Q2 2024 Masonry All Cap Select Commentary **July 2024**

"So, the crucial question is: What $1 trillion problem will AI solve? Replacing low wage jobs with tremendously costly technology is basically the polar opposite of the prior technology transitions I've witnessed in my thirty years of closely following the tech industry."

Jim Covello, Head of Global Equity Research at Goldman Sachs

To Our Client Partners:

The Masonry All Cap Select (MACS) composite year-to-date return was 3.0% through June 30, 2024, and for clients who have the MACS as their primary investment objective their returns should approximate this performance. By comparison the S&P 500 return during the same period was 15.3%.

Overview of Performance and Positioning

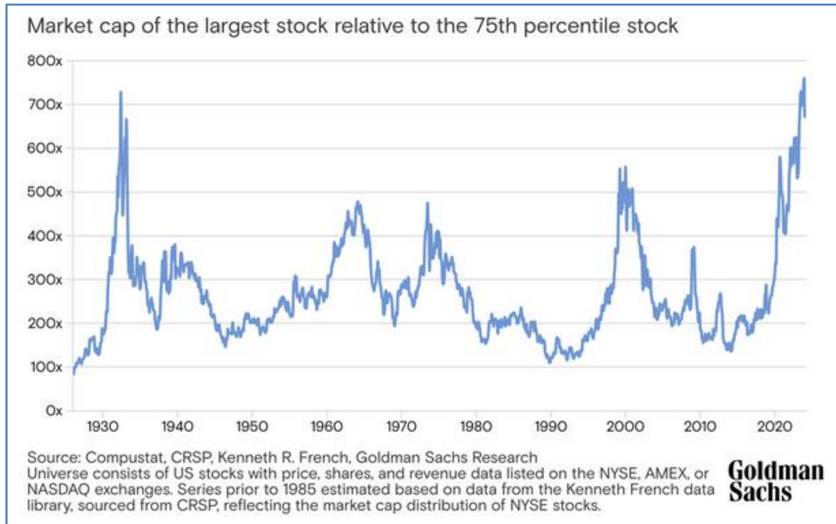
As of June 30, 2024, the MACS strategy had approximately 90% in equity or equity-like securities and approximately 10% in cash and fixed income-like securities. The portfolio's largest positions at the end of the quarter were The St. Joe Company (ticker: JOE), ConocoPhillips (ticker: COP) and the Kayne Anderson MLP / Midstream closed-end fund (ticker: KYN).

For the quarter, the portfolio's largest gainers as measured by their contribution to the overall return were KYN, Scorpio Tankers (ticker: STNG) and the Sprott Physical Gold and Silver Trust (ticker: CEF). The largest detractors were the investments in Walgreens Boots Alliance (ticker: WBA), Liberty SiriusXM Group (ticker: LSXMK) and Conoco Phillips (ticker: COP).

