CLIFFORD SWAN
INVESTMENT COUNSELORS

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REFLECTIONS ON A CHANGING INVESTMENT ENVIRONMENT

Kevin J. Cavanaugh
Principal, Investment Counselor

"It is waiting that helps you as an investor, and a lot of people just can't stand to wait." —Charlie Munger

In the investment field like many other undertakings in life, activity does not equal achievement. During periods of significant change, investors may be better served by stepping back, assessing risks and possible outcomes before changing direction or committing to a set strategy.

Changes are underway in our economy and financial markets that we believe may be historic. For years, persistently low inflation and interest rates provided an almost ceaseless tailwind to investment, supporting a risk-taking mentality. Now, inflation may prove less transient than hoped and the cost of money higher than desired. If the

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changes prove to be as profound as we believe, forward-looking corporate managers and investors should have ample opportunities to take ahold of. Those hoping for business as usual may find a tough road.

The Crowd Is Untruth

Over the years we have preached a similar sermon. The price of a common stock should, ultimately, reflect the value of the underlying business. The profits of that business will drive the value of the business over time. A growing profit stream will result in a higher business value. We look to invest in companies where the probability

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of a growing profit stream over longer periods is high. Our goal is to invest in these growing businesses for long periods, with the expectation that the wealth that these high-quality businesses generate will accrue and compound for the benefit of our clients, the business owners.

A simple and straightforward message. Right? Well, there is another aspect to the sermon that can be quite demanding. We prefer to pay an attractive price for the businesses we invest in, and we have developed a discipline to help us accomplish this part of the investment process.

A hard lesson of our truth is that the stock market can make a mockery of our discipline...at

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least for short periods. If we want to remain true to our process (we do!), this takes patience and fortitude – virtues that can be hard to maintain. The last 18 months or so has been just such a period. In part due to the intense interest in artificial intelligence and the companies associated with this technology, investors have been crowding into a relatively small group of very large companies and, for the most part, leaving large parts of the stock market behind.

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The Art of Forgetting

The stock market, as represented by the S&P 500 Index, has become quite concentrated with

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10 stocks representing about 30% of the Index's value. Interestingly, many of these very large companies have been benefiting from the post-Covid economic environment as well as the potential for AI investments. Profits at these very large companies are expanding and probably will expand further. While the U.S. economy has been relatively strong, profit growth for the balance of the companies in the U.S. markets has been harder to come by. Higher interest rates, a weak global economy, and chal-

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lenges brought on by higher levels of price inflation have, in general, hurt company margins. More recently, reports from a few large consumer-facing companies like Apple, Tesla, Nike, and Starbucks have reflected the more challenging economic and financial environment. These companies are reporting anemic sales and pressures on profit margins, while the prospects for renewed growth are unclear. After a period of over-consumption, tighter monetary conditions are forcing consumers to tighten their belts, affecting sales of even the popular consumer brands.

At this point, investors are betting that the small group of very large, mostly technology companies will remain insulated from the challenging economic and financial environment. However, economic cycles have historically proven more important than investment themes (like AI). The two most evident examples are the Nifty Fifty stocks of the early 1970's and the Dot

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Com stocks of 2000. These periods of extreme concentration in the markets were unwound over time, causing tremendous loss of capital for investors. For the most part, the companies that were popular during these periods proved resilient and the investment themes played out about as expected. However, these companies were priced for perfection and earnings did not expand as expected due to changing economic backdrops. Even the best of the lot underperformed for a decade or longer and others did not even make it through the more challenging economic environments.

Great Expectations

For much of the last 30 years, businesses and investors have benefited from relatively benign inflation and declining interest rates. As a result, corporate profit margins have expanded significantly. Since the pandemic, we have seen a record-low level of long-term interest rates and a spike in corporate profit margins, especially for the larger companies. For some time now, the prices of the larger companies seem to be reflecting favorable expectations of a renewed period of low inflation, lower long-term interest rates, and expanding profit margins. Wall Street analysts'

> *"High expectations coupled with high valuations is a poor combination for investors."*

projections of earnings growth for the S&P 500 companies this year are an optimistic 11% and forecast a similar level of earnings growth for the next couple of years. These great expectations do not seem to be factoring in the decisive changes underway and appear to us to be more backward-looking. High expectations coupled with high valuations is a poor combination for investors. Investors' confidence will likely be tested in the coming months as we learn whether the most popular companies can remain insulated from the changing economic and financial backdrop.

