2023 Annual Letter

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We had a good year in 2023 with our stocks up roughly 7%. It was nice to be up so much in 2023, but similarly to the stock market, these recent stocks remain 40-50% losses, with cumulative 3-year performances at -7%.

In the year's letter, I'll review the drivers of our results over the past two years. As usual, I'll also summarize our trading activity and the performance of the businesses that we've owned over time.

At the end of 2016, our portfolio was filled more towards US government bonds (T-bills) rather than or resources for the rest of the letter (bond and stock) we could be. Since 17 with through my research for these articles as well as my outlook for future returns.

2021-2023, In Brief

I struggled to find in that year's letter, I wrote the following:

> *"While it is true that the past performance this year is low credit given our long-time horizon, that factor is not 10x off our worst of our long-term rough the decades of 2000-2010.*
>
> *A few investments are down -40-50% from initial purchase price. Let's just say for simplicity that I bought 1 share of something at $1 and it now is worth $0.50. If this is just a temporary blip and the price goes back to (it relatively) soon, then it is true that we didn't lose much. But if it has been years, perhaps 2 years, I could have been better off, in retrospect, if I sold the stock in 2019 or 2020 and we would not sold it at a very very good.*

Since then, we have sold most of the stocks that we owned at the end of last year, mostly at a very good price. We have also added a few new companies, mostly in the energy and utility sectors, and we have added to our holdings in Alphabet (GOOG) and Meta (FB) in the last 2 years. We have gotten to earnings and subscribe counts slightly although it is clearly feeling the effects of that increased competition.

While I wish there could be a quick resolution here, the truth is that business results are lumpy. Sometimes, it takes a long time for a company to get back on track or other investments, or relationships to much cheaper. There is uncertainty and risk in every potential investment. My job is to only seen an investment when the risk/reward does favorably and directly enough that a bad outcome in any one place doesn't wreck the whole portfolio. I believe the current risk/reward here is, in fact, quite favorable, but I understand that it is not a sure thing. Let's review what we have made some profitable year's factored too much of some of the risks plus one.

Berkshire Hathaway returned 15% this year as the company continues to create value consistently and conservatively. Berkshire Hathaway is one of our largest holdings and is on track to make a good long-term return.

Going through some of our smaller investments, Visa and Mastercard continued their steady growth in revenue and earnings and the stocks returned 20 and 13%, respectively. Alphabet (Google) and Meta (Facebook) both had a very good year, and the stocks returned 50% and 65% respectively. Microsoft earned the year as a relatively low growth company, but the stock returned 57%. Amazon had a very good year in growth and multiple expansion. Salesforce is a 20% from our position price so it has continued to grow at a decent rate and more importantly has exhibited strong expense control. Salesforce's stock returned 50% in 2023. Alphabet, Meta, and Salesforce also continue to buy back a significant amount of their stock.

Our Portfolio – Low Invested In Stocks Then Normal

When we set out the trading activity for our stocks in 2023, I will be more than I thought, we to begin Bitcoin, our portfolio was much heavy tilted towards consumer that they have been historically.

For most of the time that we've been investing together, our accounts, when considered in aggregate, have been roughly 75-80% invested in stocks and 20-25% invested in cash.

To start 2016, our accounts were roughly $___ cash in aggregate, with $___ of our portfolio invested in stocks. We had a very high percentage of our portfolio invested in stocks, yet roughly 80% of our total assets, down significantly from our historical positioning.

In these letters I usually focus on developments at the businesses we own, as those will be the primary determinant of our success over time. However, equity prices in aggregate are long-term returns is our allocation between stocks and bonds. Given that we owe much less in stocks compared to normal years, I want to spend the rest of this letter talking through how I think about that decision.

Stocks in Bonds – Historical Cash Considerations

I invest money for roughly 60 households. In the previous section I talked about our holdings as a whole, but in reality, there is significant variance from household to household, as our financial circumstances and goals are quite diverse.