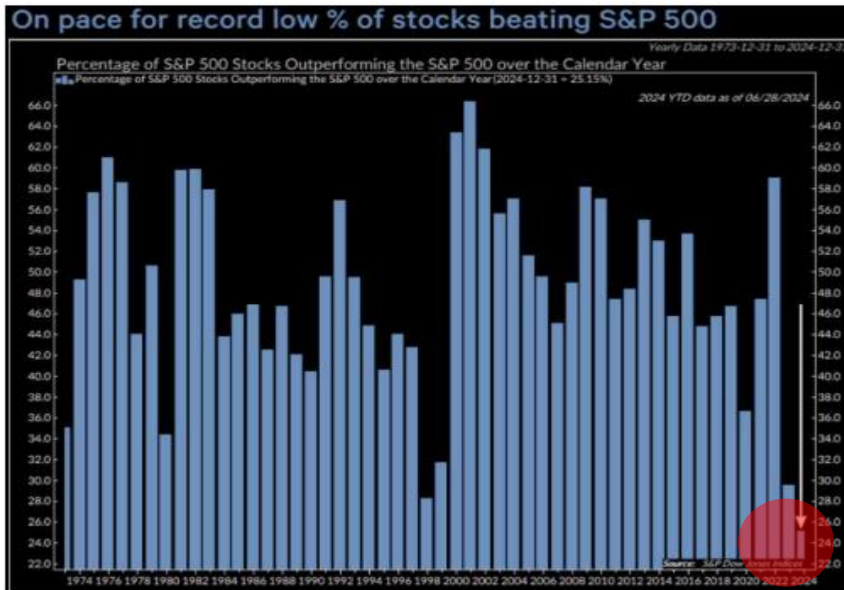
Market Thoughts and Observations

There were ten companies that accounted for 73% of the gain in the S&P 500 in the first half of 2024. In our view, 8 of the 10 trade at very rich valuations particularly when contrasted with our portfolio. In the 2nd quarter of 2024, the S&P 500 gained 4.3% while these ten stocks gained 5.6%, implying the return of the other 490 stocks in the index in aggregate were negative. A few pertinent facts to consider given the state of the markets today:

Market concentration is at extremes…. <u>after the apex is reached the 'rest' of the market leads</u>

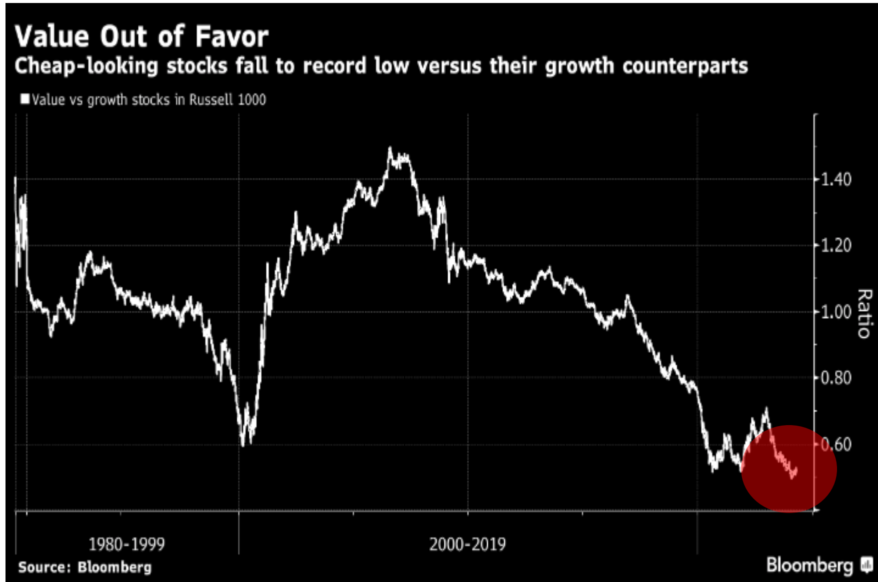


And it has been over 50 years since so few stocks have outperformed the S&P 500…. <u>with subsequent years reversing this trend</u>

