underweight to both China and Hong Kong, which helped our overall performance in 2023.

In fixed income, 2023 returns were almost a mirror image of 2022. Fixed income market also experienced a fair amount of volatility during the year, with 10-year Treasury and 10-year Treasury Inflation-Protected Securities (TIPS) falling in March, spiking in October, and falling to end the year close to where they began, at around 4%.

In 2023, we generated strong absolute and relative returns across our portfolios excluding private investments. Both our public equity and public fixed income portfolios outperformed their benchmarks. In public equity, we benefited from an overweight to U.S. equities and extremely strong returns within our U.S. Large Cap and Emerging Markets, offset by weak relative performance within our Developed International and U.S. Small/Mid (SMID) Cap portfolios. Key thematic drivers within our public equity portfolio during 2023 were:

- A continued focus on high quality companies and a bottom-up approach
- Early and meaningful artificial intelligence (AI)-related exposure

We were disappointed in our underperformance in developed international equities, entirely driven by our large exposure to, and weak performance from, Select Equity Group (SEG). Despite this result, we still have conviction in SEG and believe the fundamentals of their underlying companies and portfolio are strong. Within midcap, strong performance from BBH Mid Cap was offset by underperformance by Clarkston, our SMID-cap manager, which struggled in the 2023 environment favoring larger-cap technology companies.

While we did have exposure within our portfolio to the seven Tech Darlings, we are underweight the index's exposure, which sits at an all-time high for name concentration. In 2023, this was a headwind to performance; however, our U.S. Large Cap portfolio did meaningfully outperform the S&P 500 due to strong stock selection and strong fundamental performance of our underlying holdings. Over the long term, fundamental performance is rewarded while multiple expansion often sees a reversion to the mean.

Thematically, what we decided in 2022 informed our 2023 results.

2022 Decisions	2023 Attribution
Reaffirm our public equity investment philosophy and high-quality company focus	Overweight to high quality companies drove our public equity performance
Remain invested in equities; it's rare for the S&P 500 to decline two years in a row	The S&P 500 returned 26.3% after its worst-performing year since 2008
Be patient with managers; fundamentals drive prices	Some of 2022's worst-performing managers were 2023's best

In public fixed income, outperformance across all fixed income strategies was a key asset class driver of strong absolute and relative returns. Thematic drivers were a timely duration extension throughout 2023, and a strong Q4 rally in interest rates and decrease in credit spreads. Finally, in private investments we expect Q4 uplifts in private equity, and it is unlikely that real estate, distressed, and private credit kept up with the S&P 500 return in Q4; actual returns are to be determined due to the standard quarter lag in reporting.

At BBH, we are lucky to have an internal fixed income team who have been able to generate yields above that of the broader market.

BBH Capital Market Expectations

We underscore the fact that rather than using our 20-year capital market expectations for top-down investment decisions, as some in our industry do, we instead create these assumptions to help with simulations that are used in financial planning. These are forecasts of index-level data, and therefore do not include any after-fee excess returns that our managers may generate.

This being said, our 2024 capital market expectations indicate that we are generally anticipating slightly slower returns across asset classes for the coming year and imply that even after the year we experienced, we would be surprised if the S&P 500 meets its 2023 return threshold over the next 20 years.

For investors with portfolios comprised of fixed income and equity market indices, we believe that it may prove challenging to produce a return greater than 6% nominally over the next 20 years. If your return goals are above that profile, you must introduce managers who seek to generate excess returns over a long period of time, and/or have exposure to alternatives, to your portfolio.

Evaluating Our Opportunity Sets

It is helpful to use where we stand from a valuation standpoint in determining what opportunities are available for us looking forward. Looking at the forward P/E ratios for the S&P 500, MSCI EAFE, and MSCI EM indices, the opportunity set for equities appears slightly less attractive than where we sat this time last year. For non-taxable and taxable fixed income, while yields in Q4 came back down they remain attractive by historical standards overall.

At BBH, we are lucky to have an internal fixed income team who have been able to generate yields above that of the broader market. Lastly, looking at fixed income credit spreads, we note that they narrowed in 2023 and remain below their long-term average. We remain careful about taking credit risk at this point in time.

BBH Portfolio Positioning

In 2024, we continue to optimize our portfolio to enhance expected returns and reduce risk with these five priorities:

1. Focusing on high quality companies (public equities): These are companies that exhibit secular growth, strong pricing power, and are run by exceptional manager teams.

2. Capitalizing on the new fixed income regime: We think of public fixed income as providing portfolios with stability, liquidity, and yield. In 2023, fixed income had not lived up to its expectations; however, with recent shifts in the fixed income environment we now have a more positive outlook for bonds in 2024.

3. Increasing allocations to alternatives: Over time, we expect the number of private investment strategies and the allocation to these strategies to increase for our clients. The wide dispersion of manager outcomes in private investments offers an opportunity to benefit from manager selection. We anticipate investing in the soon-to-be-launched BBH Alternative Credit Fund, managed by BBH Partner Neil Hohmann, which will focus on structured equity and asset-based lending opportunities. This fund is planned to launch in Q2 2024.