In general, the year with relatively long time horizons for your investments will have most of your assets invested in stocks rather than those of you with relatively shorter time horizons. This is not a hard and fast rule, but it is a rule of thumb. By "time horizon", I mean that you may have a productive use for your money relatively soon, whether it's for retirement, a house, or anything else.

We have now been investing together for 11 years. We have generated quite strong returns through a combination of a large allocation to stocks, a period of strong returns for the stock market in general, and roughly 10% a year in compounded returns for our stocks above the inflation.

If we discount those, we can continue our investing journey together, the focus will be firmly on the preservation of the value that you, through hard work and diligence saving, have entrusted to us. Our investment, in turn, is to preserve and grow the value of your financial independence, freedom, and security.

For those of us that will be 65 growth stocks, it is business as usual, and we will likely continue to hold the majority of our accounts in stocks. The main fundamentally stocks and bonds will depend on how much you are consistently saving, with a higher savings rate leading to a higher allocation to stocks, and the number of attractive opportunities available in the market.

Stocks in Bonds – Individual Stock Considerations

To me, the core tenet of investing is that, if you are going to take risk, you need to get paid a commensurate return for taking it. As I write this, we can invest our money in resources and make a little from return of roughly 4-5%. If we are going to take more risk than that, we need to be compensated for that risk. Historically, the stock market has ranked a potential investment made in the higher than that multiple from resources so that we're compensated for the extra risk that we're taking.

It doesn't pay to be irrationally afraid, thus, but in general, we want to be sure we're compensated for the risk of owning stocks, you should be able to expect returns that are at the same time 5-10% per year higher than the risk-free rate, or if the risk-free rate is very low, then 4% a minimum. All estimates are uncertain, but I do my best to make sure that we are compensated enough over time for the risk we take in our investments.

When I looked at our stocks at the beginning of 2021, I thought that many of them were offering returns over 5-10 times of roughly 10-15% per year, which is a very high spread to the 4% risk-free rate at the time, under clearly that the incremental 4-8% bundle. We had been consistently buying more and more of our stocks, and, clearly that the incremental 4-8% bundle was worth the risk we were taking.

Amazon is a good example of this dynamic. Last year the stock closed at $84 and I thought that it was worth a very conservative EAR 10% which is the price that I would check out if stocks roughly a 4-8% return. The company had a good year operationally, and at this price I believe it could reward $10 with the stock which the year or $102, or a close to an estimate of 10% return.

Stocks are, of a similar way, underestimate the growth in the intrinsic value of the underlying businesses, and most of these moved towards prices where I look forward, I can reasonably expect of perhaps 5-10% annual gain of return of 10-15%.

Lower expected future returns make these investments definitively less attractive. All else equal, I would prefer that we own less of, but I'd rather owning them than not owning them.

A further consideration is that as a stock goes up, it becomes a larger and larger portion of our portfolio, and it can even force us, if we don't do anything, to be overweight.

In the past, I had allow for these investments risk. Sometimes that was because of my convictions, which (in retrospect) underestimate the calculus. But other times I didn't let my hands tied by managing the size of positions so they worked for us, letting them get too large and so the "reward downsized."

Two of my recent mistakes, First Republic Bank and Chewy, were the result of large winners becoming positions that were too large and not taking enough action to reduce their size. I ended up being wrong about those businesses, and the combination of being wrong and having too large a position in them made the losses on the businesses worse than we (or more mistakes in these stocks than we should have).

Going forward, our top to remedy this is to be a little quicker to sell or lower some of our investments as they go up towards their estimate of their fair value. That way, the expression we'll be at large 1% of estimation of the business's prospects is necessary, we'll never experience losses.

As most of our stocks performed very well last year, I have actively trimmed the size of those positions for the reasons mentioned above. I made those decisions based on the merits of each individual stock, but in aggregate it has led us to be selling.