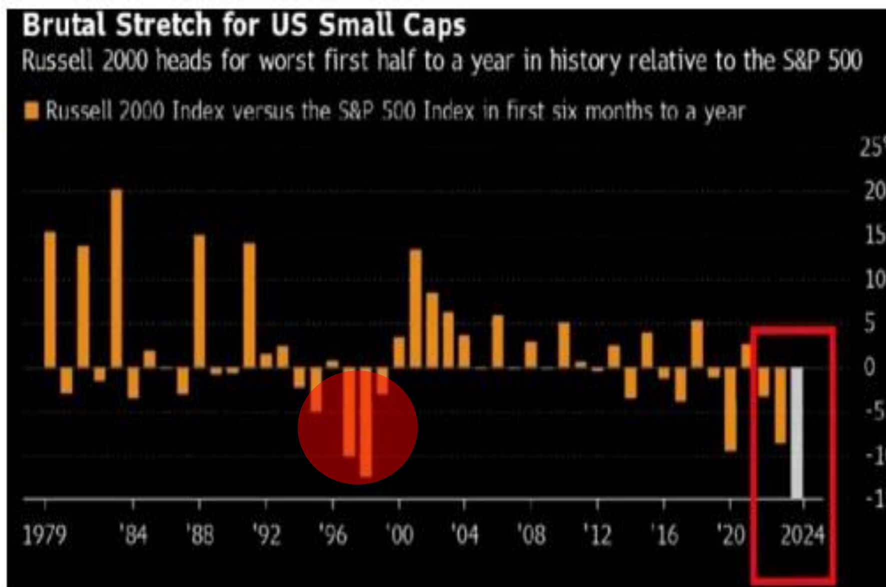


Source: NDR

Value is out of favor, and this has pushed the valuation differential between value vs. growth stocks in the Russell 1000 to a record low…. <u>this is a cyclical phenomenon and historically has reversed with value leading growth once the trough is reached</u>

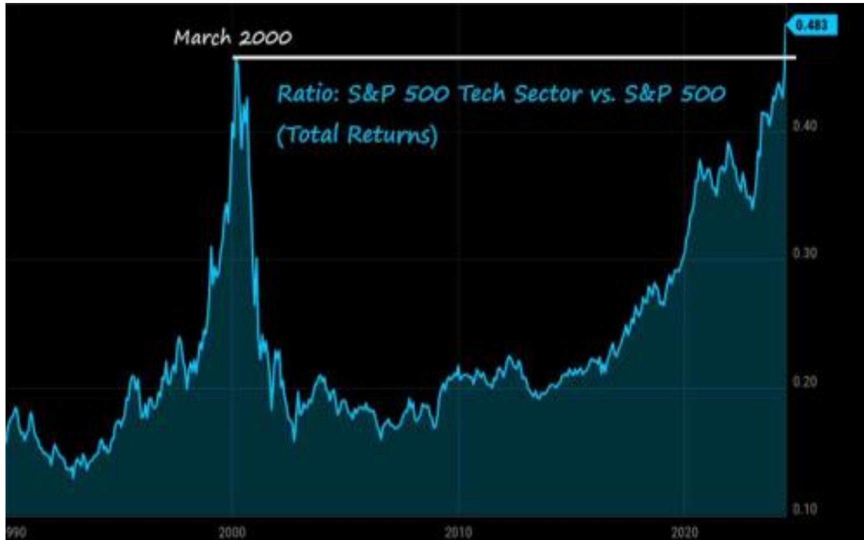


While small cap stocks relative to large cap stocks just experienced their worst performance since 1979 with echoes of the dotcom bubble ringing in our ears…. <u>a reversal that follows historic trends indicates U.S. small caps will outperform in the years ahead</u>



Source: Bloomberg

And the returns of the US Tech sector relative to the S&P 500 are at levels surpassing the peak in March of 2000…. <u>the economy and markets are dynamic and are supportive of the idea that the current trend of U.S. tech outperformance will reverse</u>

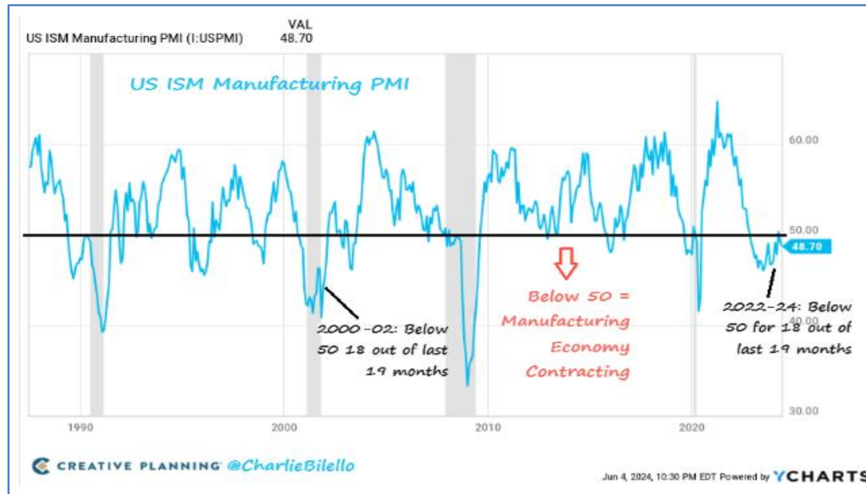


Source: Bilello

Yet another example of market extremes…. <u>and also of their subsequent reversals</u>