Common Sense

As mentioned earlier, for sometimes uncomfortably long periods,

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markets can make a mockery of the best efforts of disciplined investors. During such periods, chastened investors may look for guidance and support from the wise and battle worn. During the first weekend in May, the latest Berkshire Hathaway shareholders meeting streamed from Omaha, Nebraska. Renowned investor and Berkshire co-founder Warren Buffett was on his game, displaying amazing stamina and acuity for a 93-year-old. Buffet's long-time business partner Charlie Munger, who died in November at age 99, was there in spirit, with Greg Abel proving himself a worthy heir apparent. Buffett and Munger may or may not have possessed superior intellects, but over the years have exhibited a rare extreme of common sense as it relates to creating business value as well as managing investments and prudential stewardship.

Buffett and Abel made a few salient points over the weekend that mirror our current thinking. Buffett has been slowly consolidating his stock holdings over the last few years and building up a significant amount of liquidity ($200B). He has kept this liquidity invested in short-term government securities earning a fair return at present. Buffett mentioned that the pool of large companies in which he might invest looks picked over and generally expensive. If, however, he managed a smaller pool of funds that would allow for investment in small or mid-sized companies, the prospects for earning excess returns would be improved (at Clifford Swan, we do not face this restriction in the portfolios we manage). They did not paint an overly optimistic backdrop over the short term but are still confident about putting the large pool of funds to work in high-quality, mostly U.S.-based companies. Ajit Jain, Berkshire's insurance guru, pointed out that inflation can be a friend for certain businesses. We agree – historically, small companies have outperformed larger companies during inflationary periods. Finally, Buffett also spoke about taking capital gains this year to avoid likely increases in the capital gains tax rate.

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Their perspectives ring true, and the Berkshire team's patient approach makes good sense to us against the changing investment landscape. We have been building reserves in conservative fixed income securities and seeking out long-term, tax-efficient investment in the lesser picked over sectors of the stock markets.

PROTECTING AGAINST AI-DRIVEN FINANCIAL FRAUD

George E. Hasbun, CFP®
Principal, Investment Counselor

It's 2:00 a.m., and you are sleeping soundly when your cell phone rings from an unknown number. You answer the phone to hear your grandson's voice on the other side. He is in distress and explains he was in a car accident. It was his fault, and he needs some money to get out of the predicament he is in. He begs you not to involve his parents because he will get in serious trouble. Next, he hands the phone to another individual who explains how to send the funds to cover the damage your grandson caused. You quickly transfer the funds because you know the voice on the other end was your grandson's, and you'd do anything to help him. Unfortunately, you've fallen victim to the latest artificial intelligence scam – voice cloning. The voice on the other end was computer-generated, and your grandson is perfectly safe at home. The criminals have vanished with your funds.

"...consumers lost roughly $10 billion due to fraud in 2023. That's an 11% increase over the previous year."

As technology continues to advance, so do the methods of financial fraud. Seniors, in particular, are often targeted due to their perceived vulnerability. With the integration of artificial intelligence (AI) into various aspects of our lives, the risk of AI-driven financial

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fraud targeting seniors is on the rise. Federal Trade Commission

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data released in February showed that consumers lost roughly $10 billion due to fraud in 2023. That's an 11% increase over the previous year. This number is likely even higher since many cases of financial fraud do not get reported because the victims feel embarrassed and don't want to report they were targeted by these criminals.

Understanding the Threat:

AI-based scams are increasingly being employed by fraudsters to perpetrate sophisticated scams that can deceive even the most cautious individuals. On the FBI's website, William H. Webster, who has served as the director of both the FBI and CIA, explains in a video that he was the target of an elder fraud scheme. Awareness of frequently used schemes is the best tactic to avoid being duped.

A common tactic involves AI-generated phishing emails or text messages. These messages are crafted to appear legitimate, often mimicking communication from trusted institutions such as banks or government agencies. Through AI, scammers can personalize these messages, making them seem highly convincing. Once a victim falls for the scam and provides personal or financial information, their accounts can be compromised.