Importantly, I do still think the returns from the stocks we still own will be satisfactory. As mentioned above, our goal here is that the group of stocks we own should be able to deliver a return of 5-10% per year in excess of the risk-free rate. Some have a large variety of factors. Given that the returns I expect are materially lower than they were last year, although still adequate on an absolute basis, it is just my preference that we own less of them than we did one year ago.

As I'll discuss in the next section, valuations for the stock market as a whole look quite high. That environment has made it difficult for me to find new stocks to buy, so all of the selling activity being by counterbalance but resulted in higher balances of cash/cash equivalents.

Stocks in Bonds – Environmental Considerations

I thought a would be helpful to include a few charts that help to show the state of the current environment we're in. These charts help answer the question posed above of how much of our investable assets we want to be taking on risk if I were corporate bonds or stocks instead of treasuries?

The first chart shows how much extra yield an investor will receive if they were BBB rated corporate bonds. These are relatively safe investments grade bonds that don't default very often. The extra yield you receive is mostly a function of the market's risk appetite. A lower yield means investors are accepting lower returns to take on credit risk, and a higher yield means investors are demanding higher returns.

As you can see, investors are getting paid very meager returns for taking on credit risk in today's environment.

This next chart shows the price/earnings ratio for the S&P 500. In general, a higher PE ratio means stocks are more expensive and market participants are more optimistic, demanding lower returns than normal in order to hold stocks. As of today, stocks are more expensive than at any time over the past 20 years, excluding the brief period in 2020 when they were coming up very abnormal levels.

The bar chart shows the yield you are expected to receive if you own stocks. This is presented as the "earnings yield" or, mathematically, earnings/ price, which is the inversion of the chart shown above. The chart then compares the earnings yield for stocks to the yield you receive if you own corporate bonds.

Given that stocks' earnings grow with inflation (based data), it isn't as simple as saying that stocks are cheap because their earnings yield is higher than corporate bonds and it now the earnings yield is higher than corporate bonds, it's cheap, as the chart shows, currently the yield that equity investors receive is lower than the yield on corporate bonds, and so a relative bias to bonds, equity yields are much lower than they'd be than over the 15 years that we've been investing together.

Not Chasing Returns

To summarize the above section – we are currently holding much more of our assets in treasuries instead. Part of the reason is that some of you have reached your financial goals, and we're much more focused on preserving that wealth. Another part of the reason is that I'm not finding investments that are compelling enough to justify holding an entire allocation to your portfolio. Last, the general market environment is such that investors are generally not getting paid much for taking risk, which has made finding new investments difficult.

Given these factors, what are we to do?

The first option would be to sell more of our stocks, even though I think the returns on those individual securities will be strong because the stock market generally looks expensive. This is never how I have operated, as I always believe it is better to be invested on a much by much basis. The companies we own are strong, performing well, and I believe they will continue to do so. Selling them because I think the market is likely high selling ones that is going to place, but as of now, I am high enough returns to keep owning our current positions.

The second option would be to hold our mean, invest in the near-term ideas in the stock market or perhaps some higher yielding corporate bonds, and hope that even through these incremental opportunities aren't great that they'll work out on their investments.

The third option would be to let our treasury bond balances continue to accrue and only invest when time seeks when there are more great opportunities to be had.

As choosing between options two and three, individual attitudes obviously vary, but my guess is that most of you generally have a negative reaction to owning less stocks than you have in the past. I'm in that camp, especially when I look at the yields we can make by way of owning US bonds.

Given how strong the returns have been over time, many people think it's irresponsible not to pile as much money as they possibly can into the US stock market. I have a slightly different view, which is that sometimes US stocks are priced fairly enough that a reasonable estimate of the future suggests returns that are materially higher than treasury bonds.

I believe the one set in that current environment, which is why I haven't worked to buy more stocks in our accounts. I have chosen instead to hold a little more cash than I would in normal times, because I believe that the current environment is a time when I can wait about for little increased in stocks, with a little more slope than is normally available.