We will only know with certainty in the years ahead how we ended up in our current circumstance, but we do have some thoughts that follow:

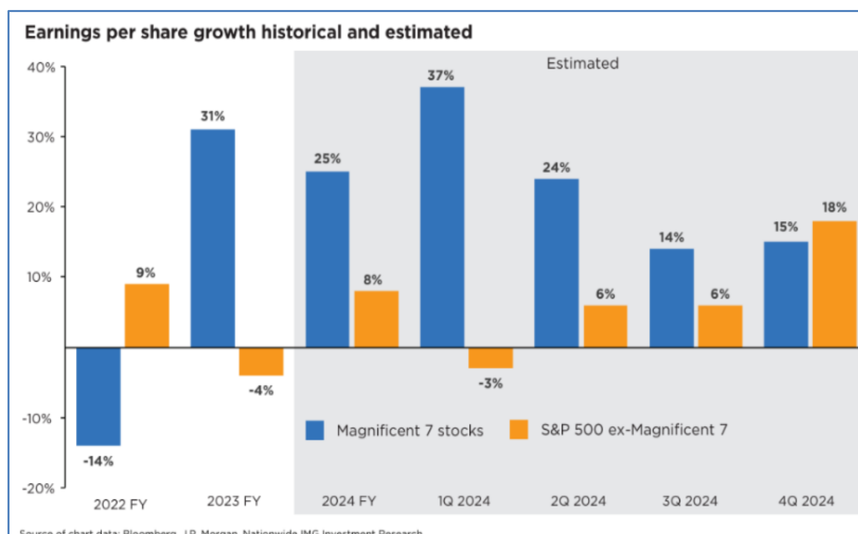
1) Record fiscal spending may have very well lifted GDP to positive readings while the 'real' economy has suffered through what looks and feels like a recession to many in the U.S. This has rekindled the trend of the last decade where investors sought out those handful of stocks (FAANG and now Mag 7) that could grow in a moribund economic environment.



The negative readings of the US ISM Manufacturing PMI (measuring the manufacturing economy) from 2022 to present more closely resembles a recessionary period than one of robust economic growth.

2) The sudden and substantial spike in the Fed Funds rate hurt both economically sensitive stocks and those with leverage on their balance sheets while benefiting those with substantial net cash on their balance sheets. In particular, this bestowed favor on large cap stocks over their small cap brethren.

3) The earnings growth of the Magnificent 7 in the last 18 months relative to the other 493 companies in the S&P 500 has been very good. While this should have resulted in some outperformance, it looks to have been taken to an extreme rarely seen in financial history. The future growth in earnings implied by today's valuations for the current market leaders is highly unlikely to be realized as we highlighted in our last quarterly letter where we used NVIDIA as an example.