4. Increasing optionality to AI: We believe that if AI is going to change the world as much as many expect, our portfolios should be well-positioned to benefit from this shift.

5. Encouraging rebalancing: Particularly after a year like 2023, we believe that rebalancing can enhance long-term compounded returns.

Our 2024 outlook supports our portfolio positioning decisions, and we remain focused on investing bottom-up and worrying top-down. Key themes that IRG is monitoring for the year ahead include:

- **Geopolitical risks** (e.g., the Israel-Hamas and Russia-Ukraine conflicts, China, Eastern Europe, and Houthi attacks). These may lead to inflation and increased volatility.
- **Market concentration.** The last time the S&P 500 Index outperformed the S&P 500 Equal Weight Index by this wide of a margin was in 1998. This could result in a small cap rebound.
- **Equity market valuations.** The S&P 500 equity risk premium is at its lowest level since 2002, and developed international stocks are trading below historical multiples, potentially meaning strong fixed income yields and a rebound in international equities.
- **Inflation.** Core inflation remains elevated globally, specifically in services. We are watching its impact on consumer spending patterns, and are on the lookout for fewer rate cuts and increasing inflation.
- **Interest rates.** There is a difference in the magnitude of rate cuts in 2024: the Fed is projecting three cuts, while the Fed funds futures curve is projecting six. This may result in increased volatility.
- **Artificial intelligence.** AI and machine learning will continue to largely impact business models and employment trends in 2024, likely leading to a differentiation between "winners" and "losers."

In response to these developments, our portfolio positioning is focused on preserving and growing capital. With regards to preserving capital, we are first and foremost focused on the importance of rebalancing and high-quality companies.

We also note that historically, the outcome of U.S. presidential elections has not had a large impact on S&P 500 returns; what matters overall is the fundamentals. The strong fundamentals of our top Domestic Qualified Taxable Balanced Growth (DQTBG) portfolio holdings show that we must remember to focus on value instead of price.

We expect the embedded value in the portfolio to be realized over the long term, and we see our portfolios as quite attractive in spite of the recent run-up in the broader equity market.

2024 and Beyond: Our Private Investment Program

We believe that private markets hold many features and benefits that make them attractive to some of our clients, including illiquidity premiums, a diversified portfolio, opportunity for alpha, and the reality that fewer U.S. companies are going public. Therefore, we recommend allocating across the private investment program. We select alternative strategies that serve different purposes to optimize the overall portfolio.

When thinking about private investments we discourage market timing vintages. Returns for a single private market strategy are cyclical and impossible to predict; rather, we aim to invest in the best managers consistently over multiple funds.

Finally, some reminders as we progress through 2024:

- Prepare for higher market volatility
- Rebalance your portfolios
- Remember that portfolios are built with complementary components
- Increase fixed income and alternatives exposure
- Never forget to focus on the long-term

Thank you for your continued trust in BBH, and we look forward to 2024 and beyond. ■

Inside BBH: 2023 Owner to Owner Summit Roundup

Thank you to our clients who made the 2023 Owner to Owner Summit in Nashville a big success! Business owners shared their insights on a host of topics including building and transitioning their multi-generational businesses, nurturing unique cultures, product innovation, managing through surprises, and being intentional about their legacy.

The summit opened with thoughts from Scott Clemons, BBH Partner and Chief Investment Officer, on the top ten things a business owner should know about the economy. After remarks from BBH Partner and Head of Private Banking Jeff Meskin, attendees enjoyed insightful presentations from a wealth of speakers, including:

- Victoria Mars, former chairwoman of Mars, Incorporated
- Travis Boersma, co-founder and executive chairman of Dutch Bros Coffee
- Mike "Coach K" Krzyzewski, former head coach of men's basketball at Duke University
- Malcolm Gosling, president and CEO of Gosling-Castle Partners, Inc.
- Ray Masucci, founder and chairman of RPM Group
- Allon Bloch, chairman of Greene Tweed

Guests chose between breakout sessions with Ben Persofsky, BBH Managing Director and Executive Director of the BBH Center for Family Business, and BBH Principals Ali Hutchinson and Lewis Hart on family business succession, generational wealth planning, and raising capital in today's market.

The summit also featured a panel on Nashville healthcare, moderated by BBH Principal Travis Dunn, and a discussion on thriving across generations of a family business with Malcolm Gosling, president and CEO of Gosling-Castle Partners, Inc., Malcolm Gosling Jr., and BBH Partner Kathryn George.

We truly enjoyed this opportunity to bring our clients together, allowing them to network, build relationships, and have some fun! We look forward to gathering together again soon.

If you are interested in learning more about the Owner to Owner summit or what BBH can do for your family business, reach out to your relationship manager. ■

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2023
Owner
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Summit

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