Over the past 15 years that we've been investing together, the US stock market has made 10% per year, which is from an EV initial investment into 4.5. If we wait, the stocks have gone up at a strong rate for pretty much the whole time and we have made a good return on our investment. If we had waited, we would have made a much extended period related to the early 2000s, when some of our stocks were down 50-70% in 2000-2002, and we would have made 10% per year, 5.5 stocks have made -4% per year, which was still of initial investment into roughly 80% of value today.

In short, if you have been US based investor, and you haven't been almost fully invested in US stocks, you've made much less money than you could have. The conditional more people to think that investing in stocks for the long term is always the right decision.

I generally think that investing in stocks is a great way to try to build wealth over time and preserve the purchasing power of your hard-earned money against inflation and taxes. However, invest and to think more critically about what has happened in the past and what might happen in the future.

If you are assuming the historical stock returns, I believe that most equity investors don't always make terribly long-term decisions.

Our treasuries between the 20-25% cash we hold, which is only I haven't worked to buy more stocks in our accounts – I have chosen instead to hold a little more cash than I would in normal times, because I believe that the current environment is a time when I can wait about for little increased in stocks, with a little more slope than is normally available.

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2 bouts of higher volatility and lower market prices.

If you look at US markets over the past 10 years, a time when they posted abnormally strong returns, there were a couple of large drawdowns that provided opportunities across the board – one during COVID in 2020 and one as interest rates increased in 2022. Clearly, investors with large treasury holdings could take advantage of these opportunities.

Even more importantly, however, there were plenty of good opportunities in more isolated sectors when the whole stock market wasn't as weak – industrial companies in the beginning of 2016, software and growth stocks at the end of 2018, and many value stocks in the fall of 2020. Investors with access to cash could put it to work at great returns during any one of these times, even if the stock market was not trading too weakly.

For our relatively large cash balances to serve us well in the future, we only need 1 or 2 opportunities like this in order to deploy our cash balances at very strong returns. You can never predict exactly what will happen in financial markets, but you can be sure that in any given sector, when the future starts to look a little scary, prices will come down significantly and investors with access to cash will have opportunities to make investments at attractive valuations. When you have cash, volatility is your friend.

Outlook

While predictions are difficult, I am comfortable saying that we should all be expecting forward returns lower than the ~14-15% per year we've generated on our stocks historically and the ~11-12% we've generated on our whole portfolios. This is not any great tragedy. We have been blessed with a very good environment over our first 11 years, and we capitalized on that, made very strong returns, and grew our wealth at a high rate. But things aren't always, or even often, that easy. It's normal to have more difficult environments sometimes.

While I believe that our strategy will generate good results, and while I like the investments that we do own, they aren't as cheap as they were last year. If we simply held everything we own today, it will be difficult to generate portfolio-level returns of much more than 5-8% per year over the next 10 years. Our large treasury holdings will limit our returns on that money to 4-5% per year, and given relatively high valuations on the stock market, I think it would be difficult for us to make more than about 8-10% on our current equity portfolios over that time.

That being said, our portfolios can and will change over time. We are likely to get some good opportunities to sell our treasury bonds and invest the proceeds into stocks at high returns. Financial markets rarely move in straight lines, and we're positioned to benefit strongly from any weakness.

For now, we will wait. The main reason I struggled in 2022 was because I was impatient in 2021 and chased some investments that I shouldn't have. I'm loathe to repeat that mistake, especially after an 11 year period where we have generated such strong returns and have built our wealth into strong positions where most of you don't need to take much risk to achieve your goals. We can afford to be a little more conservative than normal.

Conclusion

We had a good year in 2023, reversing our losses from 2022 and making some incremental returns above that. It caps off a strong first 11 years where we have made strong gains in our portfolios by being invested almost entirely in equities.

Looking forward, given an environment where valuations are relatively high, we should all expect to make lower returns in the future than we have in the past. With conservative positioning and large balances of government bonds, we can welcome the ensuing volatility that is likely to come our way, and if things get difficult, we can put that money to work at good returns and drive continued strong results into the future.

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