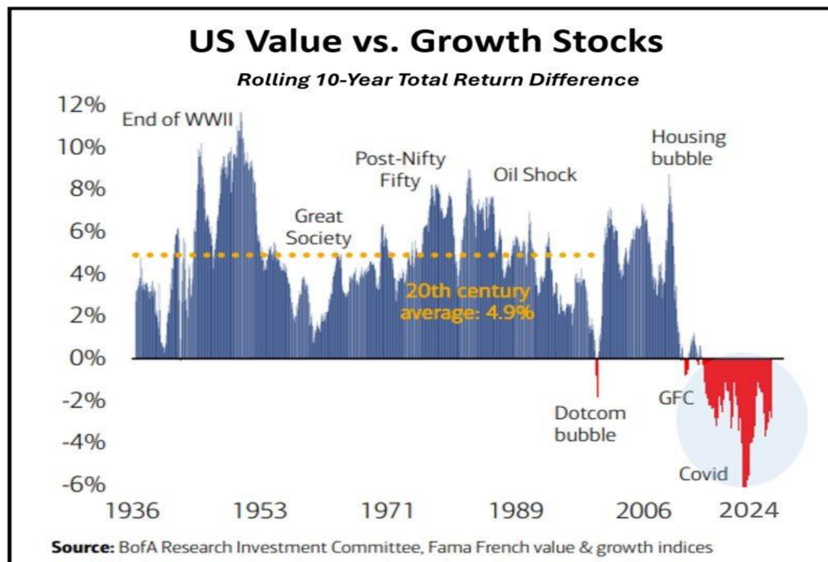


4) And finally, the advent of AI fever has accentuated the factors in points 1-3 and acted like an accelerant thrown into an already burning fire.

And, so it seems, investors have been caught up in a euphoria that favors growth stocks over virtually every other type of stock both domestically and abroad. This might make sense if one's view is that the current economic and financial conditions of today will remain in place for many more years. At Masonry, we don't believe they will. In preparation for the changing tide, we own a plethora of securities that trade at, what we believe to be, very inexpensive valuations.

We maintain our belief that the period since the Great Financial Crisis was an anomaly in financial history. To many investors, the stock market leadership that has been mostly in place since 2009 is the new 'norm' but we believe that view is mistaken and unsupported by the facts that demonstrate the cyclicality of the economy as well as stocks (**Chart 1**).

Chart 1



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Due to the high and growing U.S. debt-to-GDP ratio and an increasing budget deficit, it's almost assured that the Federal Reserve will resort to cutting rates sooner than later, disregarding the impact this action may have on future inflation. The simplest solution is to move U.S. Treasury issuance to the front of the yield curve (already being done) and then lower the rates at the front end (The Fed had indicated they are close to doing this).

When the economy (ex-government spending) finally regains its solid footing is when inflation will most likely rear its ugly head once again. The principal reason for the next wave will be the continued unwillingness of suppliers to expand capacity which has in recent years been constrained by the higher interest rates but was preceded by a decade of miserable economic returns from their capex spends. Additionally, their current shareholder base requires an

adequate return on their capital and a return of capital via dividends and share buybacks which will come at the expense of money that had been previously allocated to growth capex.

It would defy the historic precedence set during the last two inflationary episodes in the U.S. (post WWII – **Chart 2** and the 1970s – **Chart 3**) if the first wave of inflation we just experienced is also the last. In further support of two more inflation waves are economic forces at work which make it unlikely (supply and capacity constraints being one) we are finished on the inflation front. If lower rates spawn another wave of inflation, many market participants may find themselves 'offsides' and experience a similar outcome to that experienced in 2022 when the S&P 500 was down over 18%.

Chart 2

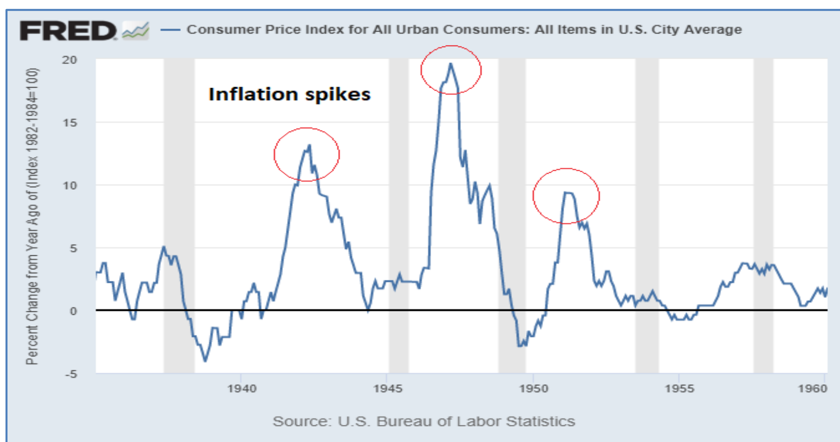
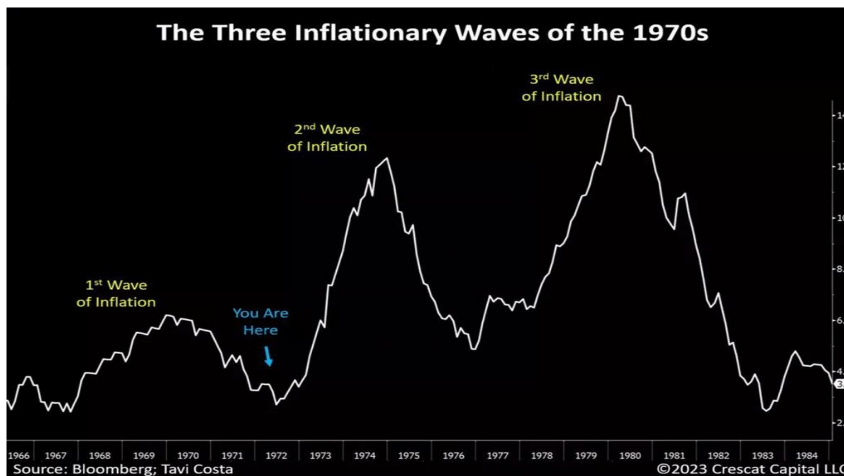


