FORTIS FINANCIAL GROUP

October 23, 2024

Dear Clients and Partners:

The markets continued their strong performance in Q3 2024. The composition was slightly different as we will discuss below. Below we show returns through June (first half of 2024) and through September 30, 2024.

Equities 1H24

YTD

	Value	Blend	Growth
Large	6.6%	15.3%	20.7%
Mid	4.5%	5.0%	6.0%
Small	-0.8%	1.7%	4.4%

Equities Through 9/30/24

	Value	Blend	Growth
Large	16.7%	22.1%	24.5%
Mid	15.1%	14.6%	12.9%
Small	9.2%	11.2%	13.2%

Source: JP Morgan

In Q3, equities did well but Mid and Small Caps did best. Value, across all sizes (Large, Mid and Small) had strong returns of around 10% each. Why did Mid and Small and Value outperform this quarter?

- There is certainly an element of reversion to the mean. As of June 30, 2024, Small and Mid Caps were up 1.7% and 5% respectfully while Large Caps were up 15.3%. Many traders will get offsides and this explains a portion of this.

- The economy is holding up well. Some soft data has arrived, but every time there is a re-acceleration in the economy. This includes the data outside of the government statistics like Visa / Mastercard spending. A strong economy is particularly important for Mid and Small Caps. NVDA and MSFT are not as immediately affected by a slowing economy, whereas something like a homebuilder certainly will be.

- Interest rates finally came down. Value is generally slower growing businesses than Growth, such as Utilities, Consumer Staples, etc. Many of these pay dividends that, during times of higher risk-free interest rates, are worth less to investors. For example, if you can make 3% in a utility company or over 5% on US government debt, many people will default towards the government debt. That math changes as the interest rates on US government debt come down. In addition, smaller companies are often more impacted by the cost of debt on their operations compared to, for example, mega-cap tech stocks with massive net cash balances on their balance sheet.

Looking at interest rates the below outlines this move in interest rates in Q3 clearly:

Bonds 1H24

U.S. Treasuries	Yield 6/30/2024	Yield 12/31/2023	Return 2024 YTD
2-Year	4.71%	4.23%	1.10%
5-Year	4.33%	3.84%	-0.42%
TIPS	2.08%	1.72%	0.70%
10-Year	4.36%	3.88%	-2.03%
30-Year	4.51%	4.03%	-6.20%

Bonds Through 9/30/24

U.S. Treasuries	Yield 9/30/2024	Yield 12/31/2023	Return 2024 YTD
2-Year	3.66%	4.23%	3.99%
5-Year	3.58%	3.84%	3.99%
TIPS	1.56%	1.72%	4.85%
10-Year	3.81%	3.88%	3.65%
30-Year	4.14%	4.03%	1.42%

Source: JP Morgan

At the end of the first half of 2024 only the 2-Year and the TIPS had a positive return. This means that despite interest rates in the 4%+ range, most bonds lost money as rates had risen and the value of the bonds decreased. This all reversed as of the end of the 3Q 2024 as rates came back down, aggressively. The 10-Year and the 30-Year were the biggest beneficiaries of this with significant gains in the third quarter.

Rates move up and down based on a variety of factors. Inflation, of course, is the big one. If inflation is in check, or close to it, and interest rates are above what the Federal Reserve believes to be a neutral rate (i.e., a rate that is neither stimulative nor repressive to the economy) the Fed will tend to lower towards a neutral rate. This is exactly what we saw with the 50bps rate reduction at the September Fed meeting.

The term neutral rate is likely to be a very prominent discussion point over the next year. No one, including the Federal Reserve knows exactly what this rate is. If the economy is growing just fine, as it is, at current rates, how much further does the Federal Reserve actually need to cut the short rate?

Right now, the market expects the short-term rate to be around 3.5% at the end of 2025 and bottoming around 3% in 2026. That is compared to 4.83% currently. Treasuries' performance will be equal to the current interest rates plus the change in those expectations. If the markets expect rates to drop further and/or faster, Treasuries will benefit and increase in value, thereby driving a return in excess of the current interest rates. The opposite will also be true.

While we continue to favor Large Cap over Small and Mid Cap stocks due to higher returns on invested capital (as outlined in our prior letter) to the extent rates decrease faster than expected, it could provide a tail wind to smaller companies.

There are a lot of factors involved but inflation and the economy will drive the majority of this determination. We will monitor these and share any thoughts as we see them.