Another concern is voice cloning. With the ability to mimic human voices with remarkable accuracy, AI technology can be used to create fraudulent phone calls. Seniors, who may be more trusting of phone communication, are particularly susceptible to this

> *"Fraudsters can use AI to impersonate loved ones or authority figures, tricking seniors into disclosing sensitive information or transferring money."*

type of scam. Fraudsters can use AI to impersonate loved ones or authority figures, tricking seniors into disclosing sensitive information or transferring money. The scenario described at the beginning of this article, known as the

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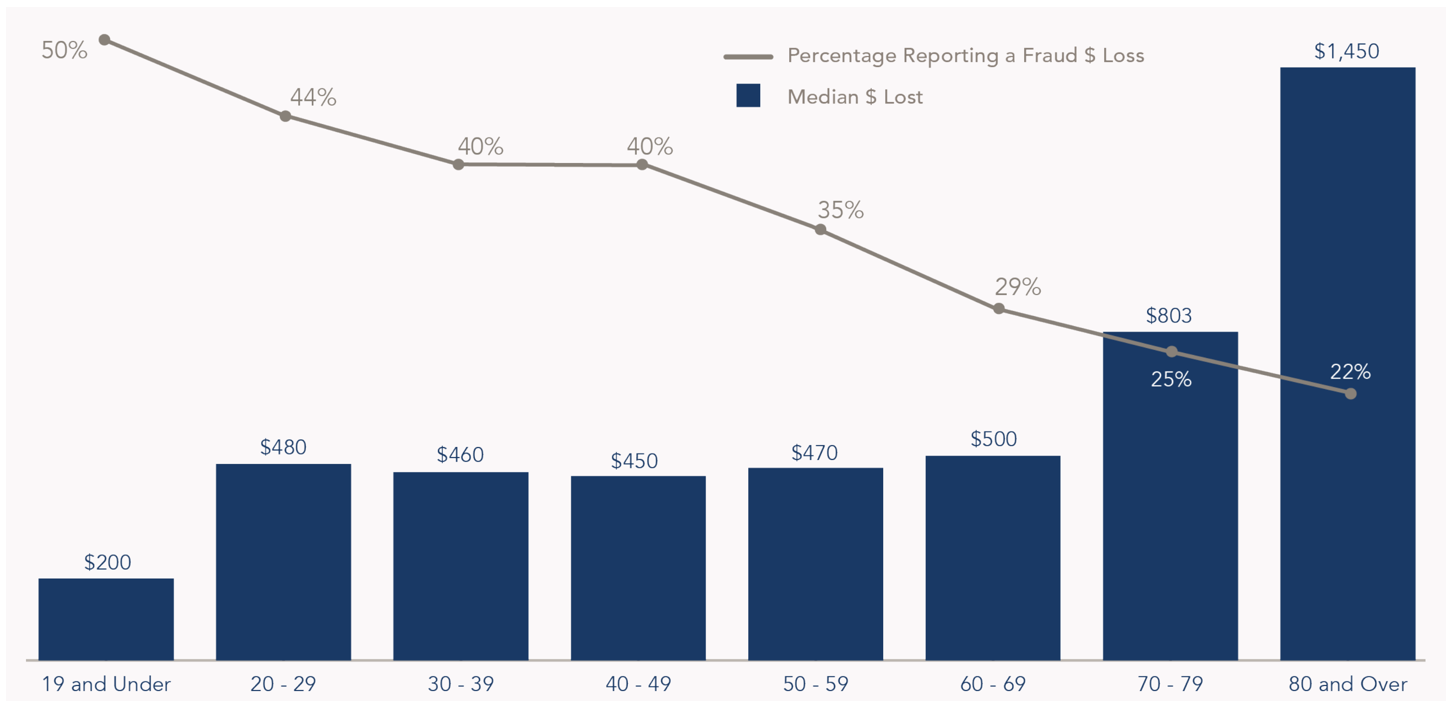
PERCENTAGE REPORTING A FRAUD LOSS AND MEDIAN LOSS BY AGE



Note: Of the 2,566,261 total fraud reports in 2023, 44% included usable consumer age information.
Source: Federal Trade Commission | ftc.gov/data

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"family emergency" scam, can be extremely convincing and elicit fear in the target victim.