Chart 3



Last, taking some lessons from the dotcom bust, we want to share our brief thoughts about the current euphoria around Artificial Intelligence (AI). The advent of the internet was met with a buildout of the pipes and networking equipment needed to both develop new businesses around the internet and transform existing businesses. It was a 'build it and they will come' mentality

with a blatant disregard for the economic returns that could be achieved. We see similarities in the current AI boom. We have read of the stockpiling of chips and massive spending by the tech leaders of today who are essentially in an arms race. What happens then, after the foundational elements of AI are laid? The next step in the AI evolution is for companies to put pen to paper and try to ascertain the return on the massive investments they have made. We have read quite a few accounts (and the quote at the beginning of this letter is in reference to this idea) that the return is still very much an open question.

Jim Covello, Head of Global Equity Research at Goldmans Sachs, has made the argument that to generate an adequate return on AI technology, AI must solve very complex problems which it currently is not capable of doing. Covello estimates the cost of the AI infrastructure buildout to exceed $1 trillion over the next several years (which brings us back to the buildout of pipes and networking equipment in the dotcom era) and he openly wonders what $1 trillion problem AI will solve. It may be that we are in the midst of over-building the AI infrastructure while still trying to determine how best to utilize the technology.

AI may eventually change the world as we know it. Our guess is that it very likely will, just as the internet has. However, that does not mean the AI infrastructure buildout will continue unabated forever, nor does it mean that every company that is seeking to benefit from incorporating AI will generate an adequate return on their investment. The answer seems more likely to be known in 5-10 years than the expected 1-2 years.

Portfolio Highlights

The general characteristics of the portfolio have not changed in any significant way. Our core positions are defined by valuations approaching the least expensive metrics we can recall in all our years of investing. That said, we remain diligent in working to understand 'if this time is different' resulting in a permanent downward readjustment to the valuations of our holdings relative to the rich valuations of the current market leaders. That said, our belief, supported by financial history and our fundamental analytical work and basic math, is that it is not different this time.

The portfolio is populated with securities trading at extremely low price-to-earnings and price to free cashflow multiples, large discounts to the replacement value of their assets and clearly identifiable pathways to realize the value we see inherent in our holdings. Therefore, it is highly probable we will be rewarded for our discipline and patience in time…we just can't be sure of the timing.

Select Portfolio Details

We remain committed to our holdings in the shipping industry, knowing that conditions in the short term are volatile and subjected to both economic and geopolitical elements. However, we take comfort in the very constructive view espoused by the management teams including that of

Scorpio Tankers (ticker: STNG). James Doyle, Head of Corporate Development and Investor Relations at for STNG said the following on the company's Q1 2024 earnings call:

> *"Never have there been so many factors driving our business. Individually, these factors are positive. Collectively, they are unprecedented, increasing global demand, low inventories, and shifts in refining capacity have increased seaborne exports in ton miles. At the same time, the fleet has become bifurcated, and supply growth has been limited.*
>
> *The result, product tanker rates have remained at high levels for the last two years. Today, spot rates for MRs are almost $40,000 per day and $50,000 for LR2s. While LR2s have captured headlines because of their higher volatility and impact from disruptions in the Red Sea, MR rates have shown remarkable consistency and serve as a clear indicator of the robust underlying global demand for refined products. This continues today."*

Another important aspect of our positioning centers around the supply constraints faced as conditions continue to normalize in a variety of industries. This includes reinsurance, oil and gas, and oil services to name a few. Robert W. Eifler, President and CEO of Noble Corporation (ticker: NE), an offshore drilling contractor in the oil and gas industry, made the following comments in NE's Q1 2024 earnings release:

> *"Our first quarter results reflect continued strong operational performance in a rising market, resulting in a 32% improvement in Adjusted EBITDA compared to a year ago. Following the short-term slowdown in deepwater contracting activity during late 2023, first quarter contracting momentum for 7G rigs has been back on trend for this up-cycle, with a significant pipeline of contracts due to come to market this year for 2025 and 2026 project commencements."*

NE trades for a multiple of just over 8x earnings per share on reasonable 2025 estimates. We believe the market is ignoring a plethora of pertinent and important information regarding the economic prospects of NE and other stocks like it.

Last quarter we wrote about our conviction and enthusiasm for WBA. During the 2nd quarter the shares drifted down to lows not seen since 1997 and now trades at just over 5x drastically reduced earnings estimates for 2025. We remain convinced that the market is overly penalizing the company during a period of transition. With over $145bn in annual sales and multiple levers to pull to 'right the ship' we believe the risk/reward is skewed substantially in our favor in the years ahead.

Firm Update

We have been very pleased with the growth of the firm so far in 2024 welcoming in clients into our separately managed accounts and new limited partners into the Masonry Partners Fund. Total assets actively managed were approximately $64 million at the end of Q2 2024. Total assets (discretionary and non-discretionary) were approximately $445 million.

Thank you for your continued confidence and trust and please feel free to contact us with any comments or questions.

Best Regards,

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HEDGE FUNDS TRADE IN DIVERSE COMPLEX STRATEGIES THAT ARE AFFECTED IN DIFFERENT WAYS AND AT DIFFERENT TIMES BY CHANGING MARKET CONDITIONS. STRATEGIES MAY, AT TIMES, BE OUT OF MARKET FAVOR FOR CONSIDERABLE PERIODS WITH ADVERSE CONSEQUENCES.

THE MSCI EMERGING MARKETS INDEX CAPTURES LARGE AND MIDCAP REPRESENTATION ACROSS 21 EMERGING MARKETS COUNTRIES. WITH 824 CONSTITUENTS, THE INDEX COVERS APPROXIMATELY 85% OF THE FREE FLOAT-ADJUSTED MARKET CAPITALIZATION IN EACH COUNTRY.

THE DOW JONES – UBS COMMODITY INDEX IS DESIGNED TO BE A HIGHLY LIQUID AND DIVERSIFIED BENCHMARK FOR COMMODITIES AS AN ASSET CLASS. THE INDEX IS COMPOSED OF FUTURES CONTRACTS ON 19 PHYSICAL COMMODITIES. NO RELATED GROUP OF COMMODITIES (E.G., ENERGY, PRECIOUS METALS, LIVESTOCK, AND GRAINS) MAY CONSTITUTE MORE THAN 33% OF THE INDEX AS OF THE ANNUAL RE-WEIGHTINGS OF THE COMPONENTS. NO SINGLE COMMODITY MAY CONSTITUTE LESS THAN 2% OF THE INDEX.

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CRUDE OIL IS THE WORLD'S MOST ACTIVELY TRADED COMMODITY, AND THE NYMEX DIVISION LIGHT, SWEET CRUDE OIL FUTURES CONTRACT IS THE WORLD'S MOST LIQUID FORUM FOR CRUDE OIL TRADING, AS WELL AS THE WORLD'S LARGEST-VOLUME FUTURES CONTRACT TRADING ON A PHYSICAL COMMODITY.

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