Our last few letters have been very data heavy. We are sure in the future there will be plenty of data to discuss but for this letter we want to discuss the qualitative portion of investing. All the math in the world will do investors no good without context. And context is, necessarily, qualitative.

The Cost of Excellence

Fortis, as you know, invests across a broad range of asset classes. Many times, clients or prospective clients will ask us what exactly we are looking at when making investment allocations. Everyone has a unique situation so there is no general answer but when it comes to investing in businesses, the answer to this is that we are looking for Excellence. What exactly does "Excellence" mean?

Excellence is qualitative but it also expresses itself quantitatively. Said another way "winners win". Having spent a very long time studying how great businesses are built there are a few things we know for sure:

- **Work ethic wins** – There is a trend in the US whereby the idea of a work ethic is somewhat frowned upon and/or deemed to create a "hostile work environment". And yet, if you read about any very successful company, the work ethic is off the charts. Flip this to sports, the best of the best always have the best work ethics as well. You cannot be a professional in sports unless you have the talent, but you also cannot be the best of the best without a work ethic. If you study anyone like Michael Jordan, Kobe Bryant or Tiger Woods this becomes obvious. Not only were they incredibly gifted, but they were also willing to put in work, when no one was watching, that others weren't willing to do.

- **Focus wins** – The best businesses have incredible levels of focus. If you read the history of the best businesses, you will see a level of focus that is so far removed from normal as to almost seem fake. A story from *"The Snowball"* illustrates this clearly. When Warren Buffett and Bill Gates met, they were with a group of successful business owners and a question was asked, "what do you credit the most for your success?" Independently they both answered "focus". Distractions are the assassins of great work. Bill Gates even had the radio removed from his car so he could think about Microsoft while driving without any distraction.

- **Execution wins -** As Henry Ford said: "Vision without execution is hallucination." There are a lot of ideas out there but the ability to execute on them is critical. Execution is really, really hard. What makes execution so hard?

    - **It is daunting** - The number of things you have to get right to build a great business can be overwhelming and stops most people.

    - **A lot of it is boring -** There is no way around it, but a lot of business is boring. Being great is a series of steps, over and over and over again. Many people have a very hard time with this.

    - **You cannot do it by yourself** - You must bring together a group of people, motivate them, both financially and emotionally, train them, and rely on them to help you. One of the biggest failures of business is the inability to delegate and trust others.

    - **You have to hold people accountable –** Most humans are not built to hold people truly accountable. It is not a fun thing to do. The best possible thing you can do is to hire the best people, constantly. Finding those people is very difficult and very talented people expect, and deserve, a lot.

  - **It never ends** - Anyone who feels like "they have made it" is bound to lose against the person who doesn't feel that way. As Simon Sinek says, business is an "Infinite Game" without a defined set of rules, field of play or clock under which the game is finished. It's never finished.

- **Flexibility wins –** This is somewhat counter-intuitive to the above, but you have to be flexible at all times while being focused and executing. You have to have enough focus to see things through and enough vision to know when the world has changed, and you need to pivot. And you then need to communicate why you need to pivot and get everyone bought into that pivot.

  A dirty secret is that knowing when to pivot is not nearly as hard as dropping your ego and admitting it. You not only have to get over your own ego, but you also then have to get over the fact that you have to go execute that pivot all over again which is…daunting.

To build a great business you have to do all of the above and if you get any of them wrong you lose, or at least you don't win as much. And you have to do that for decades. Day after day. Charlie Munger famously had a quote that being upset about problems is stupid because life is a series of problems. Embracing that is hard. Getting an entire organization to embrace that is even harder.

Investing is truly amazing, because if you understand the above, you get to invest **alongside** those that have the above qualities. If you identified Warren Buffett in the 1970s, Bill Gates in the 1980s, Steve Jobs when he came back in the 2000s, Mark Zuckerberg in the 2010s you were able to "hire them" to work for you by becoming a shareholder in their company. This is a miracle when you think about it.

This also speaks to why we overweight Large caps. Those who are truly Excellent (capital E) tend to end up with Large Cap companies. And Excellence wins, over and over again. We try to invest with those that are Excellent.

Conclusion

Our next letter will be in 2025. As always, we will be in contact if anything significant happens before then. We hope you all have a wonderful holiday season. We look forward to speaking with you all soon.

Regards,
Your Fortis Team

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