Prevention Strategies:

1. Educate Yourself: Knowledge is the first line of defense against financial fraud. Stay informed about common scams targeting seniors, including those facilitated by AI. Be wary of unsolicited emails, messages, or phone calls requesting personal or financial information. The FBI releases common elder fraud schemes on their website: https://www.fbi.gov/how-we-can-help-you/scams-and-safety/common-scams-and-crimes/elder-fraud.

2. Verify Requests: Before responding to any communication requesting sensitive information or financial transactions, confirm the legitimacy of the sender or caller. Contact the supposed sender directly using verified contact information obtained from their website or official documents. Don't call the number provided in the suspected fraudulent communication without independently verifying the number is correct, i.e., visiting the company's website or performing a Google search. Or, in the case of the "family emergency" call, tell the person on the other end that you will call them back immediately, then hang up and call your loved one directly.

3. Stay Vigilant: Be cautious when interacting with AI-driven systems, especially those requesting access to personal or financial data. Regularly review your financial statements and credit reports for any unauthorized transactions or suspicious activity.

4. Seek Assistance: If you're unsure about the legitimacy of a communication or suspect fraudulent activity, don't hesitate to seek assistance. Your Clifford Swan Investment Counselor is the perfect resource to provide an extra set of skeptical eyes. Some clients are hesitant to ask for assistance from family members for fear of seeming naïve. We are happy to review any communication requesting financial data for signs of fraud.

5. Protect Personal Information: Be mindful of the information you share online and offline. Avoid disclosing sensitive details, such as your Social Security number, financial account credentials, or credit card numbers unless necessary.

As AI technology continues to evolve, so must our efforts to combat financial fraud. Through self-education, vigilance, and preventive measures, we can all reduce our susceptibility to fraud and enjoy greater peace of mind in managing our finances. When it comes to protecting against financial fraud, caution and awareness are key.

MESSAGE FROM THE CEO

Peter J. Boyle, CFA
Chief Executive Officer

After previously serving in the role, I am very pleased to announce the recent appointment of David Lin as our next Chief Investment Officer. In this role, David oversees the firm's equities, fixed income, and alternatives teams and sets the overall investment strategy using a long-term fundamentals-based approach.

David joined the firm in 2018 as an Investment Counselor. Over nearly six years, I have had the privilege of collaborating closely with David. I am impressed by his passion, articulated dedication, and vision for advancing both the quality and breadth of our offerings, not only within investments but across the firm as a whole. As a member of the senior management team, David will play a crucial role in shaping the strategic direction of the firm for many years to come.

Please join all of us at Clifford Swan in congratulating David!

David Y. Lin

2024 RMD RELIEF FOR IRA BENEFICIARIES SUBJECT TO 10-YEAR RULE

In April, the Internal Revenue Service waived penalties for beneficiaries of individual retirement accounts subject to required minimum distributions under the 10-year rule that do not take distributions in 2024. This extends the relief period for RMDs that would have had to been taken from 2020 through 2023 to include the 2024 tax year.

The 10-year rule was introduced in 2019 when the SECURE Act eliminated the "stretch-IRA" which had allowed most inheritors of IRAs to take distributions over their lifetimes, instead requiring most non-spouse inheritors of IRAs to empty the retirement account within ten years of the original account owner's death.

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Because the timing of when the funds are taken out can have significant tax implications, an important question since the rule's introduction was whether inheritors needed to take annual withdrawals or if they could wait until the tenth year to empty the account. In February 2022, the IRS proposed (but did not finalize) regulations requiring beneficiaries to make annual withdrawals during the 10-year window if the original owner was already taking RMDs. Conversely, under the drafted rules, withdrawals are not required in years one through nine if the original IRA owner had not started taking distributions before death, but the account must still be completely emptied within ten years.

"While we have clarity that these proposed rules will be ignored for the 2024 tax year, it may still make sense to take a distribution."

While we have clarity that these proposed rules will be ignored for the 2024 tax year, it may still make sense to take a distribution. Especially for larger IRAs, or inheritors with rising incomes, waiting too long to start emptying an inherited IRA could put you in a different tax bracket when you start taking distributions. Even if taking an RMD doesn't change your tax bracket, you may want to take advantage of current low tax brackets, which are scheduled to increase in 2026.

Please talk with your Investment Counselor to consider the withdrawal strategy that makes the most sense for you.

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